BARNETT & COMPANY Investment Counsel

Perspective

The Sorrow in Being Safe:
The Ongoing Decline in Treasury Bond Prices

In 2008 the only category of investments to post a positive return was United States Treasury securities. No other asset class could match the returns of Government debt. By category the Barclays Government Index (formerly the Lehman Brothers Index, God rest their name) appreciated 5.24 percent last year with the thirty-year bond showing returns of over eight percent. This was a rather stunning contrast to the stock market indexes which were down 33 to 40 percent depending on what was being counted. International indexes were off even more.

Fast forward to 2009. So far this year the same Barclays index showed a return through the end of April of only 0.60 percent, with the long bonds showing negative returns. The damage has accelerated in May with the long bonds down now in double digits as interest rates have advanced. The stock markets are now showing positive returns and even corporate debt has outperformed Treasury securities.

The stellar performance of Government debt in 2008 was a reflection of market anxieties. Just as individuals cashed in stocks to put money into certificates of deposit, so did institutions buy Government debt. Foreign investors looked to US Treasury securities for their safety and yield, especially as the dollar rose against the currencies of other countries. In many cases the returns from dollar appreciation exceeded the interest earned on the Government bond investment.

Now the situation is almost the reverse. The dollar is falling relative to other currencies due to the volume of US Government debt being issued. A passing of the sense of crisis has encouraged investors to switch out of the safety of Government debt to issues of potentially higher return. Finally, the yields on Government securities and certificates of deposit have declined to a level where, after taxes and inflation, the returns approach zero. While a zero return may be acceptable when principal risk is perceived as substantial, it is less attractive when principal risk subsides.

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The future prognosis for returns on Government securities appears to be equally bleak. As the economy begins its recovery the demand for credit will put upward pressure on interest rates. This will in turn cause fixed rate securities such as Government bonds to decline further in price. While neither inflation nor deflation appears to be an immediate threat, economic recoveries tend to generate more inflation pressures than declines. Finally, the higher yields of corporate bonds, both investment-grade and otherwise, make such investments increasingly attractive in an environment where the economy appears stronger and the risk of default is reduced.

Municipal bonds, which are government bonds that are backed by state and local government, fall into a bit of a gray area. On the one hand they have certain tax benefits that are not accorded corporate or US Government investments. On the other hand, they lack the backing of the Treasury and are thus subject to bankruptcy risk in a manner similar to corporate bonds. Municipal bankruptcy is different from the private sector in that the title to collateral is more in dispute. It is also more politically difficult to deprive people of basic services in order to repay a debt.

For these reasons municipal bonds can have more risk than is apparent from their bond rating. In addition, the reality that muni bonds often must be purchased for long maturities to obtain a significant cash return makes them income options for those who have both high taxes and a need for steady income beyond what is being generated by taxable events.

Faring worst are the investors who both bailed out of stocks in the first two months of this year and purchased Treasury bonds with the proceeds. They likely have both a monetary loss from the sale of the stocks as well as the foregone recovery of the last two months. Adding insult to injury, the Government bonds which they bought for safety have now also gone down in value.

In investing past is seldom prologue. Thus the need to invest not in what worked in the past so much as what may work in the future. Extremes of emotions, either depressing or manic, cannot be sustained either personally or collectively. The wise investor who recognizes this can profit accordingly.

The Economy

It appears that the economy is stabilizing at current levels. Consumer spending continues to be weak, but exports seem to be picking up. The combination of domestic stimulus spending along with demand from such entities as China should make for a stronger economy going into the second half of the year.

Consumer behavior continues to be perplexing. While consumer attitudes are improving, spending is not. It could be that consumers are embracing a higher savings rate which improves their own finances and disposition while in the short run at least depresses the economy. This means that restaurants and retailers will continue to shrink until a level is reached that can be profitable at current levels of spending.

Interest Rates

The interest rate spread between corporate bonds and Treasury securities continues to shrink, as does the premiums banks charge to lend funds to each other.

As the sense of the world not coming to an end continues to take hold the spreads between different classes of bonds should continue to shrink. Also, with Government debt paying higher interest rates there will be some pressure put on home mortgage rates going forward. However, so far the terms of mortgages seem to be more of a factor than the rate of mortgage interest in deciding who is awarded loans.

Inflation

So far the rate of inflation has not been a factor in investment decision-making. While several people have forecast the Government’s deficit spending would ignite higher levels of inflation there is at this time no credible evidence of this happening.

It would appear that inflation for the year will be in the neighborhood of one percent, with the core inflation rate closer to zero. There does not seem to be much in the way of pricing pressure anywhere in the economy.

The Stock Market

After a roller-coaster ride year to date, domestic market indexes are basically flat. The market has staged a close to 40 percent rally off the lows while still being 40 percent off its highs.

Much of the progress going forward will depend on earnings expectations for 2009 and 2010. For this reason the stock market will become more selective in its choice of winners going forward. While it is not reason to become a trader as opposed to investor, it is prudent at this time as all times to assess the future of each investment and weigh it against the current price. As the economy changes its complexion and the Government becomes a more active regulator of the financial sector, there will be investment winners and losers. To paraphrase Emerson, these times can be the best of times for those investors who know how to interpret them.

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