

Big Wave Commentary

The Next Bubble is Forming US Govt. Bonds

The fundamental problems that created the current economic mess we are in today were simply a far too easy monetary and fiscal policy that encouraged leverage, consumption and risk. Borrowing as much as you could and investing it an asset that never went down in value was the formula for success. It happened in the 90's with the dot com bubble and it is happening now with the housing market. It is the formula of bubbles. Bubbles are defined as markets that trade in high volumes at prices that are considerably higher than their intrinsic value.

In studying past financial bubbles (there are some great books written on the subject), the 2 common ingredients in the bubble recipe are a low interest rate environment that encourages extreme leverage strategies, and a psychological belief by investors that the asset that being bought and leveraged can never go down. The first factor, interest rate policy, is controlled by the Fed. The psychology is controlled by the "crowd"; the speculators themselves. The "fever" that results of a speculative frenzy is something to behold. Within every cocktail party or soccer game, conversations are dominated by how much money was made within this bubble market. The financial firms, media and even the government encourage the growing bubble by using past market successes to feed the greed of the current buyer and keep moving prices higher. People who warn of the overvaluation and danger within a bubble market are discredited. The bubble keeps growing.

As I have written before, all bubbles end very, very badly. As fear overtakes greed, the "crowd" turns ugly and getting out of the market as fast as possible, in turn, destroys it. The average bubble market usually losses over 68% of its previous value. During the last stock market bubble, the NASDAQ dropped by 74% from 2000 to 2002. The current housing market has only fallen around 10% but we are very early in the deflating process.

The Fed in recent weeks has addressed the severe economic and financial sector problems by lowering interest rates again. They are expected to continue this for some time. They have also proposed a fiscal stimulus package that is designed to give confidence and extra money to the people who need it the most. Reminiscent of the Marshall Plan, the Fed will "airlift" buckets of money over every town in America and drop dollar bills from the sky and with a loud bullhorn, instruct people to spend, spend, spend. Actually, they will be mailing checks, but you get the point.

In doing my research, I have an unmistakable feeling that major Wall Street and international financial firms fear something far worse than recession within the US. Smart money is targeting the US Government Bond market as the next bubble. At a recent conference in Davos, Switzerland, major hedge fund traders gave evidence that they are starting to position themselves for a far deeper recession. And they are zeroing in by shorting the US Government Bond market in anticipation of much higher 2009 US interest rates.

Their reasoning makes sense. The US is the largest debtor in the world today. Our biggest financial institutions are asking Third World countries for capital to remain solvent. The Fed has engaged in hyper stimulation over the past 10 years, BEFORE the current financial system downturn. Inflation is still in the early stages of a major worldwide long term ramp up. There has been an enormous flight to safety over the past year and this has fostered a big bond rally already. As the US falls harder into recession, this appetite for safety will grow and a growing number of assets will move into US Govt. bonds which some say could take 10 year yields down to 2 ¾%. As this happens and the US dollar falls to alarming new lows, investors will move their focus from credit concerns within the US system to credit concerns about the US in whole. This is what

will unleash a severe bear market within the US Govt. Bond market as traders panic and another bubble bursts.

This is a dire scenario and one that is long term in nature. Hopefully, cooler heads will prevail and this will remain a fantasy in some traders' minds. The one thing that does keep me up at night is the size of the derivatives market worldwide. It is estimated to be an over 700 Trillion dollar market with over 2/3 of it interest rate related. This market is highly

leveraged and in the hands of very nervous traders. So IF, the bond market starts to unwind and these traders start to lose vast amounts of leveraged money, extreme things can happen. The high powered hedge funds are getting short US bonds, and as one manager was quoted, are setting up for "the trade of a lifetime". If you invest in bonds, do some extra homework and watch this market.

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