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Consultants, Brokers and Agents
.....a financial **engineering approach**

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Why We Think it's Time to Sell Your Bonds!

This is a hard one to write. We have been bond buyers for our clients for 30 years, starting out with municipal bonds and most recently (the past 15 years or so) in the mortgage-backed markets. Owning bonds for income and security has been a core focus of our practice.

They have worked for a long while because:

- Interest rates have been on a long-term downward trend. This makes bond prices go up, and allows the issuer to refinance the debts they owe us at lower rates and hence, make their promises to us safer.

- The credit quality of our issuers has been excellent, due in part to lower costs of doing business. Such lower costs include increased productivity, lower interest rates, and a world-wide building boom increasing the tax bases of our municipals and the values of businesses and individuals in general.

- The "implied promise" of our government to back the government-sponsored entities (GSEs) Fannie Mae and Freddy Mac, was very comforting and reassuring; this for mortgage-backed securities only.

- Foreign governments have been willing and able to purchase the mortgage-backed securities and US government debt, this to a large supply of dollars they are accumulating that needs to be put to work in dollars, and a desire to support our dollar which we have been sending them in incredible amounts via our trade deficits.

- Our inflation rates have seemingly been under control by the Federal Reserve. Interest rates must reward investors for the loss of value caused by inflation, risk of loss of the principal and in part, taxes, and for the use of the money.

While all these trends, to one degree or another, were in place, bonds looked like a great deal for investment dollars that needed to be safe and income to be generated from it.

Trouble is, these trends may no longer be in place, especially lately, because:

- Long-term interest rates may not be going lower. With the experiences of the recent past, foreign investors (be they institutions or central banks) will want more return on their cash as they now know what kind of volatility they can be put through. It is unlikely that they will accept the same low rates of returns as they have in the past.

- These foreign buyers may not have the positive cash flow from us due to the economic slowdown we are in and further, may need to sell bonds in order to finance their own stimulus programs now and in the future.

- Our large surplus and huge budget deficits could cause the dollar to decline; hence, the investors may demand even more interest on their new purchases to compensate them for a declining dollar, or risk thereof, and possible reduced credit quality of the US government, municipalities and GSEs.

- A general lack of trust and confidence in the US financial system and the institutions that issue the debt. No one knows the future of the GSEs, who will back them up, and how housing will be financed in the future. The longer term the debt, the more this lack of confidence could cause the return on those bonds to be higher, which is of course the rate of interest.

- The current level of bond prices might in 6 months be referred to as its own bubble as it seems a lot of money is hiding out in those investments with yields that are incredibly low. As I write this, the 10-year treasury bond is yielding a scant 2.96%.

- With the Federal Reserve tossing in trillions in liquidity and reducing short term rates (which don't directly affect the long term yields) it seems pretty logical that once the economy starts humming again we are likely to have a large inflation hangover due to these massive amounts of cheap money. (It's like adrenalin which has been injected into the worldwide financial system.)

- As Warren Buffet has been saying: "When the tide goes out you see who is swimming naked." What he means with that, we think, is that when the ugly head of risk and volatility surfaces, it becomes apparent who is taking risks they don't understand. It's likely that a lot of people who now own bonds didn't understand the risk that they were taking when they bought them. This is true not so much for individuals but for countries and institutions. When the tide comes back in these people will want bathing suits before they venture back into the water; those bathing suits will be paid for with higher rates of interest.

Of course there are things that might go right for bonds…here are a few:

- As the system de-leverages (less debt out there) there should be less issuance of new bonds (not so in the near term for the US government, with perhaps a trillion dollar deficit). Fewer bonds out there may mean that the supply and demand curve to start forcing the prices higher.

- A prolonged economic slide (this one feels prolonged but really isn't yet) could cause the demand for bonds to fall and the competing investments to not look so good. Hence, an increase in demand, and higher prices and lower yield.

- If our view of the future is even a little bit true, and individual savings rates increase, this might bring confidence back into the bond markets and reduce yields.

Our perspective on the future is that we will survive the mess we have been through, but we will not get back to normal. This de-leveraging will fundamentally change our society and this change (as we have described in my prior letters) will reward more appropriately the risk that people take. This reward, like those bathing suits, will come in the form of higher interest rates and lower bonds prices.

Now, we don't think that the bonds will default or fail to pay interest because of these trends. Likely they will just trade lower in price to compensate for the lack of confidence, greater perceived and actual risk, lack of foreign buyers and the other risks I have discussed.

This may affect the corporate and municipal buyers as well as the mortgage-backed issues, because the higher yields on the government and the mortgaged backs will compete with and force all yields higher.

We think further that the competition that the bond market faces from the lowest relative stock prices and highest dividend yields we have seen in decades will be the final blow.

Hence, in part because of these reasons we do not want to make further investments in the bonds markets and if a good opportunity comes to get out of bonds and invest in dividend-paying stocks we will jump at that chance.

We feel that bonds are likely more valuable now in the markets than they will be in the future, while stocks are less valuable than they will be in the longer term. Moving from one to the other seems to be both logical and appropriate.

Sincerely,

Charles Stoll

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