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Your guide to understanding
today's economy and
financial markets

August 24, 2010

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Bubble Bonds

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One investment “rule of thumb” that has traditionally developed is smaller investors are usually late to the game...and thus expose themselves to higher levels of risk when a market bubble leaks, bleeds, or bursts. Such a time could easily be approaching in regard to the purchase or continuing ownership of bonds.

Tens of thousands of smaller investors have grown frustrated with the dismal overall performance of most stocks (also known as equities) during the past decade. Many of these investors in the past would have simply shifted some of their investment funds to financial institution savings accounts and certificates of deposit.

Many investors like the ability to sleep at night, knowing that deposits of up to \$250,000 are guaranteed by the FDIC. Most recognize that while interest rates are extremely low, inflation pressures are also historically low.

For other investors, the low interest rate on such savings accounts and CDs has led them to seek higher returns. Bonds...especially U.S. Treasury notes and bonds...have been extremely popular, whether owned as individual securities or as part of a bond fund.

The Investment Company Institute reports that from January 2008 through June 2010, outflows from stock mutual funds totaled \$232 billion. During the same time period, bond funds saw an enormous \$559 billion inflow (*The Wall Street Journal*).

For those who shifted money into bonds or bond funds earlier this year, the returns have been attractive. For those who are considering such an investment now, the risks are extremely high.

The Other Risk

Human nature suggests that thousands of average investors who bought bonds earlier this year have boasted to their families and friends about the attractive returns they have generated by buying longer-term U.S. Treasury notes or bonds. As their buttons are bursting from their chests, they also note that these returns have been generated from investments that are U.S. Government guaranteed...

...They are somewhat correct

...and they are woefully misinformed

For example, an investment of \$100,000 into the 2.625% 10-year maturity U.S. Treasury note due on 8/15/2020 (bought at face value or par) is guaranteed by the U.S. Government as to semi-annual interest payments of \$1,312.50 on February 15 and August 15 of each year. In addition, you will receive back your

\$100,000 principal investment on August 15, 2020.

This security has no “credit” risk. Believe it or not, debt issued by the U.S. Government to finance enormous budget deficits is still considered the safest, most liquid (marketable) investment in the world. It is this assurance that helps people sleep at night.

However...and this is a BIG however... the investment is still subject to “market” risk. The value of the bond fluctuates daily, based on the general movement of interest rates.

Since the 1950s

The 10-year U.S. Treasury note yield (investment return) at mid-day on Tuesday, August 24 was 2.53%. The 30-year U.S. Treasury bond yield was 3.62%.



With the exception of a few weeks very late in 2008 and very early in 2009 at the height of the global financial crisis, current yields are the lowest in more than 50 years, since the 1950s! The same is true for 15- and 30-year fixed-rate conventional mortgages, which averaged 3.90% and 4.42%, respectively, last week.

Long-term interest rates have fallen sharply in recent months because of high anxiety about slowing global and U.S. economic growth, as well as high anxiety about possible default by Greece and other southern European nations. Possible deflation in coming years, as well as stocks going nowhere in recent months have also contributed to rising bond prices...and lower yields.

Barring another global economic or financial meltdown, or other major hits to the U.S. and global economies, such long-term interest rates are not likely to move much lower. Yes, some suggest we could see a period of deflation in the U.S. economy, as discussed in last week's issue of the *Tea Leaf*. Under such a scenario, long-term interest rates could move even lower.

The Party's Over?

However, most economic forecasters and financial market professionals suggest that the amazing and largely unexpected decline in long-term interest rates has about run its course. They would suggest that the primary direction of long-term interest rates later this year and throughout 2011 is to somewhat higher levels. They point to the fact that while the U.S. economy has definitely slowed down in recent months, the odds do not favor a return to recession.

Note: We do know that the first U.S. Commerce Department estimate of a 2.4% real (after inflation) annual growth pace during 2010's second quarter could be roughly cut in half when the first revision is released on Friday of this week. The consensus forecast for U.S. economic growth during 2010's final quarter and for 2011's first half is near a 2.5% annual growth rate.

Forecasters might note that there have been 33 official recessions since 1850, and only three times has the economy

fallen back into negative growth within a year, according to the National Bureau of Economic Research, the official scorekeeper for the U.S. economy (www.Bloomberg.com).

...but I digress

The point is that a meaningful rise in long-term interest rates in coming months or quarters—when and if it does occur—will lead to sizable investment losses for many previous (and especially) new investors into direct bonds or bond funds.

Two Risks

Financial market emotions can turn on a dime. At some point, high anxiety about \$1,000,000,000,000 and larger annual budget deficits could (or will) return. All of this excessive government spending must be met with borrowed money...much more borrowed money. Long-term interest rates could easily rise.



For example, if 10-year U.S. Treasury note yields were to rise one percent in coming months, simply back to the still low 3.53% level of last Spring, an investor buying notes or bonds today would have a 9% loss of principal should they need to sell...a loss of \$9,000 on a \$100,000 investment.

A similar 1.00% rise in the 30-year U.S. Treasury bond yield to a still low 4.62% would create a principal loss of nearly 20% for an investor buying the long bond today and needing to sell later... a loss of nearly \$20,000 on a \$100,000 investment! An investor in a long-term bond fund would see similar losses, while an investor in a shorter maturity bond fund would lose less...

Understand that a U.S. government guarantee applies to *credit* risk only...

...*market* risk is a whole 'nother animal

“TEA”ser

Golfer: “That can't be my ball, it's too old.”

Caddy: “It's been a long time since we teed off, sir.”



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