

Treasuries Shaky as Investors' Sanctuary

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McClatchy-Tribune Regional News

April 20, 2009

Apr. 20--America has seen a lot of speculative manias during the past decade -- whether the wild buying spree in technology stocks in the late 1990s, the euphoric boom in housing in the middle of this decade, or the seemingly unstoppable rise in oil and other commodities last year.

Now there may be a bubble developing in the market for Treasury debt, if only because there is no safer place for investors to park their cash and escape the collapse in stocks, commodities, mortgage debt and other stricken markets.

As in the past, a stream of money turned on by the Federal Reserve to prime the economy is flooding the market most favored by investors -- this time, the \$6.9 trillion Treasury securities market rather than oil or housing.

The administration and Congress have been happy to oblige the enormous burgeoning of worldwide demand for Treasury debt in the last six months by enacting massive stimulus, bank rescue and budget plans that are due to rack up unheard-of debts and deficits over \$1 trillion annually for years to come. Treasury borrowing is well on its way to \$2 trillion this year alone.

But there are big differences between this and earlier events. While the housing and oil bubbles were fed by irrational exuberance, speculation and greed on the part of investors, the current flight to Treasuries is being fed largely by fear and an aversion to taking risks in other markets.

And, if the rush to Treasury debt turns out to be unsustainable, it will be the U.S. government and taxpayers -- not investors -- who will pay the biggest price.

"There is a danger, and it could easily get out of hand," said hedge fund mogul George Soros in recently discussing the string of bubbles that has plagued the U.S. and world economies. The turn to Treasury investing got started for seemingly good reasons last fall when the private credit, stock and commodity markets tanked and investors rushed into safe havens.

"In order to make up for the collapse of credit, we are effectively creating money," Mr. Soros said. The Fed and Treasury have stepped in, with the Treasury now borrowing on behalf of banks, auto companies, small businesses and consumers -- just about everyone having trouble obtaining credit -- through a variety of recently established programs. The problem is, "if and when credit is restarted [in private markets], you will then have an incredibly swollen monetary base" that could lead to "an explosion of inflation," he said.

The danger cannot be seen right now, when the economy is experiencing deflation, or falling prices, as a result of the deep recession, he said. But when the economy starts to pick up again, then the Fed will be "faced with the task of draining the money supply as fast as credit is created" to avoid an inflationary spiral and other problems.

It is when the world economy and markets return to normalcy and health that the Treasury bubble is in most danger of bursting and raining down dire effects on the U.S. economy, analysts say. As investors abandon Treasuries for other markets, the Fed, Treasury and Congress must successfully negotiate their way back to a world of smaller public debts and tighter money. If they don't, the result could be a huge jump in inflation and interest rates for the Treasury and every other borrower in the United States -- potentially triggering another financial crisis.

Flocking to safety

One clue that the Treasury market may be in a bubble is the extreme drop in Treasury rates since September, when the global financial crisis broke out. The clamor for short-term Treasury bills by investors seeking safe havens got so heated at points last fall that the yields on those bills fell to zero and even below -- meaning that investors were willing to pay Treasury to keep their money rather than the other way around. The yield on Treasury's bellwether 10-year bond also plunged from about 4 percent before the crisis to as low as 2.54 percent in recent weeks.

Timothy A. Canova, a dean at the Chapman University School of Law, said a bubble is developing not only in Treasuries, but in the U.S. dollar, which for decades has been seen as a safe haven by investors. The dollar has risen by nearly a third against other major currencies since the onset of the crisis.

"A bursting bubble in the dollar in general and Treasuries in particular would be a catastrophe," he said. It likely would involve "a sudden drop in Treasuries and dollar-denominated assets" that would produce a "contagion" in markets around the world akin to the collapse seen last fall.

The Fed has taken a lot of the blame from economists for nursing bubbles with loose monetary policies. Then-Federal Reserve Chairman Alan Greenspan has been skewered widely for stoking the housing and credit bubbles by pushing interest rates to record lows in 2003 out of fear the United States was entering a period of potentially destructive deflation. While deflation never proved a threat, the housing and mortgage markets took off in a euphoric climb that sent house prices soaring at double-digit rates, created a mountain of bad debt, and ended in today's monumental bust and recession.

"The Federal Reserve alone is the father of the mess that the economy now confronts," said Walter M. Cadette, visiting research fellow at the **American Institute for Economic Research** and a former vice president of [J.P. Morgan](#). He swept aside other culprits fingered in the crisis, such as banks and investors taking inordinate risks with little-understood derivative securities. "The cheap money was the 'sine qua non,' the only necessary condition for the bubble," he said.

Fed feeds Treasury mania

The Fed since last fall has been nurturing the Treasury bubble in its drive to revive the economy from a deep recession. The Fed's role in the Treasury boom does not appear to be as inadvertent as it was in past bubbles. Not only has the Fed under Chairman Ben S. Bernanke been printing money at prodigious rates, but it has pushed short-term rates close to zero -- dramatically

lowering the Treasury's borrowing costs -- while taking the unprecedented step of purchasing Treasury bonds to encourage borrowing and help finance the debt.

Peter Schiff, president of Euro Pacific Capital, said the Fed's announcement last month that it will purchase up to \$300 billion of Treasury bonds was ill-advised, as it sent a message to investors that the Fed is prepared to print money and absorb the Treasury's increasing load of debt at any cost.

"The move will push the U.S. government debt bubble into its final stages of expansion," he said. "When it finally bursts, the supports holding up the U.S. dollar will be utterly removed."

The Fed says its goal, of course, is not to spur a debt binge by Congress -- something Mr. Bernanke has consistently warned against -- although that has been the unintended effect of the Fed's efforts. The central bank's stated goal is to drive down long-term interest rates -- particularly 30-year mortgage rates -- to try to reverse the collapse in the housing market, which the Fed believes is a core cause of the recession.

The Fed has accomplished its goal of driving mortgage rates to record lows near 4.6 percent, touching off a big refinancing wave and easing the way for people with adjustable-rate mortgages that are resetting by the millions this year and next. But so far, the Fed's efforts have produced only a muted response in the housing market. Economists hope the Fed is putting a floor under cratering home sales.