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U.S. deficit spending stoking fears of a bond bubble

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The concept of U.S. government bonds as a safe haven is taking a beating.

After investors abandoned just about any security that's not a U.S. Treasury, commentators are pointing out that the folks in Washington backing all this debt might not be the best credit risk around.

The idea that we are in the midst of a "bond bubble," along the same lines as the tech and the real estate booms, is getting widespread play. The Financial Times devoted several pages to the concept yesterday, as did a fund headed by the former president of Bank of Montreal.

This debate is moving mainstream, with Merrill Lynch chief economist David Rosenberg writing: "We are certainly not bearish on Treasuries nor do we see them in some form of 'bubble' as so many now believe to be the case."

What's the case for a bond bubble? Well, first, consider the past: U.S. interest rates have fallen to historic lows, reflecting the ongoing economic crisis. Recall that when rates fall, bond prices rise, and vice versa. As an asset class, U.S. Treasuries posted a fabulous 14-per-cent return in 2008.

Now, look ahead: U.S. government bond issuance is about to hit previously unimaginable levels, as president-elect Barack Obama finances several years of T-as-in-trillion-dollar annual deficits. Foreign lenders, chiefly Chinese government agencies, have become America's biggest lenders.

The possibility that this all ends in tears was summed up yesterday in a posting from a Toronto-based distressed debt fund called Recovery Partners, whose chairman is former BMO president and deputy finance minister Grant Reuber.

Recovery Partners CEO Alex Jurshevski, a credible Bankers Trust veteran, argued: "What the current configuration of U.S. interest rates and currency values essentially means is that we are in a bubble which has arisen in part because of policy actions taken to combat the deflating subprime bubble. It is an aftershock, not an equilibrium state of affairs."

"We submit that this state of affairs is fundamentally unstable, unsustainable and financially very risky," Mr. Jurshevski said. His bearish view is that failed bond auctions, rising rates, falling Treasuries and a steep greenback selloff are in the cards.