MARKET MONITOR

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Don't Abandon Bonds Because of Poor Returns, Apocalyptic Predictions and Complex Pricing Behavior

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Warren Buffett liked to say that you should be fearful when others are greedy and greedy when others are fearful. His rule wasn't strictly related to stocks but to all investments, including bonds. Bonds have been an asset class shunned by many investors and even those investors for whom they might be most beneficial. People have criticized bonds for being too conservative because their returns are too low while others avoid them because of the counterintuitive way that bond prices react to changes in interest rates. Ironically, an investment made to help conservative investors preserve capital is often suspiciously viewed as an arcane instrument devised by Wall Street bankers to bilk money from mom and pop.

Other investors misunderstand the risk to U.S Treasury bonds that they hear described as the "risk free asset." The risk-free rate of return, which is the more precise term used when referring to Treasuries, was developed by finance professors to help them build securities pricing models that calculate the required premium to earn over a comparable risk-free rate of return. The asset that comes as close to accurately reflecting that is the U.S. Treasury bond. However, those that express supreme confidence in owning Treasuries to avoid all risk should consider that in the past 10 years the 10-Year Treasury note index has lost money 40% of the time. That's hardly the performance of a risk-free asset. All investments have risk, as do U.S. Treasuries. Just ask the investors who bought a long dated bond when rates were 4% and they believed that locking in that rate for the next 10 years would allow them to earn an attractive rate of return without having to worry about the chance of a default. Now that rates on the 10 year note have surged higher to 4.75%+ the investors who are holding the 10 year bond with a 4% coupon own bonds that may have a loss 6%-7% of their original principal value because they're earning less interest then the new bonds being issued at 4.75%.

So, contrary to what seems to be the logical result of rising interest rates, bond values do drop when rates go higher. Maybe the best way to remember this is to think about the investors mentioned above that hold bonds that are paying rates lower than the current market rate and ask yourself, "would I rather be holding a bond with a higher rate or a lower rate?" You always want to be the lucky investor who buys bonds at their peak interest rate, because you'll earn more interest income than the guy who is holding the lowest yielding bond who bought a dud or in investment analyst terms - an overpriced asset. Don't allow this inverse pricing quirk to bonds be a reason that you avoid them, but think about it as an investment opportunity as people do when the stock market drops. When bond values drop because interest rates have gone up, it's good to consider whether now is an opportune time to buy something that has become cheaper.

Investment Returns - Selected Years

Year	S&P 500	10 - Yr Treasury
1973	-14.31%	3.66%
1974	-25.90%	1.99%
1977	-6.98%	1.29%
1978	6.51%	-0.78%
2013	32.15%	-9.10%
2018	-4.23%	-0.02%
2021	28.47%	-4.42%
2022	-18.01%	-17.83%

But just how much cheaper have they become is the $64K question. A commentary written by an operation known as Valens Research, cites the opinion of a private equity titan, Apollo Global Mgmt., that declares the trouble in the bond market has only begun because corporate defaults forced by the Fed policy of "higher rates for longer" will eat up business cash flows with higher debt payments, causing the $750b in bonds set to mature over the next two years to run into funding problems. On the flip side is the largest bond manager in the world, Blackrock, that says, "buying longer-duration bonds now is a once-in-a-generation opportunity." Depending on the advice you follow, you'll either sell all of your bonds or load up on the riskiest long-term bonds. Or maybe choose a less radical option where you split the difference?

If we let history provide some guidance, we could look at the last ugly period of inflation and consider how bonds performed in the 1970s. When the Bretton Woods accord

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A Bear Market Case for Bonds or 7 Years of Gains?

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collapsed and Nixon took the country off the gold standard so he could spend money like the Keynesian he proclaimed to be, fiscal/monetary conservatives were surely convinced that our economy was doomed to have stagflation for decades. You might be surprised to learn that from 1970-1979 there was only one year that bonds posted a negative return and the ten year average return was 5.58%. During the same time stocks lost money in three years but averaged 7.52%. Inflation took a bite out of these returns, but nevertheless the nominal results were positive. What is worrisome for our current decade is that bonds have been negative for 2 of the first 3 years and it appears they might be heading for a third year out of four at the end of 2023. From 2020 to 2022 bonds have an average return of -3.64% and the results appear to be heading south.

Maybe we are in a bad history making decade caused by extremely sloppy monetary and fiscal policy as we had in the 70s? In 2009 our country seemed to develop the delusional idea that we can spend all we like because the government can print more money. This has a name: Modern Monetary Theory. We have printed about a net of $7.25 trillion since 2009 with most of it occurring in 2020 and 2021. This, as we know, has caused inflation that may be around for a while longer and could keep interest rates high and make it hard for bonds to make money. This is the bear market case for bonds. A more optimistic view would be that most of the difficulty in the bond market has been experienced especially if we record a 3rd consecutive year of losses and that bonds will be due for a turnaround, caused by lower inflation and a Federal Reserve that might start to lower rates and possibly find it possible to curtail its quantitative tightening (QT) policy which has put more upward pressure on interest rates. Under this scenario, bonds could finish this decade with seven consecutive years of gains and still underperform the 1970s, which doesn't seem to be too much to ask.

Market Snapshot:

Bonds are in Charge and Driving the Stock Bus

BY: MICHAEL ALEXENKO, CFA

How would you feel if the investment you own was prone to daily price swings of 3% of its principal value? For the DOW 30 that would mean regular 1,000 point daily moves. This is the type of volatility we've been experiencing in the bond market but it's disguised because of the way the change in bond values is reported. The 10-year Treasury note as the "risk free asset" should not be having price changes of 2%-3% daily. This is occurring because our government is issuing a massive supply of bonds to fund a $2 trillion annual shortfall, while at the same time the Federal Reserve is selling off $100 billion of Treasury bonds each month. Add to this that countries like, China, Russia, Iran, Saudi Arbia, Turkey and Venezuela are also selling their Treasury portfolios for political and economic reasons. The concern on Wall Street and Main Street alike is that our government is unnecessarily running a deficit that is at least twice as large as it should be when we have 3.5% unemployment , and we are still facing a real threat of recession next year. Until there is some more evidence that inflation is coming under control, that the Federal Reserve is ready to stop raising rates and that some fiscal sanity hits Washington D.C., the bond market will continue to be the center of attention. Fiscal sanity is probably the most difficult to achieve, but 2 out of 3 could be the treat or maybe do the trick?
Happy Halloween!

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