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H. Bradlee Perry
Marble Harbor Investment Counsel Advisory Board Member
Investment Consultant

Here We Go Again – Another Bubble

In the past 33 years investors have experienced three huge bubbles in the stock market (oil stocks in 1979-80, technology in 1999-2000, and housing and financial stocks in 2003-6). In each case investor enthusiasm drove the shares of a group of companies that were generating exceptional profit growth *at the moment* up to ridiculous, unsustainable price levels. Then, when earnings gains slowed down, to a more normal pace or less, stock prices collapsed. Declines over the ensuing two years ranged from 45% for oil shares, to 85% for the tech group, and 85% for both housing and financial stocks.

Today we're well along in a different kind of bubble, but certainly it has reached a precarious state of risk. Surprisingly, this one is in <u>bonds</u>, good old stable bonds, not stocks. Also different is the source of this bubble. It's not the "irrational exuberance" of emotional investors. Instead it's the result of a carefully considered decision by dispassionate, presumably rational people, the leaders of the Federal Reserve System, who were pursuing a legitimate objective.

When the housing bubble burst in 2007-8, banks began to lose gobs of money in bad mortgages. This soon eroded their capital, pushing a few right into bankruptcy and many to the edge of the cliff of failure. So Congress and the Federal Reserve, with uncommon speed, jumped to the rescue – lending money to all the weaklings and buying their bad assets. Fortunately, this vital action did prevent a total financial collapse, which would have caused a major business depression such as devastated the world in the 1930's.

But the aftermath of this near-miss has proven to be quite difficult. Despite surprisingly rapid healing of the banks, the economy has failed to recover in similar fashion. The rebound in business activity, and particularly in employment, has been distressingly slow. So to alleviate that problem by stimulating the economy, several years ago the Fed began a program that came to be called "Quantitative Easing," aimed at increasing the quantity of money in the financial system.

This entailed large-scale Fed purchases of government bonds and mortgage-backed securities. Through three iterations, called QE-1, QE-2, and QE-3, the pace has accelerated to a present buying level of $85 billion a month – cumulating so far to a total of nearly $3 trillion of new money poured into the economy.

The aim of QE has been to drive down interest rates and push up the prices of stocks and other assets, which officials hoped would stimulate borrowing, spending, and rehiring of laid-off workers. But this has not worked out, at least yet. As Martin Feldstein, Chairman of the Council of Economic Advisers under President Reagan said recently, "the program has done little to raise economic growth while saddling the Fed with an enormous balance sheet . . ." (overloaded with bonds). Perversely, the QE programs have mainly boosted leverage and risk-taking in investment markets.

The main impact of this massive easing of money has been to drive bond prices up to unimaginable highs and interest rates down to the lowest level in the history of our country. That has been fine for all the owners of bonds, but now bonds have risen so much that there is great risk in all their prices, beyond issues with very short maturities. Over time valuations of all securities eventually regress to their normal levels, and bonds are quite certain to at least head back *toward* normal sometime in the next few years. The timing of that, of course, will depend on when the Fed decides to gear down and then stop its aggressive easy money policy.

When this happens, the adjustment in bond prices will be large. How great is indicated by how far below past norms interest rates are today. Here are a few figures on that, comparing present rates with those in the most recent periods of normal economic activity and normal bond market conditions.

10-Year U.S. Treasury Bonds

	Yield
Average 2001-2007	4.50%
2013	2.00

30-Year U.S. Treasury Bonds

	Yield
Average 1995-2007	5.30%
2013	3.20

High Yield Corporate Bonds

	Yield
Average 2003-2012	10.00%
2013	4.90

Obviously present yields are extremely low by all past standards. And in the corporate market there are some striking examples of this. The first came in 2011 when IBM flabbergasted investors by successfully selling a 3-year bond issue at just 1.0%. Given that typically short-term borrowing rates for high-quality corporations had averaged 4.0-5.5% under normal conditions in earlier years, the only appropriate adjective for that rate was "incredible."

That was followed more recently by a 5-year Microsoft issue yielding 0.99%, a 10-year Nike bond at 2.27%, Berkshire Hathaway 5-year debt at 1.3%, and two startling Apple issues, a 3-year at 0.45% and a 10-year at 2.42%. No wonder investors who need decent incomes to cover their basic expenses (both individuals and institutions) feel greatly disadvantaged by the Fed's current policy – even though they appreciate its desire to boost the economy.

In addition to very high prices, the current bond market is marked by another symptom of bubbles: a downgrading of quality as investors chase greater potential returns. This shows up in the high-yield sector, where issuance of new "junk bonds" (as they used to be called) has almost tripled from an average of $100 billion a year in 2005-9, to just over $200 billion in 2010-12, and an annual rate of $285 billion in the first four months of this year. And this has occurred while the interest rates on these low-grade bonds have fallen by half. Today's yields on them are, of course, the best available in the market; but they, too, are very low by historical standards – which makes them quite risky.

Illustrative of not heeding past lessons, bonds without most of the normal restrictive "covenants" that bonds usually contain (including limits on debt ratios and adequate coverage of interest charges by current cash flow) are becoming popular again. Memories of previous heavy losses in "cov-lite" bonds seem to have faded away. Remember the words of the old Peter, Paul, and Mary song, "When will they ever learn?"

Covenant-Light Bond Issues

2007	$140 billion
2008	0
2009	0
2010	8
2011	40
2012	60
2013	120 (4 months annual rate)

Not surprisingly, the biggest buyers of these bonds, through pooled funds called "collateralized loan obligations," are state and local pension funds. As I've written previously, their super-generous pension commitments to public employees are greatly underfunded, and they are desperately seeking high yields to catch up. This is why about 66% of all public pension fund assets are now invested in the riskier alternative investments sector, vs. 48% for corporate defined benefit pension plans. How this will work out remains to be seen, but certainly there will be some costly losses.

Today the big question in investors' minds is when will the Fed start to reverse its extreme easing policy and head back toward some sort of normal interest rates? Until recently, they have said they won't do that until the unemployment rate has declined from its present 7.6% of the workforce to 6.5%, and economic growth has picked up from its current slow pace. The Fed's comments over the past year have implied they think that may not occur until 2015. But recently some Fed officials have hinted they might make small moves to reduce their easing sooner than that. So, as Jon Hilsenrath and Victoria McGrane observed in the May 23 issue of *The Wall Street Journa*l, the Fed has left the market guessing, with a blurred picture of what's to come.

Clearly the credit barons don't know when they'll take the first steps, so neither can investors know. It depends greatly on unpredictable economic numbers. But eventually the Fed will have to act, either because of an improved economy or QE's creation of excess money that starts to build threatening inflationary pressures.

A closely related question is how can the Fed successfully engineer a *gradual* pricking of the gigantic bond market bubble, enabling a smooth transition back to normal interest rates that would prolong the inevitable price declines in intermediate-term and long-term bond issues. The scope of this problem is illustrated by the size of the ultimate price declines that must occur eventually to get prices back to normal. The figures below show what would happen if prices reacted fully *at once*. But if the adjustment takes a few years, the movement of bonds toward maturity values would cushion their declines a little.

U.S. Treasury Bonds

	Current Yield	Past Normal Yield	Immediate Price Decline to Get to Normal
10-Year Maturity	2.10%	4.50%	- 20%
30-Year Maturity	3.30	5.50	- 33

The difficult with this uncertainty is that even if the Fed does slowly reduce their buying of bonds under QE-3 before stopping altogether, once they change course at all, investors are likely to say, "OK, it's a new ballgame; the Fed is moving back toward normal. We don't know when they'll get there, but that's where they're going. So, gradual as *their* transition may be, *we* have to prepare right away for the eventual end by selling lots of bonds now."

And if investors come to that conclusion, it seems to me that even if the Fed proceeds very gradually, trigger-happy investors may head for the exit in a big rush. This isn't certain of course, but investors tend to react very quickly to new developments nowadays. And *if* they do in this case, they could sell in big volume – causing prices to plunge and bond yields to rise much more rapidly than the Fed's intentions.

Another possible scenario is that after the U.S. economy fully recovers, it will grow more slowly than in the past, causing interest rates to remain somewhat below prior norms. This would moderate ultimate bond price declines, but they would likely still be quite substantial from today's lofty levels. We're really sailing in uncharted waters there. There has never been such a massive program of monetary easing before and thus never a reversal of monetary policy on the huge scale facing us now. So <u>no one, including the Fed, can predict what will happen</u>. All we can say is that there is the *possibility* of a big drop in bond prices ahead in the next few years. And from an overall financial perspective, this is very important because the bond market is nearly twice as large as the stock market in size of assets. So while the percentage price declines here are sure to be quite a lot smaller than the plunges in stocks after their big bubbles burst, the aggregate dollar losses in bonds may be very large. Even if this does not happen, it's better to be prepared for the possibility and not have it occur, than to be unprepared and get socked by a big slump.

If the most favorable scenario possible occurs, and interest rates rise only slowly over the next few years, bondholders are still likely to experience at least moderately negative total returns. This would be because price drops would almost certainly be somewhat greater than the present very low interest rates on a majority of all bonds outstanding today. A 5% price decline on a 3% interest-paying bond obviously won't provide any money to buy groceries or pay professors' salaries.

It is likely that a falling bond market would tend to push stock prices down somewhat, too. But that would be cushioned by the fact that stocks today are close to their historically normal valuations, while bond valuations are in outer space. I've always said price risks are determined by degrees of over-valuation.

Obviously the way for investors to protect against losses in their bond holdings if a big decline does occur is to own only bonds scheduled to mature in the short-term, no more than a few years out. Such bonds are so close to being paid off at par, if the issuing agencies and companies are financially sound, that bondholders with short holdings will experience little price shrinkage.

Of course, there is a sizable cost to having such protection: today's extremely tiny yields on short-term bonds. But that looks like a very worthwhile "insurance premium" to pay for virtually complete principal protection for part of one's portfolio in a generally risky investment environment.

This makes sense when we consider that typically investors own bonds for two reasons: a generous fixed income that they can count on and usually relatively low market price volatility versus all other types of investments. In today's uncertain world, price stability has to be an important component for part of almost every investment portfolio, and short-term bonds do provide that. So the temporary lack of income on those investments seems to be a sacrifice worth making.

This discussion reminds me of the old Chinese curse, "May you live in interesting times." We certainly are with respect to the most exceptional bond market in history.

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Marble Harbor Investment Counsel, LLC
101 Federal Street, Suite 2505
Boston, MA 02110
617-956-6710
www.MarbleHarborIC.com