Rapport

Surviving the Bond Market Meltdown

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Surviving the Bond Market Meltdown

Although one could argue that the U.S. Federal Reserve Board – through record-low interest rates and a substantial increase in the money supply – may have overplayed its deflation card and is now laying the groundwork for an inflation run up as early as next year, it would be safe to suggest that the twenty-two-year-long trend of falling interest rates likely hit rock bottom as of mid-June 2003. In so doing, it reversed a three-year-long rally in which bonds sharply outperformed stocks, the first time that has happened since the Great Depression of the early 1930s. The 14 percent sell-off in thirty-year U.S. Treasury bond futures over the subsequent ten weeks was the fastest since the 12 precent drop in 1987 and the most severe since the 21 percent collapse in 1994. If nothing else, it is a vivid reminder to all of us that being fully invested in bonds is as hazardous as owning only stocks and stock mutual funds.

The implications could be far reaching if the decline in bond prices was to persist. Mortgage rates would rise, causing a slowdown in housing construction. A reduction in mortgage refinancings would impact consumer spending. Governments and corporations would have to pay more for borrowings and business spending could fall. Such would negatively impact both common share and trust unit prices. In sum, everyone might get hurt, especially those who have become hooked on falling interest rates!

That said, all is not lost! The recent rise in rates is really not all that worrisome for the moment as it appears to reflect a receding fear of deflation and increasing confidence about the strength of the economy, and demand for loans. With economists scrambling to raise 2004 forecasts for GDP growth, it is only natural that rates would rise. Notwithstanding, current levels still reflect an assumption that inflation will remain very low for some time to come.

Given so much as a four percent annual growth rate in GDP, it still might not be enough to make much of a dent in the output gap – the difference between how fast the economy is growing and how fast it can grow. As such, it can probably run full speed ahead for as long as two more years before the Federal Reserve Board might feel compelled to raise short-term rates.

However, if the massive fiscal and monetary stimulus pumped into the U.S. economy over the past while was to rekindle inflation two or three years from now, increasing the need for the U.S. government to sell bonds to pay for the mounting federal deficit and causing rates to move still higher, it is unlikely that ten-year U.S. Treasury notes would trade at rates much greater than 5.5 to 6.0 percent, up from 3.07 percent in June 2003, the lowest level since the late 1950s. If such were to come to pass, interest rates would still be a far cry from the 15-plus percent levels of two decades ago.

Though rising bond yields will slow the growth in earnings per share and, thereby, tend to temper earnings multiple expansion, common share and trust unit holders need not get their knickers in a twist for the moment as the stock market seems to want to go higher in the next while, whether you or I are aboard for the ride or not!

The outlook for the North American economy is not without its challenges: high and unsustainable debt levels for governments, corporations and consumers; huge underfunded pension liabilities; a massive number of bankruptcies; a dirth of savings; record trade deficits; continued weak economic growth in many other countries; and ongoing geopolitical risks.

And lest we forget, the last two bond bull markets ended (in the early 1940s and late 1980s) with high quality U.S. long-term bonds yielding less than 3 percent, around 2.5 percent as an average. Please remember too that experience rules against the forlorn hope that the big winners of the last bull market for stocks will be the leading lights of the next. As such, it is little wonder why the gold bags are out in full force and are feeling so good about themselves these days and why some of us are calling for everyone to be aware of the ides of the stock market.