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## 2012/11/23: Weekend Thought: There is NO Bond Bubble... more so Cash

November 23, 2012 Alan R.

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It has been the bane of the "Bond Vigilantes" (adamant bond bears) that all of the fiscal crises and incipient signs of economic growth have not led to a major capitulation of the primary government bond markets. Another short term round of that is apparent today. Equities are spurred higher in this week's recovery from the midmonth break, yet govies are holding steady... just as they did yesterday in the face of the higher equities. And due to better than expected German economic numbers, today's rally would seem more than just technical. Likely even more frustrating for the bond bears.

While we will get back to more current market discussion below, the current intermarket asset class performance must be taken in a twofold broader context. The first is that the immediate threat to the equities is less from a still troubled Europe, and more so on the question of whether the US Fiscal Cliff issues can be resolved timely. The far broader and more meaningful aspect for the sometimes seemingly mindless resilience of the govies is the question of whether there actually is a Bond Bubble? Our assessment for some time has been that as long as equities appear risky due to government policy interference and instability, equities are indeed at risk due to the potential for significant global economic weakening.

This is our classical *Taxationism*<sup>1</sup> fear. While many assert that the US election clarifying the path forward is constructive, we are not at all sure. What it guarantees is that the 'Obama program' will mostly proceed according plan. Possibly business will indeed be able to plan around the higher taxes and aggressive regulatory enforcement. On the other hand, the Obama health care reform and other measures might just lead to layoffs, closures, and at the very least many individuals facing the higher expense of shifting to personal health care plans from company-sponsored 'group' policies. Also to say the least, not good for consumer discretionary spending.

<sup>1</sup>Taxationism © 2010 Alan Rohrbach & Jack Bouroujian. All rights reserved unless explicitly waived

Def.: Combined impact of taxation, regulation and protectionism to an oppressive degree as official policy

If that is going to weigh on the US economy, the one developed economy showing some growth now is going to weaken once again into next year. And that is a good reason why people still feel more comfortable in bonds than equities. All of the capital flow data on fund investment tends to back that up as well. And yet, there isn't really any 'Bond Bubble' as such. If anything, there is a 'Cash Bubble'. That was brought home to roost in a [Financial Times video report on Monday](#).

While the title of the piece is *Marooned in a bond 'safety bubble'* and the opening discussion focuses on bond vs. equities flows, the point which eminently come to the fore is there no historic basis for this. As the graph below illustrates...

...global bond investment allocation is no more than roughly around its historic mean of 30%. Of note is the lack of recovery in the equities allocation since the 2008 crash into the extended early 2009 economic and equities market weakness. This speaks volumes about the degree to which investors are still very worried about the general economic outlook. They have in fact maintained a much higher cash allocation that at any time since the sustained economic weakness of the early 1990s.



Does not seem Bond allocation a 'bubble'... more so Cash

There are two further aspects of this which can be briefly summarized. In the first instance, the defensive maneuver by investors is more extreme than even the "long-term equities outperformance" school had surmised. It seems that investors seeking safety are happy to settle for essentially zero return at present rather than even the very depressed returns offered by risk-free government bonds. As such, they are even losing more ground to inflation in 'real yield' terms at present than an investment in government bonds would provide.

However, the other side of that equities-averse coin is that they may be fairly smart in heading the warning about the overvaluation of ostensibly "safe" bond investment. Even though we are still skeptical at present into next year, economies and equity markets will begin to recover at some point. Once that occurs there will likely be an escalation of interest rates. And when we say "escalation" it means a rather rapid and substantial interest rate rise once it gets started. That will incur commensurately heavy losses for anyone holding longer-term government bonds.

The implication for the markets is fairly clear. There is good reason there has been no implosion of the heavily over-allocated government bond market. Quite simply, the over-allocation doesn't exist. It speaks volumes about the degree to which primary government bond markets have not suffered greater damage that the Bond Vigilantes have warned of. It seems it is not just the central bank quantitative easing programs that have supported the government bond markets.

It is also a lack of oversupply and strong professional investment flows into bonds within the currently still weak economic environment. All of that may change across time, but for now there are still plenty of willing buyers of a less than over-supplied product; especially at those times when equities appeared troubled. And while it may be focusing back down to the very short term view of current markets, that is a good reason why bonds have begun to hold steady while the US equities head back up toward the more critical December S&P 500 future resistance in the 1,400 area as Congress heads back in Washington DC next week.

### General Market Observations

This remains very similar to our observations in yesterday's *Happy Thanksgiving with NO Ambush* post. This week's recovery in equities has been pretty impressive right from the weekly gap higher opening into the December S&P 500 future low 1,370 area Monday morning. As we have already reviewed a lot of the background on that in the primary government bond market reaction in [Wednesday's TrendView BRIEF UPDATE](#), we suggest linking back into that and the [Weekly Summary](#) for further background. The current [Technical Projections](#) available in the right column are still the relevant price levels in spite of not having been updated of late. We will be addressing that soon in order to refresh the [Select Comments](#).

The dilemma is that the broader background is still rather bearish on balance. And if there is no address of the Fiscal Cliff issue in the US from the top of next week, we suspect the equities can come back under pressure and the govies can rally. Yesterday's analysis also noted the key covies supports that should be watched while equities push higher.

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The one other market worth noting is of course the foreign exchange, and especially the weakness of the Japanese yen. That said, as explosive as the rally has been out of last week into today, **US10Y** has stalled yesterday at the bottom of its  $82.85-83.30$  resistance noted in **Thanks for your interest.**

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