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Captive bidding at the auction:   
How bond vigilantism was swamped

Time flies when you're making money: 19 years have sped by since the start of **the great bond bull market**. So traumatic was **the preceding bear market** (it spanned the administrations of U.S. Presidents from Harry Truman to Ronald Reagan, **1946 to 1981**) that fixed-income investors took a pledge: Never again would they be the dupes of a central bank. They would henceforth sell at the first sign of inflation.

So market interest rates would increase before the U.S. Consumer Price Index could spurt. The Fed might nod off, but the bond market vigilantes pledged they would never sleep again.

Now look at them. With a generation's worth of capital gains tucked under their ample belts, they are snoring in hammocks or swatting golf balls. Financial markets the world over are worse off for their unannounced retirement. James Grant

Many financial commentators have opined on the absence of the "bond vigilantes" from the US Treasury market. Bond traders now willingly accept low yields in the face of broad based commodity inflation, which hitherto would have, according to Mr. Grant, whose views I highly respect, above, inspired significant selling from the now "sleeping" bond vigilantes. I've been doing a bit of checking on the US bond market and think I have a few answers to the question, "where did the bond vigilantes go?," although a better question might be, "whose efforts have swamped bond vigilantism in the Treasury markets?"

# The good old days

In 1955, US federal debt totaled $234B, of which $163B (70%) was tradable on the open market. The biggest single player was the Fed, which, in 1955, carried $24.4B worth of Treasury Securities on its balance sheet, or just under 15% of marketable debt.

# Is the Fed the culprit?

Federal Reserve acquisitions of debt rose steadily from 1955 to 1970, when holdings peaked at just over 25% of marketable debt. But, as standard closed system economic theory argues, Fed purchases, i.e. debt monetization, did not keep yields down. 10 year yields rose from under 3% in 1955 to well over 7% in 1970 while consumer price inflation rose from -0.4% in 1955 to 5.7% in 1970. Bond vigilantism was apparently alive and kicking back then and Federal Reserve debt monetization led, as it should, to inexorable inflation.

Thus, we can chalk off the Fed as player whose efforts swamp bond vigilantism.

# Are the foreigners to blame?

Of late, the presence of foreign purchasers, in particular, foreign official purchasers, have been cited as a reason behind the lack of bond vigilantism, even (in hindsight, partially erroneously) by me.

In 1955, foreign official holdings (the foreign private sector was not yet involved) of Treasury debt totaled $5.8B, or 3.6% of marketable debt. Foreigners were not yet players.

By 1980, this had changed. Foreign official holdings rose to just under 18% of marketable debt, while total foreign holdings rose to 20.4% of marketable debt. Despite this support, 10 year yields rose from 4.2% in 1965, when foreigners began to ramp up their purchases, to well over 12% by 1980. Consumer price inflation rose from 1.6% in 1965 to 13.5% in 1980. The decline in real yields at the back end of the curve, excluding other factors (which is rarely wise), suggests that foreign buying might have kept rates lower than they otherwise would have been, in a closed system.

Foreign acquisitions of US debt have increased dramatically since 1980. As of Q2 2007, 44% of marketable US Treasury securities are in foreign hands. 31.3% of marketable US Treasury securities are in foreign official hands. The coincident rapid increase in foreign holdings of US debt with a multi-decade decline in yields suggests that these purchases kept yields lower than they otherwise would have been. Yet, the data from the 70s, when bond yields rose despite foreign inflows, suggests that this is not the whole story.

# Enter the captive bidders

Something besides increased foreign acquisitions of US debt, happened between the early 80s and the present day which slowly but inexorably swamped bond vigilantism. That something was an increase in social security (and related programs) net income which, I argue, dramatically changed the US bond market.

From 1955 through 1980, the US Treasury market was a mainly open affair, by which I mean, most of the issued debt was marketable. In 1955, non-marketable debt made up 30% of the total and in 1980 non-marketable debt made up 33% of the total. Bond prices were, in the main, set in open markets.



Captivating the Trust Funds

In the mid 80s, in accordance with the recommendations of ex Fed Chairman Greenspan's Commission of Social Security (boy this guy's fingers are in a lot of pies), social security taxes were raised which raised the percentage of national income flowing into social insurance programs from 7.2% to 8.5% (source BEA). While a 1.3% increase in national income flow (it amounts to an increase in income from 4.8% of GDP in 1987 to 5.6% of GDP in 2006) is substantial, it doesn't fully explain the substantial rise in social insurance assets.

If changes to the income side don't fully explain the dramatic rise in social insurance holdings, something must have coincidentally reduced the outflow, which fell from 4.6% of GDP in 1993 to 4.1% in 2006. That something was a change to inflation calculations upon which cost of living adjustments (COLAs) in social security payments are made.

According to John Williams' Shadow Stats site:  
In particular, changes made in CPI methodology during the Clinton Administration understated inflation significantly, and, through a cumulative effect with earlier changes that began in the late-Carter and early Reagan Administrations have reduced current social security payments by roughly half from where they would have been otherwise. That means **Social Security checks today would be about double had the various changes not been made**.

Assuming Mr. Williams' estimate is correct, a doubling of SS outflow from the actual $549B, which produced a SS surplus of $185B, to $1,097B, assuming no changes on the income side, would have created a deficit of $363B. In turn, this would have forced the US Treasury to sell about $800B of securities into the market instead of the $250B they actually sold in 2006. I doubt current US Treasury yields would be at such low levels if such was the case.

But it is the case. Non-marketable debt has risen from the afore noted 33% of total debt to 49%. That's right, half of Treasury bidding comes from captive bidders. So much for a free and open market in US Treasuries.

In sum then, the cumulative effects of **SS tax hikes**, which inflated SS income, and **reductions in outflow** due to recalculated COLAs are, I believe, the primary cause of our strangely low bond yield environment in the US. As one who has cited with alarm the growth of Chinese reserves to and above the $1Tln mark, I was amazed to find that Social Security holdings have grown even faster, and now total some $2Tln.

Forget about China's, here's a sovereign wealth fund just waiting to happen.

But, as the saying goes, it isn't just the size of the ship that matters, the motion of the ocean does as well. Many financial commentators have (rightly so, in my view) worried about diversification out of $s among foreign countries with large reserves, yet few worry about a similar risk consciousness coming from within the US.

Imagine a financial world in which the managers of the SS Trust were able to diversify out of US assets. Minimally imagine a financial world in which the managers of the SS Trust were able to pick and choose amongst domestic investments. In that world, I doubt the chosen mix would be (as is currently the case) a virtually all US Treasury portfolio with an average interest rate of 5.2% and duration of 7.2 years. Simply shifting to a much shorter duration fund would cause the US yield curve to steepen dramatically.

# Captive bidders and the Enron effect

That is, I argue, the captive nature of the SS Trust fund in conjunction with its size has been the main cause which engendered our low and reasonably flat curve yield environment. For it is the US Treasury itself which manages these funds. As those who lost all their retirement funds at Enron could tell you, captive trust funds invested in the company itself does not a diversified portfolio create- just the opposite effect is, in fact, created. When foxes (invariably from Goldman Sachs these days) guard the chicken coop, ultimately you have no chickens.

This too, however, shall pass. According to the SSA (Social Security Administration) by 2017, barring any further increases in taxes or calculation changes in COLAs, outgo will exceed income for SS and DI (Disability Insurance). National Health Insurance (HI) costs will deplete the funds even more rapidly. By 2041 SS and DI will have exhausted their funds and by 2019 HI funds will be depleted. So, within a decade there will no longer be additional surplus funds to be used to purchase US bonds which will have to then be sold on the open market. Call it peak SS Trust Funds, although peak trust might be even more apt.

# In Greenspan we trusted

It is, perhaps, fittingly ironic that the same Greenspan who bemoans increased federal spending, recommended and oversaw the conditions which allowed such spending to occur outside of a free market mechanism. The same man who proclaimed, in his oft cited, Gold and Economic Freedom:

In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no safe store of value. If there were, the government would have to make its holding illegal, as was done in the case of gold. If everyone decided, for example, to convert all his bank deposits to silver or copper or any other good, and thereafter declined to accept checks as payment for goods, bank deposits would lose their purchasing power and government-created bank credit would be worthless as a claim on goods. The financial policy of the welfare state requires that there be no way for the owners of wealth to protect themselves.

This is the shabby secret of the welfare statists' tirades against gold. Deficit spending is simply a scheme for the confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights. If one grasps this, one has no difficulty in understanding the statists' antagonism toward the gold standard.

oversaw a tremendous confiscation of wealth, but not from the wealthy, from the common man. He has repeatedly said that he still stands by the views he expressed back in 1966 and I believe him. He (and others) used the lack of a monetary standard to confiscate wealth from us- wealth which was used, inter alia, to finance the current wars. Atlas, in this case, didn't shrug, he stole.  
I expect, **as increases in trust fund surpluses slow, US interest rates will rise, most likely dramatically** in the years to come.

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<http://www.ssa.gov/OACT/TR/TR07/VI_stochastic.html#wp101750>

Simulated probability distributions of the annual trust fund ratios for the [combined](http://www.socialsecurity.gov/OACT/STATS/table4a3.html) [Old-Age and Survivors Insurance Trust Fund](http://www.socialsecurity.gov/OACT/STATS/table4a1.html) (OASI) and [Disability Insurance Trust Fund](http://www.socialsecurity.gov/OACT/STATS/table4a2.html) (DI) Trust Funds are shown in figure [VI.E1](http://www.ssa.gov/OACT/TR/TR07/VI_stochastic.html#wp101750). [Even a change in the first derivative of this curve could affect long-term interest rates.] The two extreme lines in this figure illustrate the range within which future annual trust fund ratios are estimated to occur 95 percent of the time (i.e., a 95-percent confidence interval). In other words, actual future trust fund ratios in a given year would be expected to exceed the upper bound only 2.5 percent of the time or to fall below the lower bound 2.5 percent of the time. Other lines in the figure display additional confidence intervals (80-percent, 60-percent, 40-percent, and 20-percent) around future annual trust fund ratios. The median estimate for each year indicates the trust fund ratio which is projected by this model to fall exactly in the middle of possible outcomes for that year. It is important to note that these lines do not represent the results of individual stochastic simulations. Instead, for each given year, they represent the percentile distribution of trust fund ratios based on all stochastic simulations for that year.

The median estimate for each year indicates that the assets of the combined OASI and DI Trust Funds would be exhausted by the end of 2040 with a probability of 50 percent. This exhaustion date is 1 year earlier than the year of exhaustion projected under the intermediate assumptions. Figure [VI.E1](http://www.ssa.gov/OACT/TR/TR07/VI_stochastic.html#wp101750) shows that the 95-percent confidence interval for the trust fund ratio in 2030 ranges from 406 to 83 percent of annual cost. In comparison, the 2030 trust fund ratios for the low cost and high cost alternatives are each outside this range, at 454 and 22 percent, respectively. By 2081, the range represented by the low cost and high cost projections increases substantially beyond the boundaries of the 95-percent stochastic confidence interval, as seen from the values for the open group unfunded obligation in table [VI.E1](http://www.ssa.gov/OACT/TR/TR07/VI_stochastic.html#wp102692). This increased variation of the alternatives relative to the stochastic confidence interval is also seen in the positive trust fund ratio for the low cost scenario for 2081.

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| Figure VI.E1.-Annual Trust Fund Ratios |
| http://www.ssa.gov/OACT/TR/TR07/images/VI_stochastic_VIE1.gif |

On the other hand, here is a claim that OPEX petrodollars are driving long term rates down.

<http://www.bloomberg.com/apps/news?pid=20601087&sid=aLld5KIuhSx0&refer=home>

The biggest quarterly rally for U.S. government securities in five years is getting an extraordinary boost from the burgeoning reinvestment of petrodollars by the Organization of Petroleum Exporting Countries.

OPEC members increased their holdings of Treasuries 12 percent this year through July to $123.8 billion, Treasury Department data show.