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Intelligent Money

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The Great Bull Market in Bonds

It's been about thirty years now. Hard to believe. The United States has witnessed a nearly continuous rally in bond prices. Interest rates are near or at all time lows right across the board for government, agency, municipal, and corporate bonds. The great bull market in fixed income coincided with a substantial increase in public sector debt. How did we get here and what are the implications for investors?

How Did We Get Here?

Those of us old enough to remember the 1970s recall robust price increases. The US suffered from both high unemployment and high inflation in the late 1970s. We called it "stagflation". Federal Reserve Policy at the time had targeted interest rates which often resulted in higher money supply growth rates. Loose money coupled with supply shocks such as the Arab oil embargo caused dramatic price increases during the decade.

Paul Volcker was appointed chairman of the Federal Reserve Board by Jimmy Carter in 1979 and was given a broad mandate to tackle "stagflation". Volcker kept a lid on the money supply available to banks rather than control interest rates. The price of money skyrocketed and loan volume fell. The Federal Funds rate increased to 20% in June 1981. Other fixed income markets followed suit. Treasury yields climbed well into double digits.

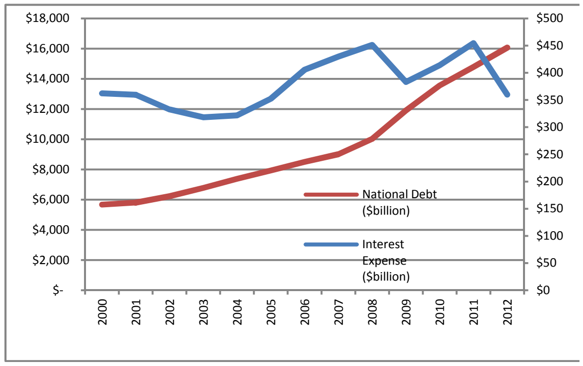
Volcker's tight money policy was successful in taming inflation... at the cost of a brutal recession. Prices increased at a rate of 13% in 1981 but inflation was reduced to 3.2% by 1983. The federal reserve had established its credibility as an inflation fighter. With inflation psychology driven from the marketplace, interest rates had much room to fall and, indeed, they have.

There were other factors that reduced inflation as a threat over the past 30 years. Globalization and automation have reduced the bargaining power of American workers. Commodity price shocks have been remarkably mild. In that kind of environment, lower interest rates can spur investment and employment.

Interest rate reduction has also become a "go to" policy response in times of economic crisis. The Fed publically stated that it would support the treasury markets in the aftermath of the stock market crash in 1987. More recently, the Fed provided massive support to all kinds of bonds during the subprime crisis. Its balance sheet increased by about $2 trillion in the space of few months as it drove bond yields to all time lows. The position of the dollar as the world's reserve currency has allowed the US to issue huge amounts of debt while paying fire sale prices on the loans. That position as reserve currency is not guaranteed indefinitely, however.

Winners and Losers?

The very low interest rate environment decidedly favors the borrower rather than the saver. The US government is the biggest borrower out there and one of the biggest beneficiaries of the current rate environment. Annual interest payments on treasury bonds have actually fallen since 2008 despite ballooning debt! The chart below illustrates:



The average interest rate on US government debt has been cut in half to 2.5% in the last five years. It doesn't take advanced math to figure that our interest cost (and deficit) would increase by $300 billion to $400 billion annually if interest rates returned to pre crisis norms.

The real estate industry is another winner with an easy money policy. Mortgage lending rates are at or near all time lows as of this writing. The average 30 year residential mortgage in the US today is only 3.32%. The government is not only guaranteeing

Louis Kokernak CFP, CFA
Haven Financial Advisors
Austin ~ Dallas
voice 512 791 4335
toll-free 800 898 5480
fax 800 888 5480
louis@havenfinancial.com

Special Notes of Interest:

In 2011, 7% of US companies contributed nothing to their employee's 401k plans, up from 2% in 2001.

The labor force participation rate has fallen to 63.6%, the lowest since the rate was compiled in 1983

Production of natural gas in the US has increased by one quarter in the last five years

"The biggest losers are probably much closer to home. Americans saving for retirement are facing a daunting task. The promised yields on today's bond investments struggle to keep pace with inflation".

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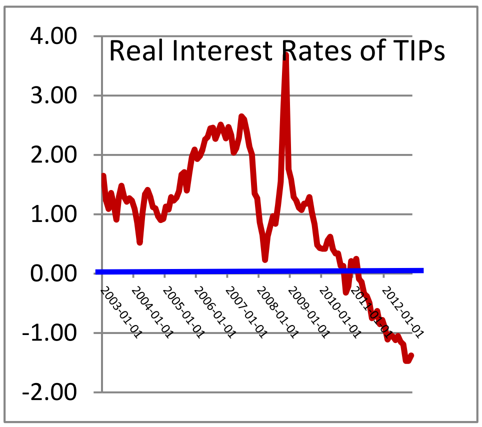
What about losers? Some argue that depressed interest rates in developed economies like the US encourage excessive capital flows to more fragile developing market economies with higher nominal interest rates. These flows may cause undesirable currency appreciation and create asset bubbles in markets with comparatively little liquidity.

The biggest losers are probably much closer to home. Americans saving for retirement face a daunting task. The promised yields on today's bond investments struggle to keep pace with inflation. The Treasury's own inflation-protected securities (TIPs) now offer investors a *negative* yield relative to expected inflation.



Other bond markets have rallied in similar fashion. In fact, prices are so high that it is mathematically impossible for investors to realize the same returns in the future that they have enjoyed in past decades.

Let's consider Vanguard's Total Bond Market fund(VBMFX). It is a good example of a high quality bond fund that tracks a broad fixed income index. The current yield to maturity on bonds in the index is 1.6%. That yield is far less than what investors have experienced in modern memory. The following table compares today's expected return with historical performance.

Time Period	Annual Return
1926-2011	5.6%
1970-2011	8.2%
1990-2011	6.8%
2001-2011	6.0%
Current Yield	1.6%

Investors have responded to these depressed interest rates by taking more credit risk. High yield (or junk) corporate bonds have received large inflows due to their comparatively high yields. Retail investors plowed about $69 billion into junk bond funds in the first three quarters of 2012. More junk bonds were issued in the first ten months of 2012 than in any other entire year.

There is nothing wrong with taking some measured positions among junk bonds. Actual corporate default rates are typically less than perceived default rates and that means that lower credits generate better returns in the long run. Even so, the headwinds of taxation and inflation make it difficult to retain purchasing power through fixed income investment.

What can investors expect? Going back to 1926, a diversified index of US bonds has returned 5.6% each year. As we've pointed out, that same basket of bonds today yields 1.6%. Assuming that bonds comprise about half of the typical investor's portfolio, expected returns should fall about 2% on the basis of diminished bond yields alone.

If we adopt a conservative expectation that stocks return 8% (long term returns are closer to 10%), then the expected return of 50/50 portfolio should be somewhere between 4% and 5%.

The good news is that even this diminished return expectation exceeds the inflation rate – thanks to continued low inflation. However, the fiscal situation of the US continues to deteriorate. Our current debt to GDP ratio exceeds 100% with massive entitlement liabilities looming in the future.

We already rely on the continued appetite of foreign investors to hold our debt. Today foreigners own about one third of our outstanding treasury bonds. China and Japan are, by far, our largest investors. There is no serious alternative to dollar denominated assets yet.

However, China is taking significant steps to liberalize its stock exchanges and to provide a liquid aftermarket for its bonds. Its currency, the Renminbi, may rival the dollar some day. If foreign investors had a real choice, they might sell huge amounts of treasury bonds. That would drive up interest rates or compel the Fed to inflate the currency to bail out the treasury. Either of these outcomes would be bad news for savers.