

# Bring back the vigilantes

Markets can be irrational longer than most individual investors, as greed and fear take over from general rules of investing. Yet there is always a group of investors who collectively aim to keep the system honest. As the excesses in the markets persist, vigilantes take over and force change. Sometimes these vigilantes work in a systematic manner; in other cases change is effected more quickly, through major sells-offs and corrections in a short span of time. Bond vigilantes adjust either their risk appetite or their demand at a certain level of interest rates, or in the case of equities the price of the stock reflects what the investors feel is the true net worth of the company.

Lately, the markets have moved again into excess and the vigilantes are stepping up their activity. Take for example the Global Financial Crisis, when Government intervention saved the financial universe. Governments around the world expanded their balance sheets to allow the private sector some time to restructure its debt and problems. Central banks lowered borrowing costs to nearly zero to allow capital allocation to productive purposes.

The most recent problems originated in the financial sector. Traditionally, banks have done a good job of allocating individuals' savings to fund investments. Banks brought together savers and borrowers and allocated capital in an efficient manner. Somehow financial institutions strayed away from this traditional role of capital allocation. Instead of allocating capital for productive investments, banks started to allocate capital to speculative assets and propriety trading. This was a much quicker and easier way of making money than lending to a manufacturing company. When these activities were leveraged up multiple times, bank profits rose exponentially, so long as the assets they owned appreciated in value. When the asset valuation 'bubble' exploded, banks suffered a spectacular collapse, threatening the entire system. As Mervyn King,

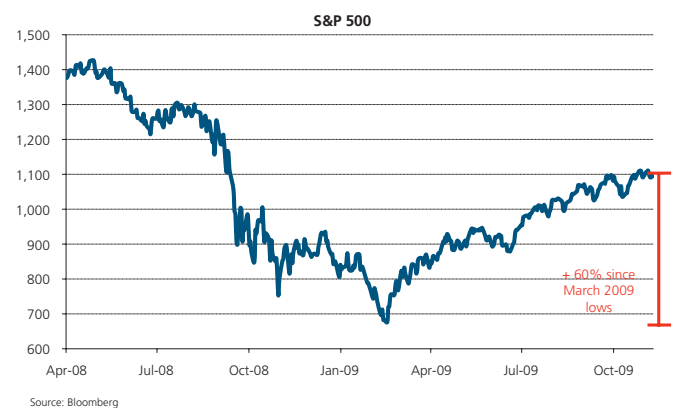
the Governor of the Bank of England, so aptly put it: 'never in history has so much money been owed by so few people to so many people'.

## Trifecta of strange asset prices

The world has witnessed a massive rally in all asset classes in a mere matter of months. But have the core issues really been resolved? Are the markets now functioning normally? Is the financial system no longer under threat? We think the answers are no to all three. So we ask: where are the vigilantes?

### 1. Equities rally

As the chart depicts, US equity markets have rallied over 60% since the March 2009 bottom.



The equity market rally can be justified on the following reasons:

- The world was saved from Armageddon in March as central bankers cut rates and pumped money into the system;
- Good firms were paired up with bad firms;
- Direct fiscal stimulus and tax cuts put money into people's pockets;
- The problem was postponed to a future date; and/or

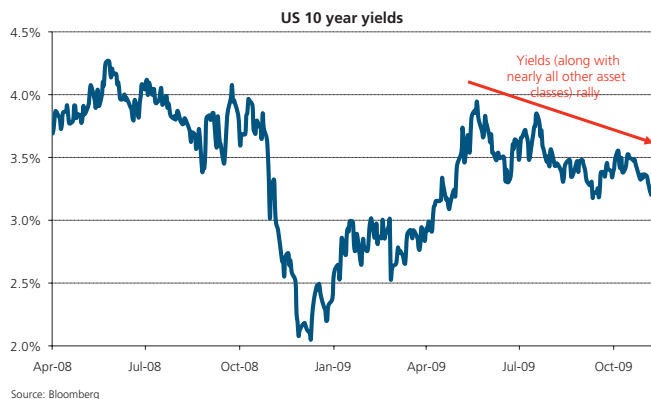
- The private sector problem was taken over by the public sector, something Gerard Minack of Morgan Stanley has called the 'Great Swap'. This 'swap' looks to have produced imbalances that seem as unsustainable as the initial issues.

These factors combined to allow risk assets to rally, as valuations had become extremely cheap.

## 2. Bond yields rally

When equities collapse, the initial reaction from the bond market is for yields to rally. Yet once normalcy returns, bond investors tend to eschew the protection of bonds for more attractive assets. Given the Fed's unprecedented moves to flood the financial system with liquidity, a rebound in growth and inflation could be likely. But, isn't it strange that bonds have been rallying when their safety is no longer needed?

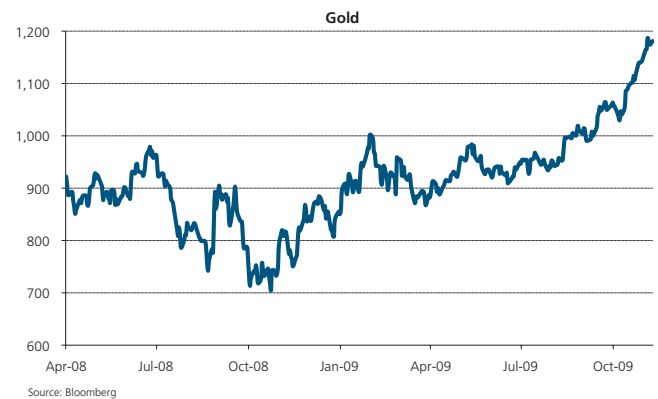
The vigilantes should keep the market more honest, by demanding that government debt pay investors more as government balance sheets deteriorated. This happened in early 2009 when US 10-year treasury yields rose from their low of 2% in January to their high of 3.95% in June. However, as the following graph shows, between June and November, the bond rally has resumed. Either the market is not convinced of the recovery or the strong arm of the 600 pound gorilla (the Fed buying debt on behalf of the Treasury) is ensuring that rates stay low. The last thing the Government wants is for the bond vigilantes to force yields higher, potentially offsetting the Fed's efforts to revive economic growth. One can argue that Governments are borrowing at artificially low (or 'teaser') rates.



## 3. Gold soars!

Over this same period, gold has also reached new highs. From a low of US\$705 in mid November 2008, gold prices have rallied nearly 70% in just over a year. What is the rally in gold telling us? Could the partial explanation be that the stimulus that has been injected into the system is inflationary for the future? Or is it that the market vigilantes no longer trust 'paper currency' and require investors to hold 'real' assets? Or is it that the US dollar no longer provides a safe haven for the savers of the world, and that gold is the only substitute?

A more accurate indicator of current market conditions may not be equities or bonds, but gold. India is stockpiling gold (note the recent purchases from the IMF) while China is loading up on various commodities. Real assets are the only assets that do well in an environment when you have low growth and high inflation.



## What are we missing?

Something is amiss. Why are equity markets, bond markets and gold (or for that matter, most assets) all producing positive returns over the past 6 months? Surely, one of them is wrong. The vigilantes will ultimately make sure that they force the financial markets to correct.

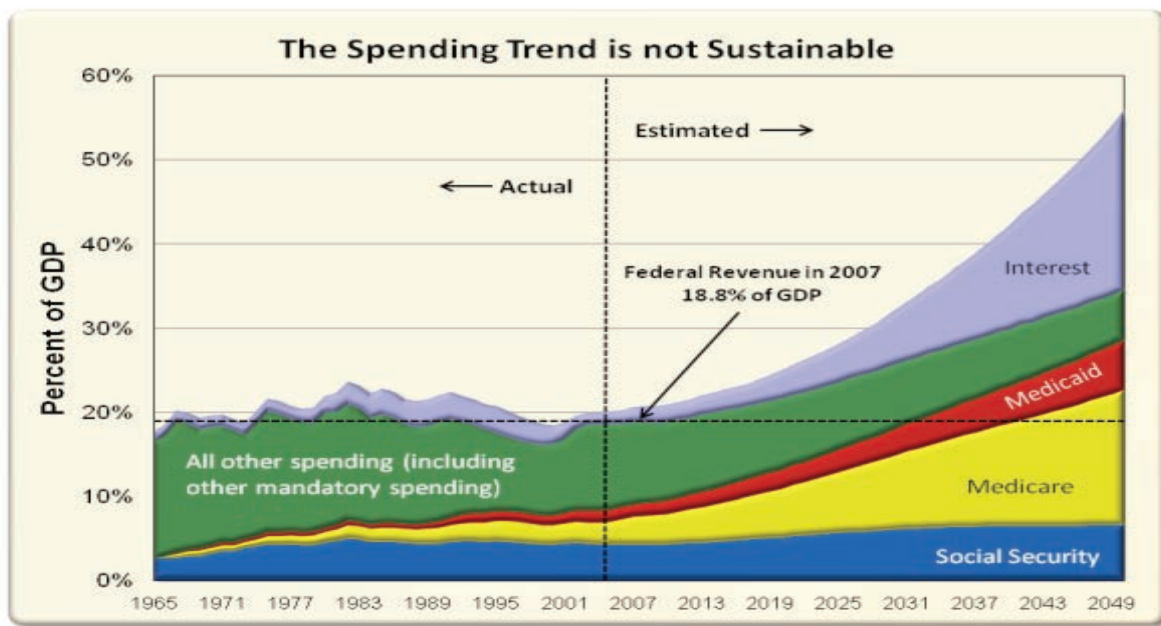
If the equity markets are correct, then bonds should sell off.

If the gold rally is worrisome, then bonds should sell off.

If bond markets are correct, then equities should sell off.

Can the US economy withstand weaker growth, weaker equity markets, and/or higher interest rates? The answer is no. The US government cannot afford bonds yields to rise given that the cost of their debt servicing is high and rising. Nor is it in the US government's best interest for equity markets to sell off. This would lower earnings and reduced confidence, putting further pressure on the cost of funding.

As the following chart from the Congressional Budget Office shows, interest obligations add a huge burden in the outer years, just as Medicare costs begin to soar. The increases are unsustainable given current revenue levels.



Source: Congressional Budget Office  
December 2005, High spending outlook

2010 is going to be an interesting year. Let's hope the market vigilantes make a comeback to keep us all honest.