Flight To….Safety?

It must have been one of those touching mother-and-child moments all those years ago in the Bernanke household when young Benjamin, frightened by the Boogeyman of Deflation hiding in the closet, cried out in the night and was consoled by a warm, cuddly printing press.

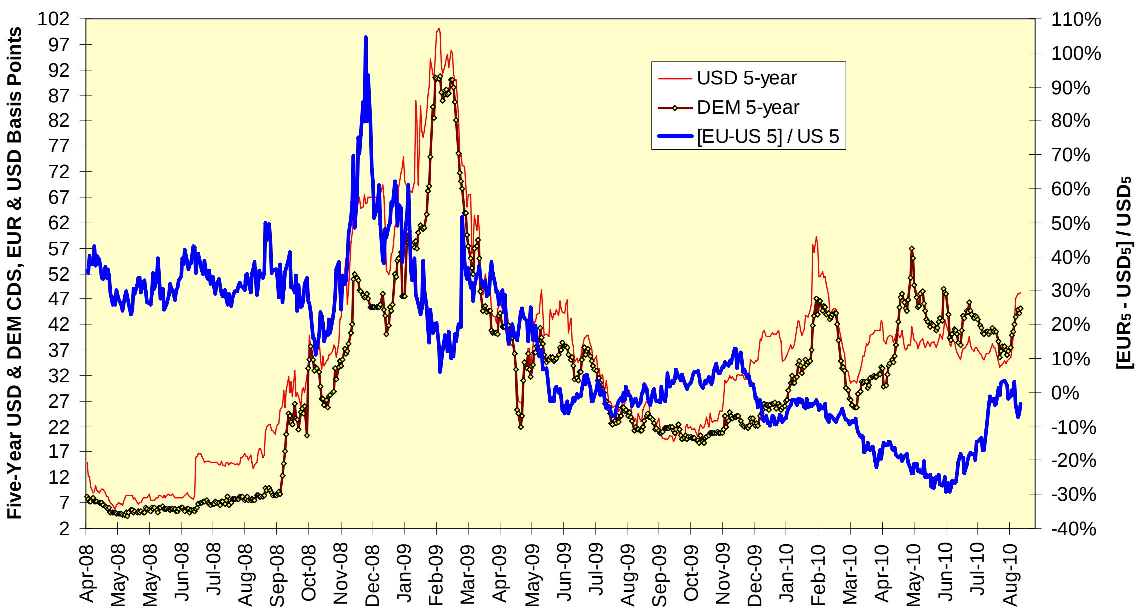
Ink everywhere.

Too many of the world's investors have come to believe in the primacy of that very same printing press as a solution for the world's ills, even though it has proven to be enormously destructive. The money sprayed about as if it emerged from an overheated and incontinent hippopotamus has yet to resuscitate either an economy weighed down by the damage caused by the last credit bubble or the financial markets manipulated from above as a hoped-for opiate for the masses. Savers have been impoverished, bank lending has been short-circuited into a Treasury yield curve trade whose depredations will, as night follows day, produce another end-in-tears when its bull market ends and the federal government has been able to dodge the true extent of its fiscal misfeasance as the costs of debt service are, incredibly, falling.

All Of The People

You might think the massive drop in Treasury yields seen since the end of March would be accompanied by a decrease in U.S. [sovereign credit risk](); it might seem illogical for investors to be buying something hand-over-fist at ever-higher prices while holding their noses. However, the sovereign CDS costs on U.S. five-year Treasuries, priced in euros, and the sovereign CDS costs on German five-year Bunds, priced in dollars, have been creeping higher over the past three weeks.

Five-Year CDS Costs On U.S. & German Bonds Vs. Normalized Yield Spread



A second aspect of this strange market is Bund yields have fallen below Treasury yields at the five-year horizon. The U.S. has used its printing press aggressively and without apology; the European Central Bank has used it more sparingly and keeps protesting its virtue whenever it is caught doing so.

What we see here are some emerging signs of impatience even as the bull market in bonds continues on both sides of the Atlantic. Should you be concerned? Yes: I noticed a similar situation more than ten years ago, in late February 2000, with regards to the implied volatility of various NASDAQ stocks. Volatilities were screaming higher even as the index was making its final push toward the 5,000 mark that may hold for the remainder of my lifetime. We now call the aftermath the "dotcom bust."

Whenever people are buying insurance while they are paying more for the underlying asset, you know their conviction is not very strong. Markets with weak longs can get clobbered quickly, even if the longer-term trend remains intact; this is one reason why selloffs are stronger in bull markets and rallies are stronger in bear markets.

The message is clear: Even if the bond market rally has a little more gas left in the tank, anything being propelled by the promise of freely printed money is becoming suspect.