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Weekly Market Flash

Bond Vigilantes Hold Fire, For Now

January 24, 2025

The 1980s was a colorful decade for many reasons, and not just limited to the cultural icons of the day like Boy George or Max Headroom. The economic arena had its own personalities. There was Michael Milken, the swaggering Drexel Burnham Lambert bond trader perched at his X-shaped desk in Beverly Hills, king of the junk bond market. And Ivan Boesky, merger arbitrageur extraordinaire and coiner of the "greed is good" mantra later immortalized by his fictitious avatar Gordon Gekko in the 1987 movie "Wall Street" (by which time Boesky himself was cooling his heels in the Lompoc Federal Correction Institution for a three-year term after being convicted of insider trading).

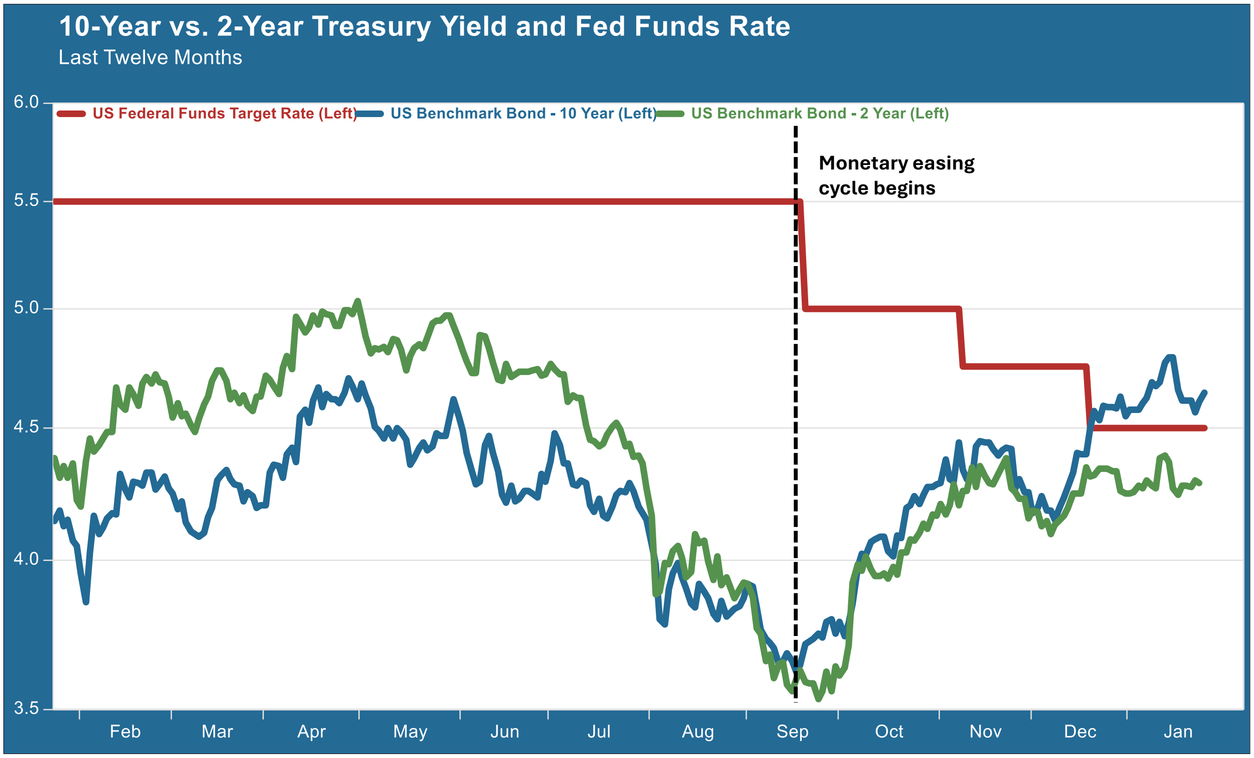
The Original Dr. Doom

The name Henry Kaufman may not ring a bell among many folks today, but back in the Roaring Eighties he was up there in the Valhalla of financial markets personages (and, unlike Milken, Boesky et al, never to be found on the wrong side of the law). Kaufman, a managing director at erstwhile bond market behemoth Salomon Brothers, was the original Dr. Doom – a nom de guerre now generally associated with the often dour economist Nouriel Roubini – and the de facto leader of a posse known as the "bond vigilantes." Kaufman and his fellow vigilantes had a dour view of US fiscal policy, which they saw as beset by out of control spending and a bond market irresponsibly awash in public debt.

The bond vigilantes could move both stock and bond markets merely by pronouncing a view on where interest rates were headed. In perhaps the most famous of these pronouncements, Kaufman's observation in August 1982 that interest rates were headed down for the foreseeable future sparked a stock market rally that lasted until the early 2000s. The influence of the vigilantes continued into the next decade, enough so to cause Democratic strategist James Carville to remark, early in Bill Clinton's presidency, that he would like to be "reborn as the bond market" given how much sway it had over the economy and life in general.

Warning Shots and Dry Powder

It should not come as a surprise to anyone looking at charts of US public debt today to learn that the bond vigilantes are back. Total public debt is currently around 121 percent of US Gross Domestic Product, more than twice the level it was during the early 1990s when the bond vigilantes were terrorizing poor James Carville. Last September, when the Fed commenced its monetary easing program with a 0.5 percent cut in the Fed funds rate, Treasury bond yields rose, a counterintuitive movement reflecting, among other things, concern about debt, the deficit and whether inflation was really under enough control to continue cutting rates. That concern continued through the fall as inflation stubbornly moved sideways rather than down, eventually causing the Fed itself to revise its earlier thinking and signal a likely pause in the easing program. The vigilantes had spoken.



Source: MVF Research, FactSet

Yields continued to rise through the first couple weeks of January as additional concerns percolated about the inflationary potential of tariffs and sharp immigration restrictions with the arrival of the new government. Since then, though, the upward trend has tapered off. The 10-year yield today is around 0.2 percent lower than where it was on January 15. But that doesn't mean the bond vigilantes have gone away. They are holding fire, keeping their powder dry but watching what will, and will not, happen with regard to campaign rhetoric becoming actual policy. A sustained upward trend in interest rates would create a world of economic problems for households, where credit card delinquencies are at their highest level since 2010, or among smaller businesses that rely on variable-rate credit instruments for much of their external financing needs. Government policymakers would be wise to channel their inner Carvilles and respect the sway of the vigilantes.

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