Why in the World Would You Own Bonds When…

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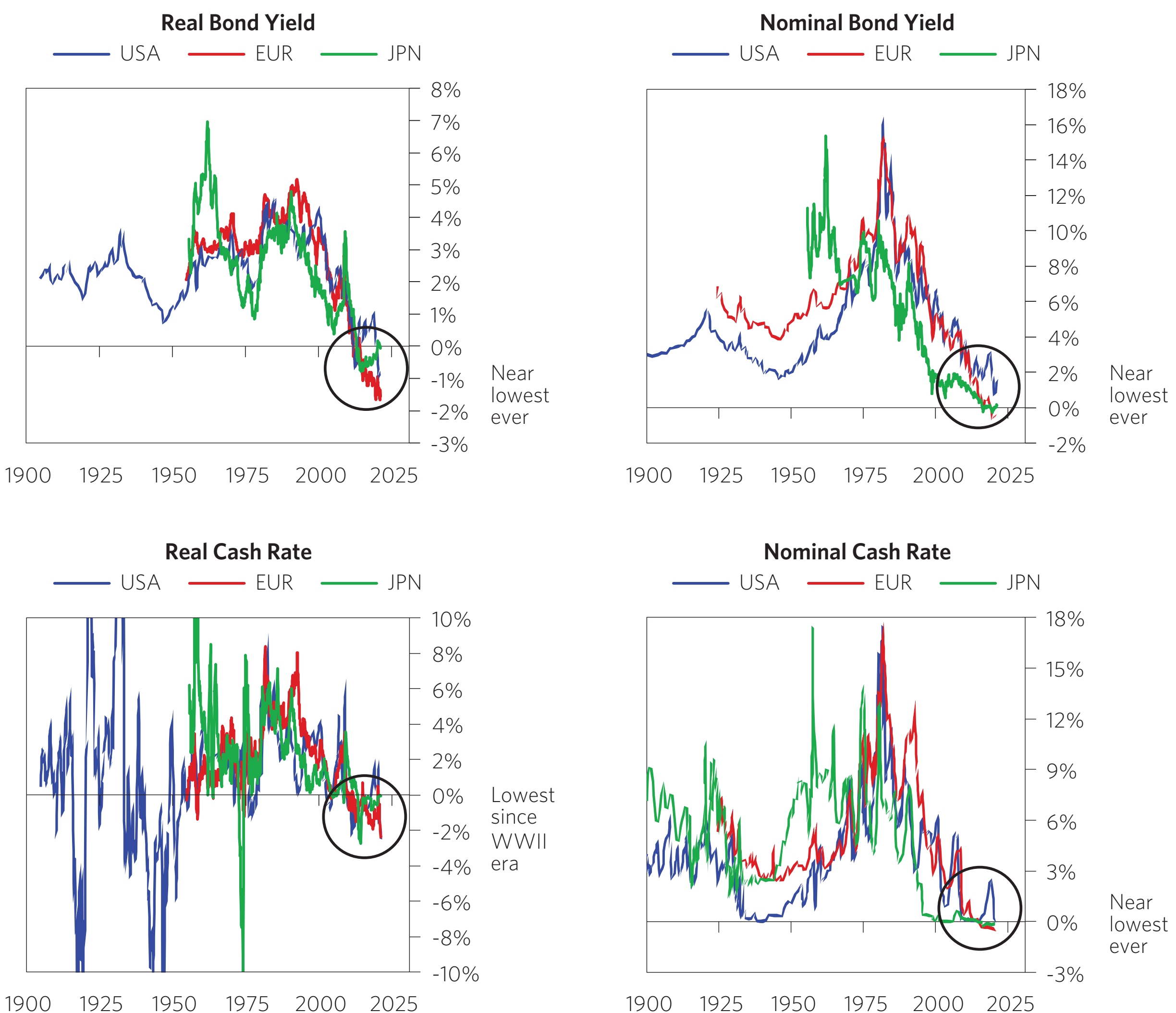
...Bond markets offer ridiculously low yields. Real yields of reserve currency sovereign bonds are negative and the lowest ever. Real yields of cash are even worse though not as negative as they were in the 1930-45 and 1915-20 great monetization periods. Nominal bond yields are just off the lowest ever made a couple of weeks ago. These extremely low or nonexistent yields do not meet these asset holders' funding needs. For example, pension funds, insurance companies, sovereign wealth funds, and savings accounts cannot meet their financial needs with these investments so holding bonds assures their failure to meet their obligations. At the same time, while there is some room for diversification benefit, because of limitations of how low interest rates can go, bond prices are close to their upper limits in price, which makes being short them a relatively low-risk bet. The charts below that go back to 1900 show these things—real bond yields, nominal bond yields, and nominal/real cash rates for the US, Europe, and Japan.



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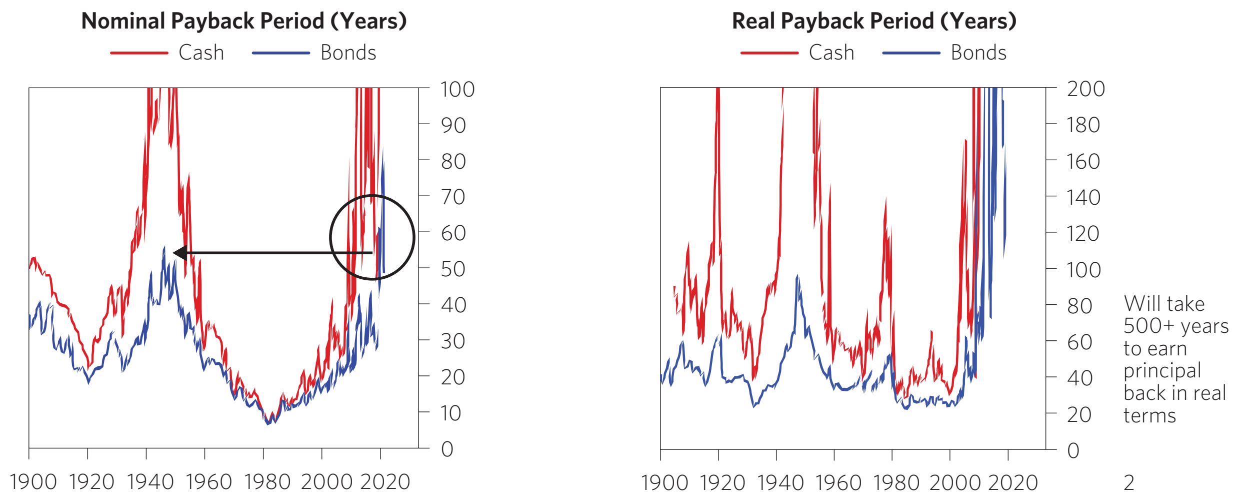
...The economics of investing in bonds (and most financial assets) has become stupid. Think about it. The purpose of investing is to have money in a storehold of wealth that you can convert into buying power at a later date. When one invests one gives a lump-sum payment for payments in the future. Let's look at what that deal now looks like. If I give $100 today how many years do I have to wait to get my $100 back and then start collecting the reward on top of what I gave? In US, European, Japanese, and Chinese bonds an investor has to wait roughly 42 years, 450 years, 150 years, and 25 years[1] respectively to get one's money back and then one gets low or nil nominal returns. However, because you are trying to store buying power you have to take into consideration inflation. In the US you have to wait over 500 years, and you will never get your buying power back in Europe or Japan. In fact, if you buy bonds in these countries now you will be guaranteed to have a lot less buying power in the future. Rather than get paid less than inflation why not instead buy stuff—any stuff—that will equal inflation or better? We see a lot of investments that we expect to do significantly better than inflation. The charts below show these payback periods for holding cash and bonds in the US, in both nominal and real terms. As shown, it is the longest ever and obviously a ridiculous amount of time.



...The world is a) substantially overweighted in bonds (and other financial assets, especially US bonds) at the same time that b) governments (especially the US) are producing enormous amounts more debt and bonds and other debt assets. This is particularly true for US bonds. US bond holdings are over a third of global bond holdings held by central banks, sovereign wealth funds, and international investors with the next largest country/currency bond being euro bonds at only roughly 60% of US bond holdings.[3] Their overweighted position in US bonds is largely because of the "exorbitant privilege" the US has had being the world's leading reserve currency, which has allowed the US to overborrow for decades. The cycle of becoming a reserve currency, overborrowing, and being overindebted threatening the reserve currency status is classic. As part of this cycle there is the emergence of the currency and capital markets of the rising and competing empire. Consistent with this classic cycle there is now a shifting from US bonds to Chinese bonds going on. Chinese bond holdings held by international investors are rising fast, though they are now only about 6% of allocations in global portfolios. This shift is going on because a) global investors are overweighted in US bonds and underweighted in Chinese bonds relative to sensible criteria of what weights should be based on sensible portfolio-weighting processes, such as the relative sizes of their economies, their relative shares of world trade, and the relative sizes of their capital markets, b) Chinese bond and other capital markets investments are growing fast and are increasingly open to foreign investment, c) Chinese bonds offer relatively attractive yields with relatively attractive currency returns because of China's favorable balance of payments conditions, and d) China's currency is increasingly being internationalized. That whole set of supply-and-demand circumstances makes for a dangerous picture for bonds, cash, and currencies in the three major reserve currencies of the

[1] Based on current levels of 30-year nominal bond yields (treated as a perpetuity).

[2] Bond payback periods are based on 30-year bond yields.

[3] Estimate based on weights in global bond indices.

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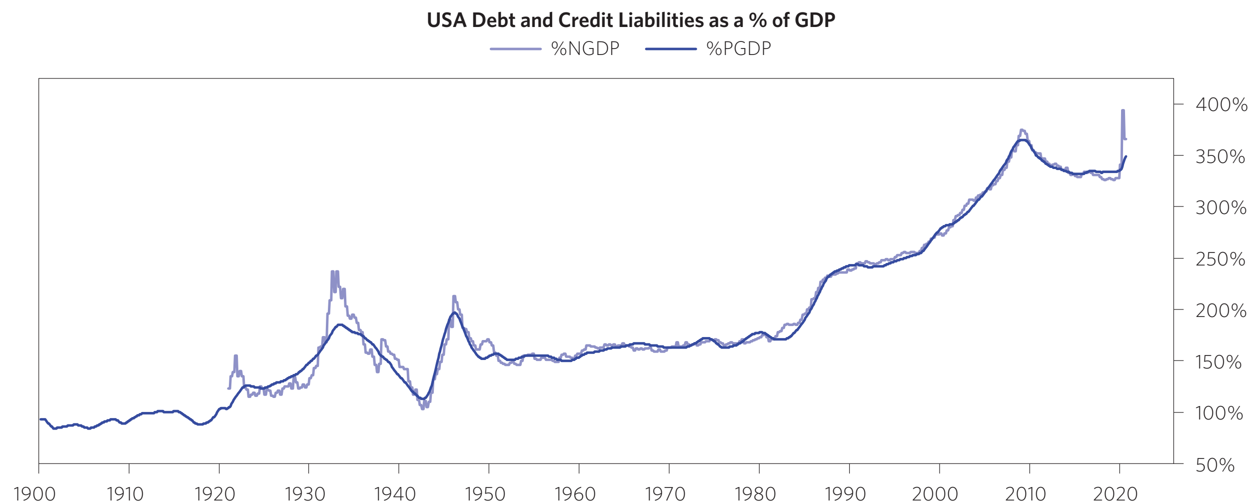
dollar, the euro, and the yen. If the new demand for these bonds falls significantly short of the new supply, which seems likely, either a) interest rates will rise and bond prices will fall or b) central banks will have to print substantial amounts of money to buy the debt assets that the free-market buyer won't buy, which would be very reflationary (bearish for the dollar and the leading currencies who do this, relative to reflation assets).

…If bond prices fall significantly that will produce significant losses for holders of them, which could encourage more selling. Bonds have been in a 40-year bull market that has rewarded those who were long and penalized those who were short, so the bull market has produced a large number of comfortable longs who haven't gotten seriously stung by a price decline. That is one of the markers of a bubble.

…Imagine what would happen if, for any or all of these reasons, the holders of these debt assets wanted to sell them. There is now over $75 trillion of US debt assets of varying maturities. US Treasury bonds and notes account for $16 trillion[4] of this and US Treasury securities of other maturities account for another $5 trillion.[5] Holders of these debt assets will either hold them until maturity and endure the previously described terrible returns or sell them. Most holders of debt assets believe that they can sell them to get cash and to buy goods and services with. After all, the only purpose of holding financial assets is to be able to convert them into the buying of goods and services. The problem is that, at current valuations, there is way too much money in these financial assets for it to be a realistic expectation that any significant percentage of that bond money can be turned into cash and exchanged for goods and services. If any significant amount tried to make that shift a "run on the bank"-type dynamic would ensue. When such a dynamic—which I call a "reverse wave"—occurs there is no stopping it. It has to be accommodated the way it was accommodated in the 1930-45 period and the 1970-80 period (and hundreds of similar periods throughout history) via printing a lot of money and devaluing it, and restructuring a lot of debt and government finances, usually including large increases in taxes.



…History and logic show that central banks, when faced with the supply/demand imbalance situation that would lead interest rates to rise to more than is desirable in light of economic circumstances, will print the money to buy bonds and create "yield curve controls" to put a cap on bond yields and will devalue cash. That makes cash terrible to own and great to borrow. Through their powers central banks can, at least temporarily, put a lid on interest rates and keep short-term interest rates low relative to long-term rates so that it becomes profitable to buy bonds with cash, which central banks abundantly provide which makes real interest rates very negative. For example, during the 1930-45 period the Fed kept the bond yield around 2.5% and the cash yield around 1%, which made it profitable to borrow cash and use it to buy and own bonds. While that can make holding bonds financed with cash profitable at low rates, under such circumstances both the cash rate and the bond rate are bad. Naturally, because cash rates are so low it pays to borrow cash and invest it in investments that are higher-returning. Back in the 1930-45 period, the Fed was able to keep yields

[4] Includes notes, bonds, TIPS, and floating rate notes ex-intragovernmental holdings. See treasurydirect.gov if interested in more detail on the current indebtedness of the US government.

[5] Note that there is additionally around $7 trillion of other US government debt held by internal government funds.

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there, and the way they did that was also through outlawing gold and the movement of capital elsewhere. So, when I look at it, while I want to be short bonds (because they have the most terrible fundamentals), I do know that central bankers can keep cash more terrible, and I do know that they might have to prevent the movement to other storehold of wealth assets and other countries.

Such moves would signal the beginning of the very last and most disruptive stage of the long-term debt cycle. So, watch central bankers' actions—i.e., see if they increase their bond buying when interest rates are rising led by long-term interest rates and when the markets and economy are strong—because that action would signal that they are experiencing supply/demand problems. Also, watch the rates of change in the injections of these stimulants in relation to the effects they are having on the economy's vigor because the more stimulants that are being applied per unit of growth, the less effective they are and the more serious the situation is.

I know this all sounds crazy to you. It sounds pretty crazy to me, too. However, I have seen this confluence of circumstances leading to this sort of dynamic many times in my study of markets and economies over the last several hundred years and I experienced this dynamic myself (in 1970-80).

This Dynamic Is Typical of the Late Stage of the Long-Term Debt Cycle

Rather than being unusual, the dynamic I am describing has happened repeatedly throughout history. While I will briefly explain how the cycle works here, if you want a more comprehensive explanation, I will direct you to my "The Changing World Order" study, which you can find here.

Here's how the long-term credit/debt cycle works. Credit growth is a stimulant that a) provides buying power that causes spending on financial assets, goods, and services and the economy to go up and b) creates debt obligations that act like a depressant when the time for paying back comes. To visualize how the cycle works, imagine that the economy is a person and government policy makers are doctors. When the economy's pulse plunges the doctors run to inject a big dose of stimulation into it. When you see them running to the patient and injecting the giant dose of stimulation, you should buy reflation assets like stocks, inflation-indexed bonds, and gold because the response to the stimulation will initially cause these assets to rise before the stimulation passes through to the economy and the patient starts running around. This injection of money and credit into the system pushes interest rates down relative to inflation and down relative to the nominal growth rate of the economy, which pushes financial prices up. When interest rates are below inflation rates and growth rates that lowers debt-service burdens in relation to incomes, which makes it easier to service the debts. Besides the real and nominal interest rate cuts being stimulative, the increased supply of money injected into the system bids up investment asset prices and can cause financial market bubbles even when actual economic conditions are still weak. After the effects on the financial markets happen, the economy (at first) and inflation (with a lag) start picking up. When all this picking up happens, one should expect the "doctors" to start cutting back on the sizes of the doses of the stimulants, and if the patient is becoming a bit manic one should expect them to administer sedatives (i.e., tighter monetary policies).

The problem with administering these stimulations over decades is that they leave unhealthy residual effects in the form of growing and large debt liabilities and assets. As the amounts outstanding grow the risks also grow. When these build up to dangerously high levels, which typically takes place over 50 to 100 years, that causes problems. In these big debt cycles debts grow faster than incomes. That is the "upwave." Naturally those who lent the money want to get paid with more buying power than they gave when they bought the bonds and those who borrowed the money are carrying extra burdens of having to make those payments. The debts are like nuclear waste that isn't easy to dispose of. Eventually these debt liabilities and assets become too large and burdensome, so they have to be reduced one way or another. When that realization occurs abruptly it triggers the previously described *"run on the bank"—central bank money printing—market action dynamic* that I call the "reverse wave." That is traumatic for those who are holding the debt assets and traumatic for most everyone

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though it eventually reduces the ratios of debt and debt service to incomes. It is also traumatic for capital markets, capitalism, and economies. During this credit/debt collapse people realize that they don't have as much buying power as they thought and financial and economic conditions worsen. There is not enough real money and credit so taxes are also typically raised a lot and there is typically a lot of conflict over who should get how much money from whom. For reasons previously explained, it appears to me that we are at that part of the credit/debt cycle.

As explained over the previous few years that cycle is only one of the three really big cycles...

...1) the credit/debt cycle,

...2) the internal conflict cycle due to wealth, values, and political gaps, and

...3) the external conflict cycle due to the leading world power, its world order, and its reserve currency (now the US) being challenged by the leading rising power (China).

The "Big Cycle" dynamic of these big forces interacting is described much more comprehensively in my study "The Changing World Order." I think it's very important so, if you haven't read it, I urge you to.

Enter a Pandemic, and Here We Are

While the previously mentioned three big issues had been brewing for a number of years, about a year ago the world was hit with a pandemic (COVID-19), the economy's pulse plunged, and the "doctors" ran to the patient and gave it a huge injection of stimulation. To get money into the hands of the people they wanted to get it to when interest rates were at 0%, the policy maker "doctors" had to do what I call Monetary Policy 3 (MP3). MP3 is the coordination of fiscal policy (in which the central government borrows and directs the money to those they want to get it) and monetary policy (in which the central bank prints money and buys the government's debt). It classically comes when the more traditional policies such as lowering interest rates (MP1) and printing of money and buying financial assets (MP2) won't get money to the people who need it most because the normal capital markets money and credit allocation process directs money to those who are positioned to make money and/or who have a lot of money rather than to those who need it most. That is the main structural issue that I believe has to be dealt with in the ways I explained in my piece "Why and How Capitalism Needs to Be Reformed" and why MP3 is used.

The most recently passed fiscal stimulus bill created a lot of funding and a lot of debt that is many times that which is needed to cover the financing hole (the "doctors" ran to the patient and gave it a huge injection of stimulation). Besides providing funds to deal with the economic consequences of COVID-19 it was a giant Universal Basic Income (UBI)—i.e., a giant redistribution funded by borrowing and monetizing. I'm not saying that policy makers should have done anything differently as I certainly see the need for such assistance and because it's not my job to say who should get how much money and how policy makers should weigh the benefits of doing this against the costs of doing it—i.e., the implications of a huge amount of debt and money creation. I'm just a practical global macro investor focusing on the mechanics and its implications trying to stay one step ahead of the crowd, and I'm just explaining that these circumstances created a lot of government debt—i.e., because there wasn't enough free-market buying of this debt, central banks had to buy it and had to print a lot of money to buy it with—so much so that they drove rates down to "artificially" low levels, which "artificially" supported financial asset prices. That move was a classic move. Now, there's just so much money injected into the markets and the economy that the markets are like a casino with people playing with funny money. They're buying all sorts of things and pushing yields on everything down. Now you have stocks that have gone up, and you have classic bubble dynamics in so many different assets. The following charts show the longer-term picture of the US government's budget deficits (deficits are near WWII levels), the United States' current account deficit, and Federal Reserve debt monetization. It also shows how the US fiscal support

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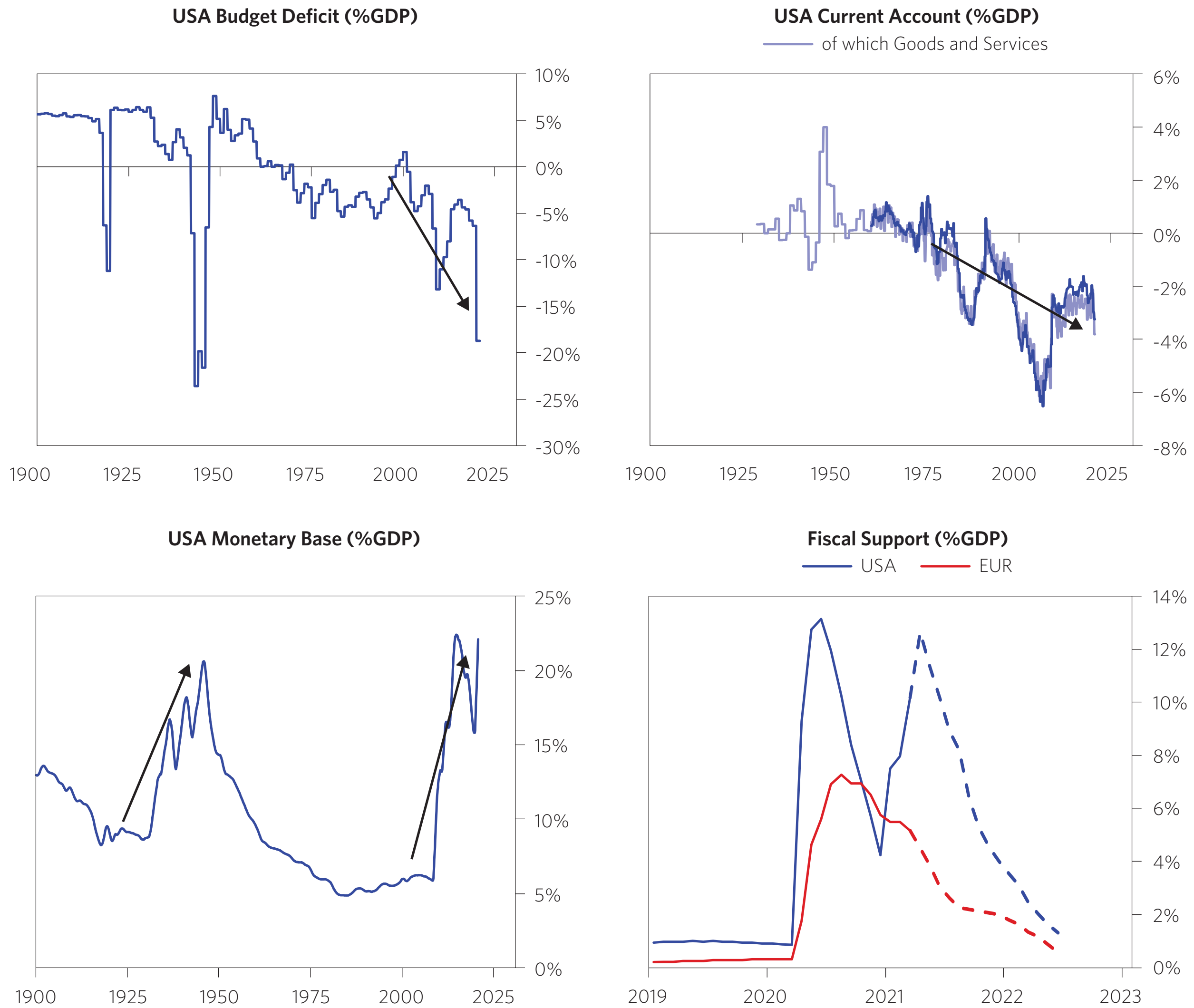
compares to the rest of the world (much larger). While 2020 and 2021 were exceptional years that led to exceptionally large deficits (like the war years) these deficits are likely to remain large until they can't remain large anymore.



In my examination of history over many centuries and in many places, I have seen many analogous cases, and by studying them have seen how these things work, many of which are covered in my "The Changing World Order" study.

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Looking Ahead and What to Do

Because I believe that we are in the late stage of this Big Debt Cycle that mechanistically works in the way I described, I believe cash is and will continue to be trash (i.e., have returns that are significantly negative relative to inflation) so it pays to a) borrow cash rather than to hold it as an asset and b) buy higher-returning, non-debt investment assets.

Based both on how things have worked historically and what is happening now, I am confident that tax changes will also play an important role in driving capital flows to different investment assets and different locations, and those movements will influence market movements. If history and logic are to be a guide, policy makers who are short of money will raise taxes and won't like these capital movements out of debt assets and into other storehold of wealth assets and other tax domains so they could very well impose prohibitions against capital movements to other assets (e.g., gold, Bitcoin, etc.) and other locations. These tax changes could be more shocking than expected. For example, Elizabeth Warren's proposed wealth tax is of an unprecedented size that, based on my study of wealth taxes in other countries at other times, will most likely lead to more capital outflows and other moves to evade these taxes. The United States could become perceived as a place that is inhospitable to capitalism and capitalists. Though this specific wealth tax bill is unlikely to pass this year the chances of a sizable wealth tax bill passing over the next few years are significant. Conflicts can increase in such difficult times when accompanied by large wealth, values, and political gaps, and the environment can become inhospitable to capitalists leading them to run from less hospitable places to more hospitable places.

I think this is the new paradigm.

For these reasons I believe a well-diversified portfolio of non-debt and non-dollar assets along with a short cash position is preferable to a traditional stock/bond mix that is heavily skewed to US dollars. I also believe that assets in the mature developed reserve currency countries will underperform the Asian (including Chinese) emerging countries' markets. I also believe that one should be mindful of tax changes and the possibility of capital controls.

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