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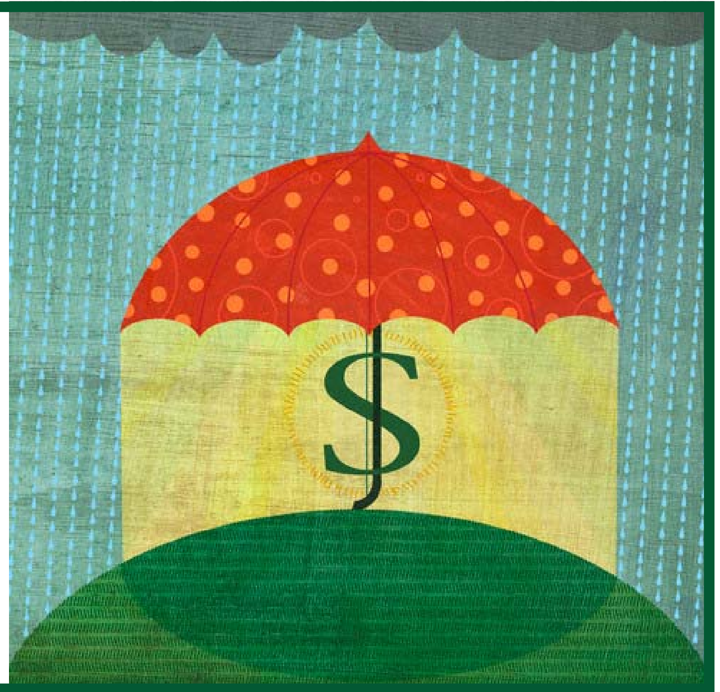
08/29/2012	Value	YTD %
Dow	13102.99	7.2%
Van 500 Index	$130.33	13.6 %
Van Total Bond Index	$ 11.17	3.4 %

SEPTEMBER 1, 2012



MEANWHILE...BACK IN THE BOND MARKET

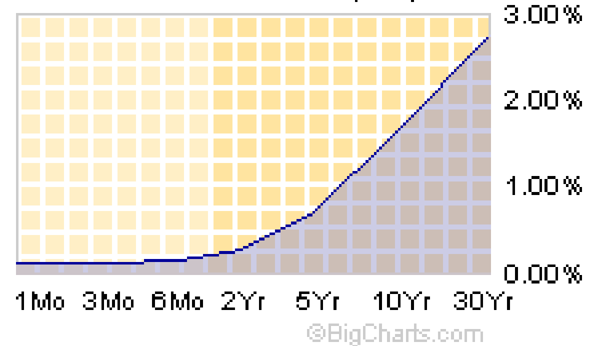
Current news is largely focused on the global economy and the stock markets of the world, as we watch European central bankers struggle to keep the Euro alive, and we live through the most meager economic recovery since World War II.

But while we ponder the stock markets, a lot is taking place in the much bigger bond markets. The bond markets are not only bigger, they are somewhat more influential, involving much more of our day to day lives. After all, a bond is just an IOU with a fixed maturity and, usually, a predetermined interest rate. Borrowing is key to the modern economy. After all, many more of us have owned a mortgage or a car loan than have ever invested deeply or directly in the stock markets.

Right now the bond markets are facing a very unusual situation. We don't genuinely know what will happen next: in some ways we've seldom been here before.

One key difference is that the interest rates paid by bonds are at historic lows. In some cases they are at all-time lows. This is because the world's central banks, such as the U.S. Federal Reserve, have flooded the world in money to reduce the impact of the Financial Panic of 2008, so supply exceeds demand, and the price of money has dropped dramatically.

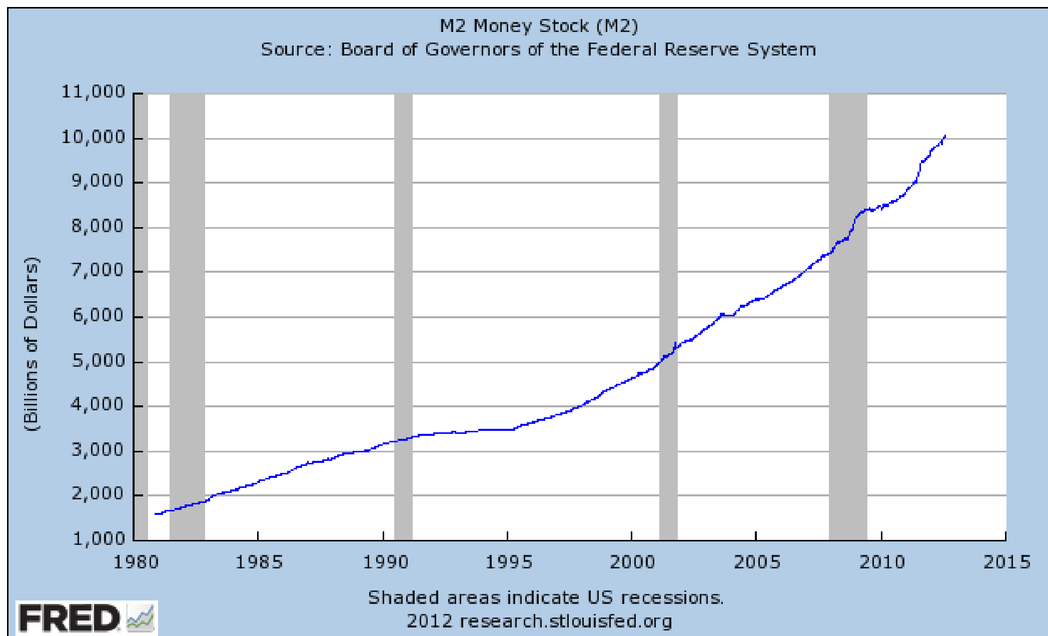
The one year Treasury note is now yielding 0.18%. The five year Treasury note provides an income of 0.7%. A ten year bond carries an interest rate of 1.65%. And investing in a Treasury note with a thirty year maturity will provide a yield of 2.76%.



Current interest rates seem hilariously low, as though our financial system is enjoying a massive dose of LSD. If these interest rates are good forecasters of the future, we are about to experience a thirty year long era of global economic stagnation unseen since the 18th Century. Fortunately for us, though, interest rates do not have a reputation as stellar economic indicators. In fact, interest rates have historically been rather bad predictors, except that inverted yield curves almost always indicate a recession ahead. But that's not happening here. To my mind, these interest rates are extreme outliers, and they indicate a "bubble" of bond pricing which must eventually burst, either slowly or quickly.

On the other hand, every time we think that yields can't get lower, they do. In fact, during the past few years we've even seen something which is as theoretical and ephemeral as the "multiverse" in physics: During recent brief periods of intense social anxiety, we've seen short term negative interest rates. These have represented the intense fear of investors who are willing to pay for the opportunity to invest in bonds which are regarded as "safe." Before 2008, this was unprecedented.

And yet, the irony is that we are awash in money. There's lots of liquidity in the economy and the banks. Check out the graph (below) of our money supply:



Clearly the money is there. It is simply that the social confusion we are now experiencing is causing people to not borrow or spend. Historically this has been fairly normal for a deep economic shock. Certainly we experienced something very similar during the Great Depression. How long this financial dyspepsia lingers will be determined as much by the public mood, by demographics, and by geopolitics as by anything overly economic.

In the world of investors, there is a deep hunger for safety and yield. So despite these historically low interest rates, people have been pouring money into bond mutual funds. According to Morningstar, investors piled $23.6 billion into bond mutual funds in July, while REMOVING $8.2 billion from stock mutual funds during the same month. It's worth remembering that fund flows are often reverse indicators of future performance.

In the process of seeking yield, investors have been stretching their average maturities, buying longer and longer term bonds or bond mutual funds in a largely futile effort to keep interest rate-based incomes from shrinking. In the process, of course, they have also been increasing their bond-related interest rate risk.

Investors are also moving towards lower quality bonds, since these reward the higher risk of owning them by paying higher yields. Buyers are forgetting that these lower grade, "junk" bonds suffered as much as stocks during the financial panic of 2008.

But the reality is that the financial implosion of 2008 has not reoccurred. Thus the top rated mutual funds are those which have taken the most risk to get the most yield or capital gains. The mutual funds which have played it safe during the post-2008 recovery have seen their ratings decline precipitously.

Meanwhile, the tax-free municipal bond market has encountered an additional set of challenges. The expected tax hikes in 2013 have increased demand for muni bonds, and thus has caused an upturn in prices with a commensurate downturn in yields. At the same time, though, cities have been driven to the financial edge by unfunded pension plans and tax shortfalls, and several have declared bankruptcy, thus signaling that the underlying credit worthiness of some municipal bonds might be suspect. In the past few weeks, Warren Buffet's Berkshire Hathaway Corporation has terminated $8 billion in municipal bond credit default swaps. This suggests that the Wizard of Omaha is seeing more risk than benefit from insuring munis. But so far, the overall muni market has remained surprisingly robust, driven by investors' desire to avoid taxes. Since 2008, mutual funds investing in municipal bonds have benefited from taking risk and extending maturities, while safer funds have lagged.

Thus it is very possible to find a relatively high-risk bond mutual fund sporting a five star ranking and a higher yield, while a relatively bullet-proof bond mutual fund might have a two star rating and a much lower yield.

I've been gently moving us towards caution. I have been mildly trimming our more ostentatiously successful bond mutual funds to garner a bit more safety. Some municipal bond funds have been trimmed back, as have our longer-maturity mutual funds. Lower-rated yet safer bond mutual funds such as FP New Income remain in our lineup, while more aggressive funds have been sold. I'm also purchasing a wider spectrum of short-term bond funds to add diversification. My perception is that these funds are designed to keep us rich, not make us rich. In today's uncertain environment, capital preservation ought to be our primary goal. ■