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Are Government Bonds and Even Cash the Next Big Bubble?

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These aren't normal economic times. Indeed, times are especially tough for investors who rely on fixed income cash flow. Gone are the days when a retiree could safely invest in government securities and, with annual returns of ~5%, maintain their lifestyle without eating into principal. With central banks around the world holding interest rates so low for so long, asset bubbles have already floated up all around us. More concerning are the enormous bubbles in government bonds and even in cash these days.

Central bankers are desperately trying to maintain economic growth by keeping rates low. Yet by doing so, they've distorted the fixed income market. As a result, total negative-yielding debt has skyrocketed. Investors who buy that paper are guaranteed losses if they hold it to maturity. According to Bloomberg, total negative-yielding debt has climbed rapidly – from $8.3 trillion in December, to a whopping $17.0 trillion by August 2019! Demand is so robust that Germany recently sold 30-year bonds with a negative yield for the first time ever while US Treasury Secretary Mnuchin hinted that the US may issue 100-year bonds to lock in today's rates. That would be wise since rates have never been this low in the entire history of the world – a clear sign of an asset bubble in government bonds.

According to basic macroeconomic theory, lower interest rates should serve to boost the economy since they incentivize borrowers to spend and invest more capital. Unfortunately, record low rates are being offset by negative investor sentiment. In part, that's being held back due to skepticism about the future, since central banks are acting like the sky is falling. Moreover, a laundry list of other concerns are spooking investors—the trade war, stock market volatility, the 2020 elections, a new nuclear arms race, an inverted yield curve, and the length of the current business cycle to name just a few. All this uncertainty has dampened investors' "animal spirits."

As central bankers continue to deploy extraordinary monetary policy, they're forcing investors who rely on fixed income to climb up the risk spectrum and into instruments they would normally avoid. They're forced into junk-rated bonds and loans, or other less secure fixed income vehicles – like structured products, collateralized debt obligations (CDOs and CLOs), and privately-issued debt. Needless to say, microscopic interest rates have juiced demand and prices for these riskier forms of debt to asset-bubble levels as well. One sign of this is the sky-high multiples paid by private equity buyers for LBO's, which typically get financed with junk-rated debt. Another is the anything-goes mentality that's taken hold in junk-debt issuance. Capital structures used to be financed conservatively, at 3-4x leverage; but now, 7-10x is the new normal and covenant-lite issuance is prevalent. Issuing junk debt to fund dividends is another risky trend, as is the carefree funding of unproven business plans with debt rather than equity venture capital. In sum, record low rates have caused asset bubbles throughout the fixed income market.

On the borrower's side of the equation, money is cheap. When rates are so low, it's easy to finance a fancy new car you can't really afford, or to buy a house with a low monthly mortgage payment. And corporations can borrow money for nearly any purpose. However, taking on too much debt when rates are so low can have adverse consequences and ultimately lead to future distress when the economy slows, rates climb again and/or debts mature. To put it bluntly, there's no such thing as a free lunch.

Another risk of super-low interest rates is inflation – a chief value detractor for fixed income securities and cash. Inflation is currently ~2% but, with all the monetary stimulus we've seen lately, the purchasing power of most major currencies is rapidly eroding. Talking about diminished purchasing power is a purely academic way of saying that inflation is becoming a bigger and bigger concern. It's already evident in rising healthcare premiums (+55% since 2008), tuition (+8% per annum), and in the cost of many other daily essentials for most people. However, many investors seem nonchalant about inflation.

For those, getting your principal back from an investment has become more popular than getting a return on it. The erratic day-to-day swings in the major stock indexes have probably caused lots of investors to feel that the stock market, where quantitative strategies and algorithmic trading dominate, is a game rigged against them. A growing number of investors have therefore fled to "safe-haven" assets, like real estate and precious metals, or even into cash despite its guaranteed loss versus inflation. Those wary of public equity markets but still looking for equity-like returns are more willing lately to make risky bets on private equity, or brand-new ventures like cannabis or cryptocurrency. As a result, bubbles have developed in "technology unicorns" – otherwise, why would their insiders approvingly grant them the name of a mythical creature that's just too good to be true? Regarding cryptocurrency, its entire existence is based on fears that central bankers have already created an inflationary asset bubble in cash due to out-of-control money printing.

Unprecedented monetary policy has already caused many assets to trade well above intrinsic value. To recap some examples: trillions in negative-yielding government bonds, 100-year bond issuance, heady junk-rated debt issuance, nosebleed LBO purchase multiples, record student loan debt, unproven businesses (financed with debt rather than equity), technology unicorns, and cryptocurrency. We're living in a time when value investing and attention to the fundamentals is out of favor while asset bubble speculation rules the day. Ultra-low interest rates help disguise and delay many problems. However, speculation is risky and, as we've seen time and again, taking on too much debt, no matter how attractive at the time, can be a recipe for future trouble. At some point, distressed investors will be digging through these same recklessly-financed capital structures to see if there's really any value there.

In the meantime, government bond investors are forced to buy into the bubble of negative yields, with the hope that some greater fool will pay them even more for the same securities that already promise negative returns. Inevitable inflation notwithstanding, negative returns are already guaranteed for investors holding trillions worth of government bonds. Regarding the bubble in cash, it too will keep growing if central banks keep the punch flowing. Diminishing purchasing power for cash is all-but-guaranteed going forward.

History is replete with asset bubbles and the outcome is never good. The Dutch tulip mania, the South Sea Bubble, Japanese real estate, the dot-com era, the US housing bust, and so many other asset bubbles of the past eventually popped. The exact cause and date are impossible to predict, but the amount of distress resulting from today's government bond and cash asset bubbles may be surprising for many investors.