

The Bond Bubble

INVESTORS HAVE PAID A HEAVY PRICE FOR buying technology stocks with outlandish valuations in 1999 and 2000, chasing rising returns with the belief that somehow things were different in the "New Economy." After considerable financial suffering, these investors have learned an "important" lesson – don't buy technology stocks. As a result, during the first quarter of 2003, investors poured \$43.5 billion into taxable bond funds, while taking \$6.85 billion out of stock funds.

SAME ROAD, DIFFERENT SCENERY

Today, investors are buying bonds with yields that are at 45-year lows as they chase rising returns, backed by the belief that this time things are different in the new economic paradigm of deflation. Sound familiar? It should, because we have been down this road before. Financial bubbles follow a similar pattern. First comes strong performance, based on some underlying fundamentals. In the case of technology stocks, earnings and revenues were growing at a rate stronger than other

asset classes during one of the longest periods of peacetime growth in U.S. history. Similarly, bonds have risen as the Federal Reserve has pushed interest rates further down than anyone expected, while signs of inflation have been nearly non-existent.

The next stage in bubble creation occurs when valuations get pushed to relatively high levels, but the fundamentals driving the performance remain in place. At this point the pundits begin making dire predictions while investors continue to chase returns. In 1998 many pundits were bearish on stock prospects for 1999. Similarly, last year many folks, including bond-guru Bill Gross, were predicting the end of the bond bull market. In 1999, economic growth continued; in 2002, the economy remained weak with little inflation and an accommodative monetary policy. Under these conditions, stocks then and bonds now appreciated even further.

THE END OF THE ROAD

As I write this, the bond market is in the final stages of bubble creation. This stage is marked by most pundits

(tired of being wrong) converting from skeptics to cheerleaders as they explain how "this time is different" to investors emboldened by years of strong gains. At the tail end of the last bull market, we can all remember the convincing arguments for why outlandish technology stock valuations were justified in the "New Economy," and investors were confident of continued gains. Now we are hearing convincing arguments for how the specter of deflation justifies buying bonds at exceptionally low yields, and investors remain complacent in the perceived safety of fixed-income investments.

We all know why the argument for the "New Economy" was wrong, so let's focus on why not to be concerned about deflation. True, there are deflationary forces in the world. In fact, my July 2002 column suggested that "economic cycles such as the current one – characterized by new technology, which led to greater productivity and an over-investment in capacity with little pricing power and deflationary forces – have not turned out well in the past."

Back then I was largely alone in my deflation concerns. True to form, I am today instead worried about building inflationary forces that no one is paying attention to; these have me concerned for four primary reasons. The Federal Reserve has changed tack and is now focusing on fighting deflation, rather than inflation. The U.S. is a service-based economy and inflationary forces remain high in services, such as health care. The U.S. dollar has declined significantly, making manufactured imports more expensive, therefore countering outside deflationary forces. Finally, at least in the technology sector, there is now a capacity shortage at the leading edge.

Historically, the stock market has performed well in periods of both mild deflation and mild inflation, so I continue to recommend over-weighting equities. However, any up-tick in interest rates could prove devastating to bond investors. After stating at the beginning of the year that the bond market might see one last hurrah with a surprise cut by the Fed, and more recently recommending under-weighting bonds, I continue to urge investors to take their profits in bonds. Of course, maybe this time really is different. I just wouldn't count on it. ☹

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