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Domestic Credit by Richard Freeman

Slaughter in the bond market

Does the bond market have a bottom? The answer is, not necessarily.

Rising short-term rates will trigger a wave of liquidation that could make the last several months look like a picnic.

Fed chairman Paul Volcker's testimony before congressional committees July 20 and 21 was misconstrued by news media which have been trained to salivate at the mention of monetary aggregates, about which Volcker has never particularly cared for very much. In fact, the Fed chairman said truthfully what most concerned him: that the important factors determining interest rates were out of his control.

These were, first, the federal budget deficit, his usual theme in congressional testimony, and, more significantly, the problem of capital inflows.

According to the International Monetary Fund economists who look at the U.S. situation, capital inflows (including $40 to $50 billion per year in flight capital) saved the United States about 2 percent in interest rates during the past year. Cessation or reversal of these flows, Volcker maintained (correctly), would push U.S. rates up.

A survey of the capital-flows situation indicates that the flows have already dried up to a great extent:

1) Latin American capital flows into the United States, a major depressant on U.S. interest rates, have dried to a trickle since the financial crisis makes it hard to bring money out.

2) European portfolio managers have stopped shifting money into dollars and are shortening maturities of their existing dollar paper, anticipating higher rates. A shift downwards of Euro-Swiss franc rates shows some funds moving to Switzerland.

3) OPEC deposit attrition from the Euromarket continues.

4) European borrowers are still heavy users of the interbank market to finance payments deficits.

5) Treasury revenue and outlay data released July 25 show worsening deficit prospects, not the "improvement" due to "recovery" presented in some inaccurate media reports of an OMB mid-year review that, in fact, contained absolutely no new information whatever.

In short, the supply of funds to the market is dwindling as a result of the staggering OPEC reversal from an average $100 billion surplus position in 1980-81 to a $50 billion-plus deficit position in 1983, while the demand for funds—due to depression-level government deficits here and abroad—continues to increase.

Despite a campaign early in the week of July 25 to promote a mood of optimism, and the 1¼ point rally in the bond market on Monday, events took their predictable course later in the week, and the slaughter on the bond markets continued.

At this point, it is ridiculous to speak of discounted inflationary expectations and other strange beliefs by way of explaining the bond market's misery. The long-term market is falling under the sheer pressure of funding requirements.

When short-term rates reach a trigger level about 1 percent higher than the present commercial paper rate (i.e., when domestic rates reach the present Eurodollar three and six-month rate), the bond market will probably surpass the low point registered in 1982.

The federal government has been issuing agency paper at close to a $100 billion annual rate, principally mortgage pool bonds, (GNMA, FNMA, and so forth.) Financial investors bought Ginnie Maes (Government National Mortgage Association bonds) during the first quarter at an average yield of 11.96 percent. The financial investors financed the purchase of Ginnie Maes by either borrowing money, or taking deposits, or the equivalent, at the prevailing short-term money market rate.

According to interviews with money managers at large institutions, financial investors are not buying Ginnie Maes as long-term investments, but as short-term high yield investments (see *EIR*, July 26). They are presumably as safe as Treasury securities and bear higher yields. But if the cost of short-term funds rises, investors will try to dump their agency holdings as fast as possible. Agency issues will become unmarketable.

Short-term interest rates have risen 1.0 percentage point since the first week of May, and now stand at 9.0 percent. An increase of another 1.5 percentage points this summer, would raise the level to 10.5 percent. At this point, most bonds purchased in the course of the year by financial institutions would lose money for their owners.

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