

## **2012: A Year of Reflation and Bursting of the “Bond Bubble”**

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“Ideas came with explosive immediacy, like an instant birth. Human thought is like a monstrous pendulum; it keeps swinging from one extreme to the other.” - Eugene Field

I had the honor of meeting Dr. Marc Faber for the first time at a conference hosted at the New York Stock Exchange focused on commodities in December. Dr. Faber was the luncheon speaker, and I was there purely to shake his hand and thank him for publishing my writings last year. After all, he was the first one to really give me an outlet to make the case that a deflation pulse was coming in 2011 as early as February. He then published three other pieces of mine, ranging from one arguing for a Summer Crash (August/September), and the other outlining my reasoning for why a “Fall Melt-Up” would occur when I first started writing about it online on various financial websites at the very end of September (October was a historic month for risk-assets).

I had no other interest in being at the conference, but I walked away from it utterly shocked at how many times the word “deflation” was used by presenters. It occurred to me that Europe caused so much fear that the consensus view was for a Japan-like scenario for all global markets. After speaking with Dr. Faber for about 10 minutes before his speech and leaving after his keynote address was done, it finally occurred to me. Expecting a return to inflation expectations suddenly became the contrarian trade.

For me and for the way my colleagues at Pension Partners think about investment management, the most important driver of asset class returns is inflation expectations. Not actual inflation, but expectations for future inflation. Broadly speaking, “risk-on” means inflation expectations are rising, which is an environment conducive towards equity risk-taking. Being “risk-off” means inflation expectations are falling (a deflation scare), meaning the environment likely favors bonds. Every single day money bets on various sectors and asset classes which have varying degrees of sensitivity to inflation expectations. What this means is that if market participants believe reflation is coming, it should ideally be expressed in multiple areas of the investable landscape at around the same time.

I can fully understand that many are scratching their heads about the most recent rally in equities. However, consider that the facts on the ground have changed. Thanks to Draghi's Long Term Refinancing Operation (a quasi-form of Quantitative Easing), not only have bond yields in Europe dramatically fallen, but so has the risk of a Lehman-like event as evidenced by the sharp fall-off in the VIX index. But wait, Treasury yields are still near panic levels, right? The bond market is disconnected from the stock market, so a collapse in equities is still coming, right? The problem I have with this is the automatic assumption that the bond market is ALWAYS right about the future. Yes, bond investors are generally more right, but that does not mean they are always right.

### **What if the Stock Market is Right?**

Following the end of the Fall, I began writing about the idea of a Winter Resolution in markets, which I argued would be an environment whereby the volatile sideways action of last year resolves itself and ends, correlations among stocks fall, and a trend (up) asserts itself. While not as headline grabbing as the Summer Crash and Fall Melt-Up, the conditions I believed would express themselves are indeed doing so as of this writing. What this means is that one should consider the very real possibility that yields on Treasuries may be on the verge of a significant move higher as money moves away from fears of deflation, and into expectations for 2012 being the year of reflation much the way 2003 and 2009

played out.

Take a look below at various price ratios which compare the price of one asset class to another. The idea of a price ratio is to identify if the numerator is outperforming (up more/down less) the denominator, and what the message of such movement might be. I've annotated each chart to show the consist message market participants send through out/underperformance based on periods of inflation expectations rising or falling.

### S&P 500/Utilities – Beta Beats Utilities due to Rising Rate Expectations



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*Comments:* Edson Gould, a legendary Technician, believed that the performance of Utilities could give one a sense of whether markets were at a top or bottom. The reasoning for this has to do with the sensitivity of Utilities to the future course of interest rates. When Utilities outperform (the above ratio falls), its because investors in the sector anticipate lower interest rates to come, which benefits future earnings for these companies because of their high leverage and associated debt roll-over costs. When would interest rates fall? When the stock market is likely to underperform bonds due to deflation fears/economic slowdown. When Utilities underperform (the trend in the ratio is up), its because of expectations for future increases in the cost of capital. Notice where we are right now.

### Junk Debt/Nominal Treasuries – Credit Spread Contraction



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*Comments:* The ratio above is one way of seeing if credit spreads are narrowing (uptrend/Junk outperforms Nominal Treasuries), or widening (downtrend/Nominal Treasuries outperform Junk). Generally speaking, when investors sense a period of inflation, they position into higher yielding debt which benefits from the growth that often accompanies reflationary environments. The arrows are roughly consistent with the behavior of the S&P 500/Utilities ratio above. Again, notice the far right of the chart.

### 10 Year Treasuries/20+ Year Treasuries – Yield Curve Steepening Ahead



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*Comments:* The ratio of the 10 Year Treasury ETF (IEF) to the longer duration 20+ Year Treasury ETF (TLT) is a way of seeing whether the yield curve is either widening or flattening. It stands to reason that a steepening yield curve would occur when inflation expectations are returning to markets. Notice how severe the sell-off was in the ratio as the Summer Crash took place and as deflation fears were hitting their peak. Since October though, the yield curve as dictated by this ratio has been in a sideways trend. Again – notice the far right of the chart. Outperformance of the numerator/IEF would likely occur by being down less than a more sharply falling TLT in a reflationary environment.

### Treasury Inflation Protected Securities/Nominal Bonds – Inflation Premium Favored



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*Comments:* The TIP/IEF price ratio is one way of seeing if inflation expectations are rising or falling within the bond market. When the ratio is trending higher, it means bets are occurring on rising prices ahead. When falling, deflation is the concern as nominal bonds become favored. Notice again the annotations which are the exact same in the prior ratio charts above. The far right appears to just be starting an uptrend much like all other inflation expectation metrics I have noted earlier.

Conclusion? If the trends I have highlighted in terms of the recent outperformance of inflation-sensitive areas of the market persist, low interest rates won't be low for much longer, and bonds could significantly weaken this year as inflation expectations get more aggressively priced in and animal spirits return to equities. Furthermore, investors love past prices, meaning that as equities make higher highs thanks to a more favorable environment for beta risk, money can pour out of bonds into stocks on a consistent basis. Dr. Faber may have to hold off on giving David Rosenberg that bottle of whiskey after all – the “bond bubble” everyone has been talking about may just be about to pop. And for equities, that's probably a good thing.

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