December 11, 2008

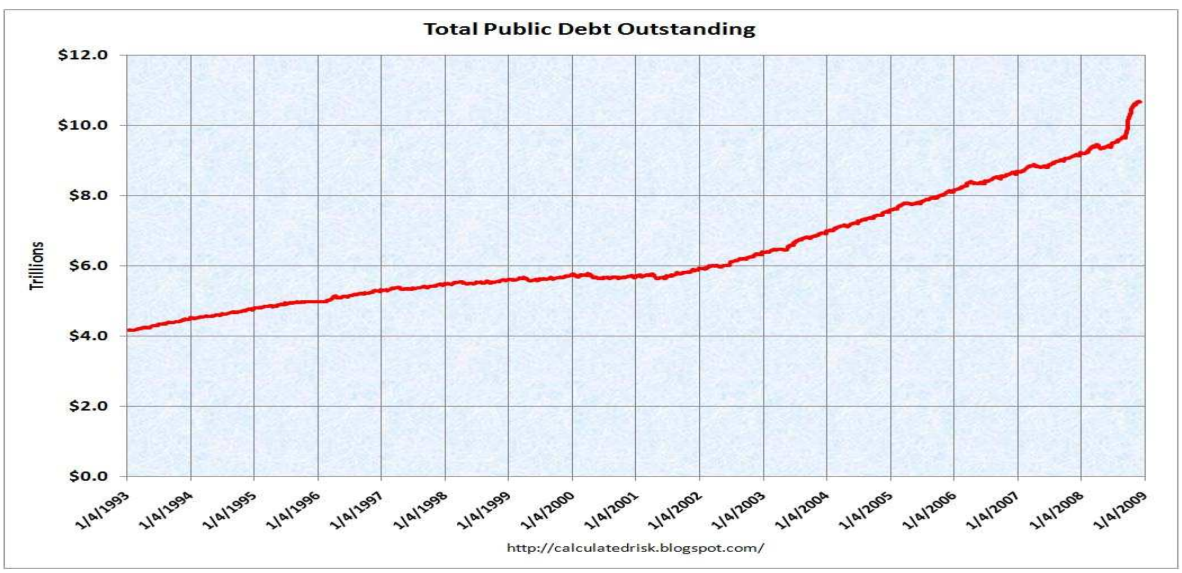
Current Bubble

Investors have just bought US government debt (4 week Bills) at zero yields. In fact three month bill was quoted at negative yields, while 10 year notes are being quoted at yield of less than 2.75 percent. The fall in yield points to increase in demand for US government debt this has been fuelled by:

(a) **Flight from "risk"**: Money has flown from corporate bonds to government debt. The perception of risk in corporate bonds has increased during 2008, especially after Lehman Brothers collapse. The junk bond yields have increased to almost 2000 basis points (1 basis point = 0.01 percent) above treasuries. Investors are willing to get zero return for safeguarding their capital.

(b) **Expectation of deflation**: There is an expectation that current crisis will lead to significant fall in demand for most commodities. This has lead to massive fall in prices of commodities. There is an overall expectation that risk of deflation is greater than risk of inflation.

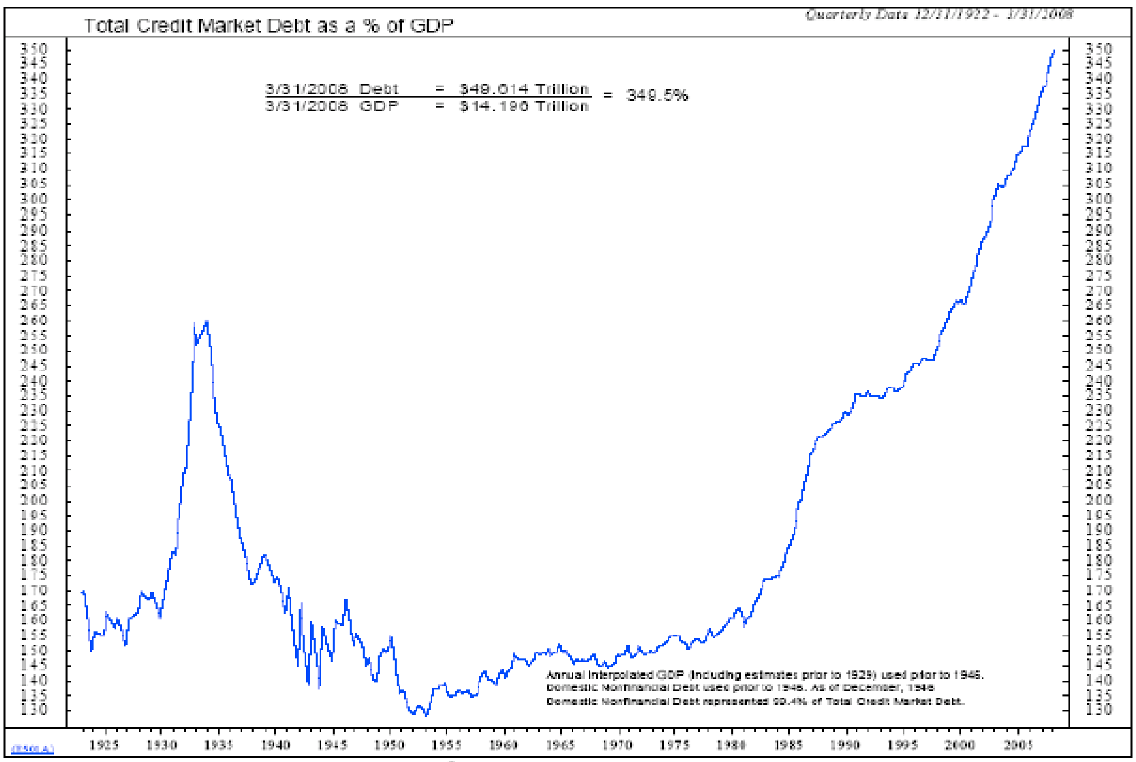
(c) **Belief in US government solvency**: The low interest rate being paid clearly seems to imply that there is no doubt about solvency of US government. A sovereign country like US can always pay off debt in it's own currency by printing more of it. In case a country has to resort to printing its own currency that will amount to default through devaluation. The low interest rate on US government debt implies that there is very high expectation of repayment without any devaluation.



The price of financial instruments in short term may be determined by forces of demand and supply but in longer term the effect of fundamentals which determine the purchasing power of cash flows from the instrument make a difference. There are reasons to believe that risk associated with US government debt have materially increased in recent times. We point to some of the important factors behind this

(a) **Shifting of risks to US government**: The US government has provided bailout money and guarantees worth $ 7.5 Trillion. The risk has been substantially shifted from balance sheets of financial institutions to US government and Federal Reserve (another proxy for US government). The capacity of US government to bear these risks is limited and shifting of these risks increases the risks associated with US government liabilities.

(b) **Increase in federal deficit**: The federal deficit is expected to be $ 1.5 trillion in fiscal 2009 compared to $ 450 billion in 2008. The total accumulated debt in last 200 hundred years for US government has been $ 10.66 Trillion and during last nine months about 20% of this has been added. Clearly this does not call for improvement in risk profile of US government debt.



(c) **Unwinding of debt based economy**: There are indications that current levels of debt in US economy are not sustainable. As level of debt goes down the US economy will itself stagnate. The capacity of US government to service its liabilities will itself suffer.

The low level of interest rate will only encourage the US government to take more liabilities and cause even bigger problems of insolvency. The low level of interest rate is like AAA rating accorded to AIG, Ambac and MBIA which made it easier for them to take larger risks and cause a bigger eventual financial catastrophe. The evidence of problems is clearly visible in Federal Reserve balance sheet. The balance sheet has more than doubled in last three months and is on course to triple by end of year. It is filled with toxic assets and this level of money printing will cause eventual inflation and significant losses to holders of long term treasury.