

Bond Market Collapse Unfolding

By Adrian Douglas

On October 15, 2008 I wrote an article entitled [“Bond Market Collapse is Imminent”](#) . The article centered on a chart of my proprietary Market Force Analysis (MFA) applied to the 10 Year Note futures market. An updated chart is shown in Figure 1.



Figure 1 US 10 Year Note Price and MFA

The black line is the price of the 10 Year US Treasury Note and the red line is the Market Force. The market force is the difference between supply and demand so it represents a measure which is at the heart of economic theory. When the MFA is rising it means that buyers are dominant and when it is falling sellers are dominant. It has shown itself to be a very reliable directional indicator of a market.

It can be seen that when the sub-prime mortgage crisis first hit in August 2007 the force went into an upward trend as investors moved to buy more “prime” debt as a safe haven.

This trend came to an end in March 2008 as the Bear Stearns collapse and shotgun marriage to JPMorgan unfolded. The force exited the uptrend channel and started tracking sideways. In July of 2008 as the financial contagion began to spread and more financial institutions started to show signs of stress the force turned negative. Despite this, the bond market initially rallied from July to September which was reportedly due to a “safe-haven” trade. However by mid September the 10 Year Note started to fall, as would be expected from the negative MFA

By October 2008 when I penned my last article it looked as if the bond market was about to collapse (see blue circle). I don't know if the Treasury folks read my articles but as if by magic the 10 Year Treasury Note went vertical out of nowhere! We now know that the Federal Reserve was pondering Quantitative Easing at this juncture where in the FED would buy Government Bonds. It looks as if they were doing more than just “pondering”! It should be noted that the price is from the bond market itself while the force is derived from the futures market. As you can see the futures market was unfazed by this interesting piece of manipulation and the force continued to be negative. The futures market and the underlying market must return to equilibrium because a continued divergence generates huge losses in the futures markets for traders on the wrong side of the trade. As can be seen it is the Bond market that has seen a reversal in price. The futures market traders didn't skip a beat. Now the bond market and the MFA of the futures market are synchronized and the direction is DOWN.

The US debt market is the biggest and most important market in the world (disregarding the Casino Royale of OTC derivatives!). The FED will most definitely try to prop it up by creating artificial demand through buying the debt. The FED can continue to be the buyer of last resort but if it is the only substantial buyer the bond market can not be propped up for long. This is like a company buying its own stock in an IPO to make it look like the stock is desirable. It is clearly “Operation Put Lipstick on the Pig”!

The fundamental problem with the economy is that Americans have been encouraged, cajoled or bamboozled into borrowing money against their future income using their house as collateral. They have spent that money on their lifestyle and had a good time but the repayments must still be made, and the income must still be earned. The American consumer has had to stop spending because he has no collateral left to borrow against. This sudden halt in spending has caused a catastrophic slow down of the economy leading to massive job losses. The banks have been torpedoed below the waterline as loan repayments were defaulted upon thereby dramatically reducing their revenues which has rendered them incapable of maintaining their ludicrous levels of leverage. Banks are unable to lend but the consumer is unable to borrow. The US Government now thinks it is smart to carry on spending on behalf of the tapped out American consumer to keep the party going and to bailout the foolhardy banks. But whose money are they spending? Clearly it is not the taxpayer's money as widely touted

because, as just discussed, the taxpayer is tapped out and the mounting job losses mean Tax revenues will rapidly contract.

The US Government can only earn money from tax receipts. The US Government is hell bent on borrowing massive amounts of money backed by the "full faith and credit" of a tapped out, credit impaired, or bankrupt population! The only difference between the American consumer and the US Government is that when the consumer is broke he is forced to stop borrowing and spending. When the Government is broke it can appear to be good for its repayments by printing more dollars. That is bad news for bond holders as they are repaid with dollars of declining purchasing power. The bond market looks like it is starting to wake up to this reality.

The Madoff scam has been reported as the biggest Ponzi scheme in history. It would appear that the media has not yet understood how the US Government debt market works! They will soon.

If the so called "safe haven" investment of US Treasury Debt continues to nose dive as the MFA predicts one has to ponder what will be left standing as a true "safe haven" investment? Gold is one of very few choices. Gold has risen every year for the last 8 years yet is still trading at approximately its cost of production! It, therefore, has almost no long term downside risk. What other investment offers such a characteristic? However, the precious metals and all the mining shares combined represent a miniscule market compared to the US Bond market. Just a small fraction of capital leaving the bond market and entering the Precious Metals and Mining domain will literally blow the doors off the barn.

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www.marketforceanalysis.com

Market Force Analysis is a unique analysis method which provides reliable indications of market turning points and when is a good time to enter, take some profits or exit a market. Subscribers receive bi-weekly bulletins on the markets to which they subscribe. MFA subscribers were advised to take a long position in the 10 Year Note at the end of Nov 2008 when it was trading at \$122. Two weeks later when it was trading at \$127 they were advised to sell. At the beginning of January when it was trading at \$126 they were advised to go short.