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Bond market drop a portent

The bond markets are collapsing. What the Treasury and the Fed do now could have severe consequences for the economy.

At deadline on Feb. 6, Treasury bond prices, measured by the 2009 issue, had fallen 14 percent during the preceding four weeks, and 4 percent during the last three trading sessions, in the worst bond market collapse in U.S. history. Unless the Treasury takes some form of radical action the bond market will continue down further. Erwin Shubert, Vice-President of Arnhold S. Bleichroeder Securities, calculates that a 20 percent rate of inflation would imply a 20 to 30 percent drop in long-term bond prices. Paying almost 12 percent for long-term funds, the Treasury is in worse shape than during the American Civil War.

Commercial banks, reportedly, are liquidating Treasury bonds in order to fund a commercial and industrial loan expansion rate of 24 percent per year (as of the last five reporting weeks). Life insurance companies, traditional large purchasers, have suffered badly from the collapse in the savings rate. All premium income during 1979 to life insurance companies rose by only 5 percent, against a 13 percent inflation rate. Should any of the life companies run into liquidity difficulties—and brokerage house analysts do not exclude this—the required sale at a loss of fixed-income securities portfolios would swamp the bond market like a busted dam.

Until one of the following three elements of the current situation changes, the U.S. bond market will have no firmer bottom than the Turkish lira or the Brazilian cruzeiro:

1) The refusal of the private sector to reduce credit demand, indicated in the high commercial lending rates;

2) The refusal of consumers to reduce living standards, shown in the November-December rundown of savings accounts and decline in life insurance sales;

3) The Treasury and federal "off-budget" combined credit demand of $91 billion during calendar 1980.

Of course, Fed Chairman Volcker has limited options. Despite strong administration support, action on legislation to keep commercial banks inside the Federal Reserve System is not considered likely during this session of Congress. Credit allocation to suppress private-sector demand is even further away. Volcker's mid-October imprecation that "the American living standard must decline" has not been accepted by consumers, who are hanging onto what part of their living standard they can sustain. To a great extent, the federal budget will impose a certain degree of austerity, by eliminating close to $10 billion of federal-agency support for the housing market. However, this cut, in the context of the mammoth federal financing requirement, does not make a dent of the dimensions Volcker requires.

However, Volcker may be forced to let pure Treasury "crowding out" and high interest rates suppress private commercial and consumer credit demand, with severe consequences for the economy.

If interest rates rise and stay above the rate of inflation, the economy will experience a severe recession. Volcker threatened to do this, but failed to act on his threat, largely because the federal government stepped up borrowing to meet an overall 42 percent per annum rate of increase in spending during the fourth quarter. Volcker's accomodation to this, combined with the rise in oil prices, put most inflation forecasts up to the 20 percent range, and produced the January slaughter on the bond markets.

The rise in the unemployment rate to 6.2 percent from 5.8 percent during January is a severe warning. It reflected a drop in mainly white-collar and service employment. The point at which the already huge dropoff in steel, auto, housing, and other industrial activity cuts into the non-goods-producing sector is when the economy will get into real trouble. Tax revenues will abate, possibly by $40 billion, according to Manufacturers Hanover Trust economists, while private sector credit demand falls off much more slowly. This is not 1974-75, when the big inventory runoff eliminated private-sector credit demand, but a situation of low inventories and even lower liquidity among both corporations and households.

Well before the drop in economic activity brings down interest rates, the expansion of federal borrowing requirements will create a self-feeding cycle of crowding out.

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