

Bonds: A Good Place Not to Invest Now

When the US stock market hit its initial 21st Century trauma phase in 2002, Merrill Lynch sought to boost its tanking retail business by blitzing television sets with a simple tag-line: “Buy bonds”, they said. Although at the time that campaign seemed to be more aimed at Merrill’s revenue than investment advice, it proved sound for both purposes.

Through September 2010, the Barclays US Long Treasury Index had returned an annualized 8.2% for the past ten years. That figure trounced all popular US and world stock indexes (except emerging markets) by a significant margin. The more generalized Barclays US Aggregate bond index also beat all the broad stock indexes, returning 6.4% for those ten years. That return was good enough to accumulate \$186 for every \$100 held in diversified, marketable bonds since October 2000, while a similar ten-year investment in the S&P 500 stock index would now be worth less than \$96.

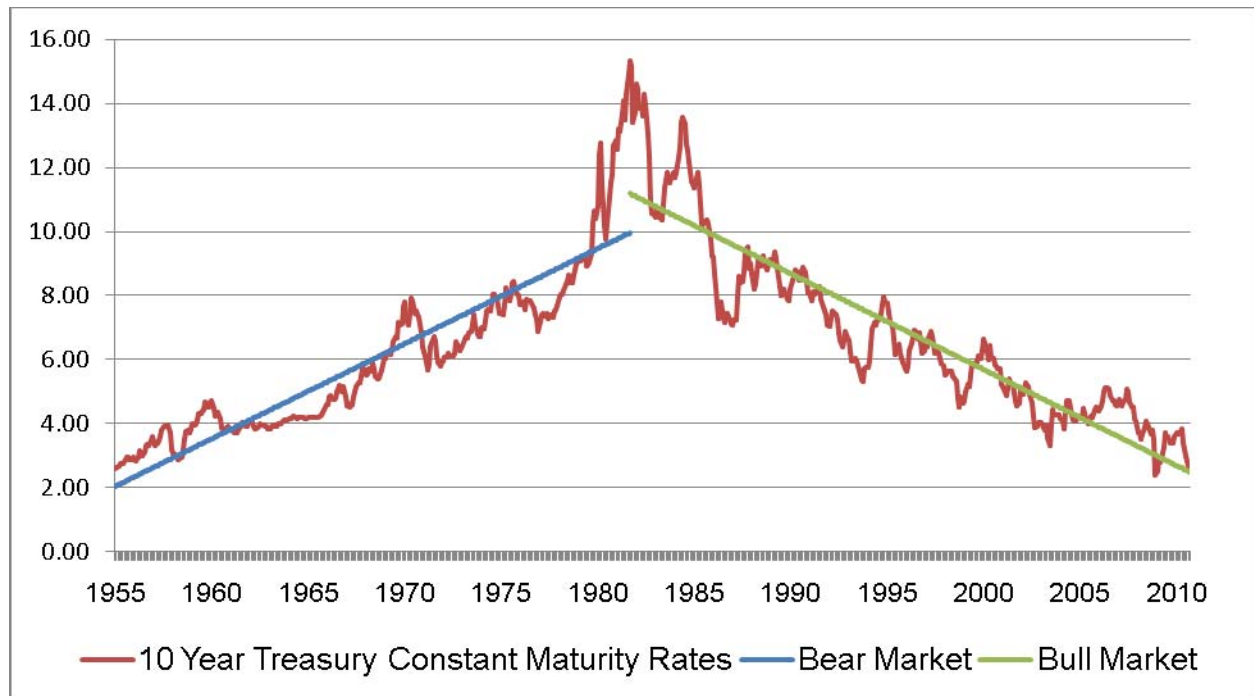
There is a single-source explanation for this historically very rare 10-year stint of bond returns above stocks. It was the US Federal Reserve Board’s persistently aggressive, deflation-fearing interest rate policy, which began early in January 2000. Indeed, the 2005-2007 home mortgage blowout was surely caused by manufactured securities, ginned up on Wall Street. But there was worldwide investor demand for a “decent” interest yield, as traditional US Government bond yields shrank under Fed pressure. Curiously, the Fed’s overdone stimulation efforts under Chairman Greenspan left his successor with a budding worldwide credit flashpoint that quickly spawned the most serious economic contraction since the lengthy, virulent 1930s crisis.

So, here we are in late 2010, with the Fed still promising near-zero interest rates as far out as the eye can see and expecting a 2nd round of so-called “quantitative easing”.... the Fed’s stimulation toolkit, consisting of various techniques for printing more dollars. The most imminent of these will apparently be monetizing the 2011 US Government budget deficit, via the Fed’s purchases of new Treasury debt (although we wonder how the Fed will

avoid buying up more toxic mortgage securities held by the twin black-sheep government wards: infamous Fannie and Freddie). This continued scenario, already declared “unsustainable” by Mr Bernanke and nearly everybody else, will set up the curious phenomenon we have been writing about for a couple of years: (1) the Consumer Price Index will show the economy is experiencing very low inflation, because the index is nearly one-half composed of depressed housing cost measurements, while (2) the real economy is experiencing what some will call hyper-inflation, caused by a necessarily declining US dollar that can purchase ever fewer units of globally-priced commodities. Soaring gold and, more recently, copper prices are already being joined by agricultural commodities. Since 2008, oil has done nothing to match its pre-2008 volatility; instead, it has quietly doubled its dollar-price.

All of this leads us to conclude that holding debt investments denominated in US dollars (or euros) does not face a promising future.... perhaps, the worst forward prospects in the past 28 years. The chart we created below clearly shows that we are either at, or near the end of a long bull cycle in bond prices attributable to falling market interest rates. In theory, the party could go on until 10-year Treasury bonds reach 0% interest yields. But, when we factor-in the added potential for the falling US Dollar to cause rising interest yields, we believe there are better intermediate term bets than bonds to be found at Las Vegas craps tables.

Despite the likely unattractive future for bonds, mutual fund investors have made steady net withdrawals from equity funds over the past year or so and plunked their money into bond funds. Large amounts of corporate pension money have been reallocated from conventional equities to long duration bonds, under so-called liability driven investing (LDI) programs and a surprising number of foundations and endowments joined the crowd that has locked-in their 2008 equity losses in order to fund bonds and alternative strategies. They may know some things that we fail to comprehend, but we are sure of one thing: such moves cannot be supported using market history.



Likely Scenario for US Stocks

Beginning in August 2010, we began to inform clients that our outlook for the near future of common stocks was decidedly positive. We continue to hold that view, for several primary macro-reasons which, in no particular order are: (1) Stimulative Federal Reserve policy is virtually promised for an extended period. This will eventually become a major problem, but for now, the markets will likely respond favorably. Whenever the debt market ultimately reacts to all of this, it will likely cause downward re-valuation of equities, as traders and investors alike adjust their earnings discount rate. (2) The aggregate share prices of the S&P 500 and other market portfolios was a modest 11-12 times its earnings, when most non-bubble market periods have supported a p/e multiple between 16 and 20. (3) Corporate cash hoards are enormous, debt burdens have been reduced or eliminated and costs/expenses are being carefully managed (job-creation, for a time, will largely be for temporary contractor positions); in brief, businesses are well set to produce profitable growth in a prolonged slow-growth economy; acquisitions will likely be on the increase, as slow-growth, cash-rich companies find faster growers to buy (unless equally cash-rich private equity funds snap them up first). (4) The falling value of the dollar will spur attractive US product prices in non-US markets; there are limits to this booster...other countries are likely to devalue their own currencies, before the dollar gets too far down. In summary, we look for solid, but not spectacular corporate earnings, especially from the

big-cap companies that have truly global businesses, and expanding earnings multiples in their market prices. (5) Massive amounts of cash are on the sidelines earning literally nothing; if the stock market sustains a smooth run for another month or two, it will likely become irresistible to those fearful cash-hoarders.

Likely Scenario for the US Dollar



Congress is Set to Reap its 2009 Whirlwind

If, and as Washington-based politicians continue to foster and feed the notion that it is they who manage and control the economy in mystical ways other than via the impact of tax policy, then US voters will apparently cast their ballots as if they believe it. When early November dawns, it seems certain they will have voted most incumbents out of office. Candidate Bill Clinton came to understand that his *comments* on the receding 1992 economy (to wit, "feeling their pain") was fundamental to his election

as president. In 2010, Democrats who claimed both ends of Pennsylvania Avenue in 2008 with the expectation that they would “fix” the economy have failed to deliver, because their mission... creating jobs... is a fundamentally impossible mission, without first creating an extensive federal public works bureaucracy to oversee vast infrastructure projects. Historical note: even the massive federal depression-recovery programs during F.D. Roosevelt’s first eight years as President fell short of restoring the US economy in the 1930s. Only a dramatic shift to 24/7 wartime production by private industry proved sufficient to put the Great Depression behind us.

In early 2009, the new President and his Democrat controlled Congress’s announced economic recovery plan to disburse \$787 billion of government “stimulus” checks promised to save and create millions of “shovel-ready” jobs. But, the curious implementation of the stimulus bill sent most of the money to state and local governments, so that they could avoid layoffs and service cutbacks; in 2010 however, with no more stimulus money, the states and cities were forced to undertake major layoffs and service cutbacks. Stimulus One’s confusing legislative process, massive deficit spending and lack of visible jobs-creating impact have sent it, and all of its incumbent elected supporters to the voters’ penalty box.

Prominent, left-oriented economist Paul Krugman has been very publicly prattling that Stimulus One failed to achieve objectives solely because it was undersized; perhaps so, but, as one pundit sardonically observed, Krugman’s not-enough (yet) theory will never be disproven, even if Congress were to enact Stimulus Two and, upon its failure due to insufficiency, Stimulus Three, and so on.

A simpler, more effective approach:
All wage-earning and self-employed Americans forego a significant chunk of their pay in the form of deductions to fund social programs, even when their situations are such that they pay no income tax. Wage earners who are paid less than \$106,800 face paycheck deductions of 10.55% for the twin, bankrupting Ponzi programs known as Social Security and Medicare, while a self-employed person whose gross business income is \$250,000, before costs and expenses (the “rich-line”, as defined by the Obama Administration) currently pays a handsome \$17,400 into these programs. The rapidly devastated US economy was/is said to be in urgent need of financial support. So, instead of Stimulus, Congress could have chosen a very rapid, direct, voter-friendly course: they might have helped wage earners and self-employeds to restore their consumption by temporarily suspending Social Security/Medicare

payroll tax collections. For businesses, Congress could have re-instated the successful Kennedy-era, 10% business investment tax credit (ITC), along with rapid write-offs of new equipment purchases. [Republicans would almost surely embrace such tax-relieving legislation and Democrats could lay claim to the fact that the ITC idea was taken from their playbook.] Thousands of pages are not needed for this pair of actions... *They would have produced instant pocketbook impact on: (a) every employed American and (b) every business of any size that chose to buy new equipment.....all without any need for new bureaucracy and all it designed to be temporary. (The ITC was temporary; it was enacted and suspended twice.)*