

## NASHVILLE NOTES

**Crash memes everywhere****Friday, February 19, 2021 9:17 AM ET**

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Many of you reading this had not started your careers yet when Fed Chair Alan Greenspan described equity markets as being "irrationally exuberant" in December 1996. The Nasdaq and the S&P 500 rose 23% and 20% from the beginning of the year to the day before his comments on Dec. 5. My recollection is the comment got press coverage along the lines the Fed chair thinks equity prices are high.

Maybe Greenspan's comment was meant to be a warning to Wall Street to not overdo it rather than an observation. The Greenspan Fed had thrown markets, especially fixed income markets, for a loop by raising the Fed Funds rate from 3.0% in early 1994 to 6.0% by the spring in 1995. Among the hikes was a 75-basis-point increase, something that is hard to imagine now given how levered government, corporations and financial markets are today.

Greenspan's irrational exuberance comment began to attract derision as equity markets continued to rise. Between Dec. 4, 1996, and the (approximate) market top on March 9, 2000, the Nasdaq rose 289% compared to "only" 88% for the S&P 500 and 69% for the Russell 2000. The ascent included a gain of 88% for the Nasdaq in 1999 followed by 24% through March 9, 2000.

Timing matters on Wall Street. The collapse of the late '90s bubble saw the Nasdaq fall 78% and the S&P 500 by 45% by October 2002 from the March 2000 peak.

Greenspan with hindsight would have held the comment until late 1999. If so, he might still be referred to as the maestro, as Bob Woodward dubbed him in a book with the same title in 2000.

Today there seemingly are market crash memes everywhere citing various data points. [GameStop](#); CCC-rated companies finding a receptive audience for new issues because their coupons do not round to zero; [cryptocurrencies](#); and [SPAC IPOs](#) are among the many candidates offered. I agree, it is crazy.

Jeremy Grantham, the value investor founder of Boston-based GMO that exited Japan in the late 1980s and called the 1999 bubble correctly, opines that the market has a few weeks or months left rather than years before a bust occurs that rivals 2000 or even 1929.

Crazy or not, no one knows what tomorrow holds. One of the catalysts cited by many for the bust Grantham foresees is a pricking of the "bond bubble." If rates rise materially, then valuations for stocks would compress all else equal. Worse would be compressing multiples and declining earnings if higher rates caused corporate earnings to fall, too.

Bond rates are absurdly low in the U.S. because the Fed has set short-term policy rates effectively at zero and/or investors see the potential for a deflationary bust as more debt is piled onto the economy.

Aside from crash memes, the other meme that has gotten a lot of airtime since 2009 is that rates have nowhere to go but up. Long-term rates have been trending higher in the U.S. since last fall, especially following the first COVID-19 vaccine announcement. Yet viewed from the vantage of a few years or a few decades the [trend in the yield](#) on the 10-year U.S. Treasury has been one of lower lows and lower highs.

Maybe the turn is at hand that will prick both the bond and equity market bubbles. The debate among some is whether the current economic reflation trade turns into sustained inflation and thereby takes bond yields ever higher in a replay of the 1970s, whose seeds were sown in the 1960s.

Before proclaiming the recent upward move in U.S. Treasury yields as the beginning of a sustained bear market, history would say long-term rates can go a fair bit higher without a Fed hike in short-term policy rates.

The spread between the yield on 10-year (1.20%) and 2-year (0.11%) U.S. Treasuries was 109 bps on Feb. 12. It has averaged 93 bps since 1976 and 143 bps since January 2009 when the Fed first adopted a zero-interest rate policy. The spread was well above 200 bps and at times was close to 300 bps a decade or so ago. So, if the 10-year U.S. Treasury rises from 1.20% to say 2.00% by mid-2021 that would not be unusual.

As for the catalyst to waylay the bond market, I have one question: Is the U.S. Treasury market a true market anymore? The classic definition of a market that I learned is a willing buyer and a willing seller both with capacity to engage in a transaction and neither under duress to transact.

How is the U.S. Treasury market really a market when the Fed purchases \$80 billion of U.S. Treasuries and \$40 billion of U.S. Agency MBS each month from

dealer banks through creating bank reserves (which then sit inert on the Fed's balance sheet as a liability). Plus, the Fed buys regardless of the price.

Yes, many asset markets are inflated, and some valuations are absurd. A crash may or may not happen in 2021. However, I question the narrative that a sustained pick-up in inflation for goods and services versus assets will cause rates to rise sharply and thereby force the Fed to raise short-term rates. Who is to say the Fed cannot purchase all new Treasury issues? I think that is largely what has happened in Japan.

It is a mess with no obvious solutions, but I suppose the U.S. government will have sufficient financing to cut checks for whatever expenditures Congress approves.

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