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Market bubbles: Brother, can you spare two trillion?

Negative returns: the new big thing.

By Thomas Watson

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Stephen Greenspan, emeritus professor of educational psychology at the University of Connecticut, knows a thing or two about market bubbles. As a matter of fact, he just published a book on what makes investors gullible. But being an expert on Street suckers didn't stop him from falling for Bernard Madoff's Ponzi scheme, which cost Greenspan and other folks (whom you'd expect to know better) at least US$50 billion. Making a virtue out of an embarrassment, though, the author of *Annals of Gullibility* is using himself to push his book and illustrate how "relatively intelligent" people can be easily fooled by financial bubbles and scams. "A big part of Mr. Madoff's success," Greenspan wrote in a recent *Wall Street Journal* essay, "came from his apparent recognition that wealthy investors were looking for small but steady returns, high enough to be attractive but not so high as to arouse suspicion."

It's a compelling logic, but there is at least one market phenomenon it cannot explain: why money managers around the world have been so willing to buy U.S. government bonds. Taking long-term inflation expectations into account, 10-year U.S. Treasury notes paying a record low yield of 2.2% offer negative returns. Nevertheless, after unloading other asset classes en masse, institutional investors have flocked to the perceived safety of Treasuries. The illogical demand for money-losing IOU's is the so-called bond bubble, and it's been getting widespread media play. This bubble has been blamed on fear and greed. Some argue deflation concerns are in play; others see the Greater Fool theory at work. Whatever the case, like demand for tulip bulbs centuries ago or dot-com stocks in 2000, the love affair with U.S. bonds could evaporate overnight, seriously tripping up the financial world's attempt to recover its footing. Alex Jurshevski, head of Recovery Partners Ltd., a Toronto advisory firm serving institutional investors, points out that Uncle Sam is about to put out his hand like never before — offering nothing in return for about US$2 trillion needed to finance the economic jump-start jointly ordered by former U.S. president George W. Bush and the Obama administration. That's on top of the US$4.3 trillion in existing U.S. debt that must be rolled over in the next 12 months.

Historically, Jurshevski notes, the United States has been able to "borrow what it wanted at prices set by it regardless of the wisdom or efficacy of the economic policies it was following." But that game of musical chairs could suddenly stop. "This postwar status quo ante has led most commentators and analysts to assume that this time around it will also be business as usual," Jurshevski says. "These pundits maintain that because Japan ran large deficits in the '90s at negative real interest rates with no problem and no impact on the currency, it will be relatively simple for the U.S. to achieve this feat. We beg to differ." Jurshevski warns U.S. bond auctions will tank, forcing interest rates to rise and a sell-off of the greenback.

Wall Street economist Robert Brusca disagrees. He thinks the U.S. will have no trouble finding buyers for its debt. Relatively speaking, he points out America remains "a great credit risk," in part because its ratio of outstanding debt to GDP is still lower than Japan's and many European nations'. "There is a certain natural order," Brusca says. "With all the credit concerns, who better to bet on than the U.S. government? Want Russian paper? Chinese? Didn't think so." So what happens when the worm turns and credit concerns start to alleviate? "The long U.S. Treasury has increased in value by over 30 points since this crisis began," says one Bay Street bond player. "That's insane. It will revert, and then some."