Bond Bubble?

"We published this piece six months ago to explain to our clients why we were 'leaving the theater' while everyone else seemed to yelling for an encore. Now world famous Bill Gross of PIMCO, the country's largest bond manager, has screamed 'FIRE' and the exodus is visible. Prices have weakened and yields have begun to rise, as can be seen by the line we added to the previously published chart, but a meltdown has been avoided, at least so far, by the Federal Reserve's 'print money for Treasury bonds' program. What will happen when that program ends or reverses, as it ultimately will do is anyone's guess. We are delighted that we are ahead of the crowd and can watch from a safe distance."

There has been significant discussion recently regarding the possibility of a bubble in bond prices. Financial panic, driven by collapsing home prices domestically, has led to an international banking crisis and a severe worldwide economic slowdown. The resulting flight to quality, amplified by the direct actions of the U.S. Federal Reserve Bank, drove U.S. Treasury yields to levels not seen in half of a century. Desperate for yield, investors then drove credit sector yield spreads down in concert with treasury yields.

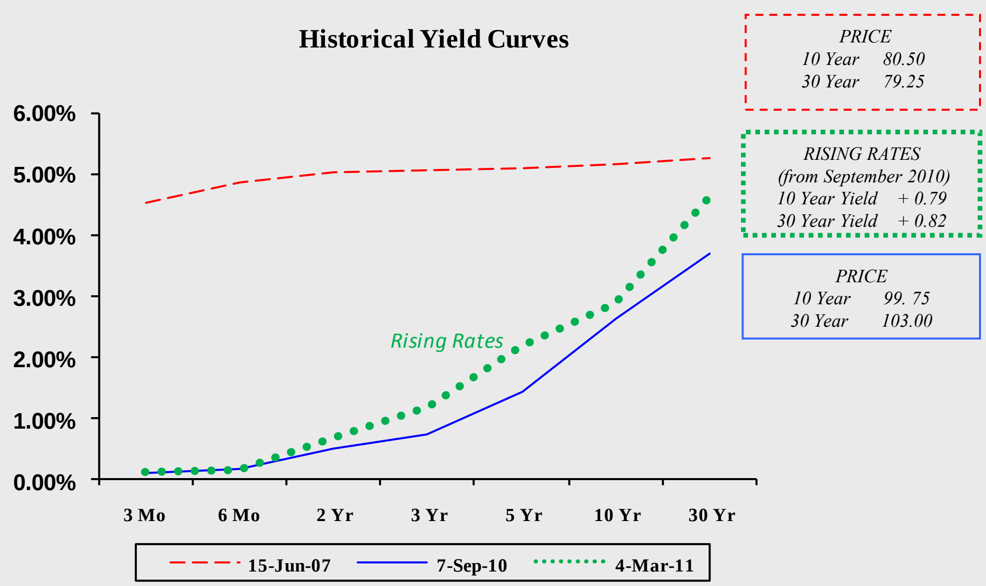
There are some interesting characteristics of bubbles: as they inflate, justifications for further expansions proliferate; bubbles always grow bigger than anyone can imagine; when bubbles burst, the pain is enormous; but most of all, peaks of bubbles can only be identified in hindsight.

Currently, any number of reasons have been given to justify even lower rates: (1) economies are still weakening and deflation seems possible, even likely, to some; (2) the economic slowdown has resulted in a declining demand for capital; (3) the Fed has driven, and will continue to drive, both short and long-term rates lower in an effort to stimulate growth and employment; (4) investors desperate for yield will buy anything; and (5) ongoing stresses keep a banking system collapse on the table continuing to stoke a flight to quality.

Current interest rates are lower (and bond prices higher) than we can justify. We believe that although weak, the economy will grow; there will be demand for capital and the Fed's efforts will forestall deflation. If we are correct, interest rates will recover in the future. But events between now and whenever that date is literally cannot be known. Policy mistakes, elections, and international events may still roil and drive rates down; this trend would be amplified by momentum investors and indexers who must pursue markets to fulfill their mandates.

Our goal has always been to exceed benchmarks and targets, over time, and our process demands risk-averse positions in dangerous times. **We believe that the current market is as dangerous as we have ever seen.** Rates have been driven far below normal by factors inherently inimical to long-term growth. But we believe that the underlying resilience, vitality, and strength of our economy will eventually, inevitably, and painfully (Chart 1) resume for fixed-income investors. Despite an inability to pick the point at which bubbles burst, and conceding that exogenous events can continue to propel rates down, our portfolios are short of their duration targets so as to protect capital from rising rates. Our portfolios contain a minimum of credit risk because, although the performance of companies may improve as the economy resumes growth, yield-desperate investors have driven credit spreads too low, and we expect spreads to widen as the demand for capital returns and as treasury yields rise. For investors who, nevertheless, must maintain a fixed-income exposure, we recommend Inflation Protected Treasuries (TIPS) because TIPS will suffer the least when faster economic growth resumes.

Chart 1



Interest rates returning to June 2007 levels would result in a 20-25% loss of principal for the 10 and 30 year nominal Treasuries, anywhere from 8-10 years of coupon income. In comparison, TIPS bonds yields rising the same amount assuming 2/3 gain in inflation expectations and 1/3 in real rate, would result in 7-10% declines, about 5-7 years of coupon income, but not counting inflation accrual.

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