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Preparing for the Correction—Part V

-J. Kevin Meaders, J.D., CFP®, ChFC, CLU*

SUMMER SOLSTICE, 2019—ATLANTA History is replete with little ironies. One of my favorites is the $20 dollar bill. Take one out and look at the portrait. Whose picture do you see? That's right, President Andrew Jackson. He's not there because he was the 20th president, as Washington was the first and Lincoln the fifth. No, that was James Garfield. "Old Hickory"—as Jackson was known—served as the 7th president. Jackson's portrait may simply be there as a lasting, snide "gotcha" from the good folks at the Fed.

The irony is that President Jackson fought like no other president to keep a central bank out of the United States. Not only did he veto a bill (which had passed both houses) calling for the National Bank's second charter, he essentially confiscated their deposits. He believed that central banks rob the common person of their labor and savings through inflation—printing money out of nothing—when workers have to work, and savers have to save.

Jackson also believed that a centralized bank was too vulnerable to foreign influence and political and financial interconnections. Even though Jackson won that round, the war was finally lost in 1913 when President Wilson signed the Federal Reserve Act.

That year, one ounce of gold cost $20.67. Today, one ounce of gold is fetching $1391. Did gold become more valuable? New and improved gold somehow? No, of course not. If anything, it's cheaper to extract gold nowadays. No, the central banks have simply printed more dollars—many, many more—than the amount of new gold coming out of the ground.

So, to fight inflation we are told to invest in stocks, bonds, commodities, real estate, and other various instruments. But there we are subjected to price uncertainty, also known as volatility. Volatility may often be quite low, but sometimes it can be heart-wrenching. Most investors sell out after such a terrible loss, thus ensuring that they realize the loss for good. A few can suffer through it and hang in there, to be rewarded some years later for their fortitude, perhaps with a new anxiety prescription.

Our job, which is no small order, is to thread the needle between these two extremes. When we want to be risk-on, we look to stocks. When we want to be risk-off, we look to bonds. And therein lies the newest irony—that portion of risk-off (the bond market) may be the epicenter of the next contagion.

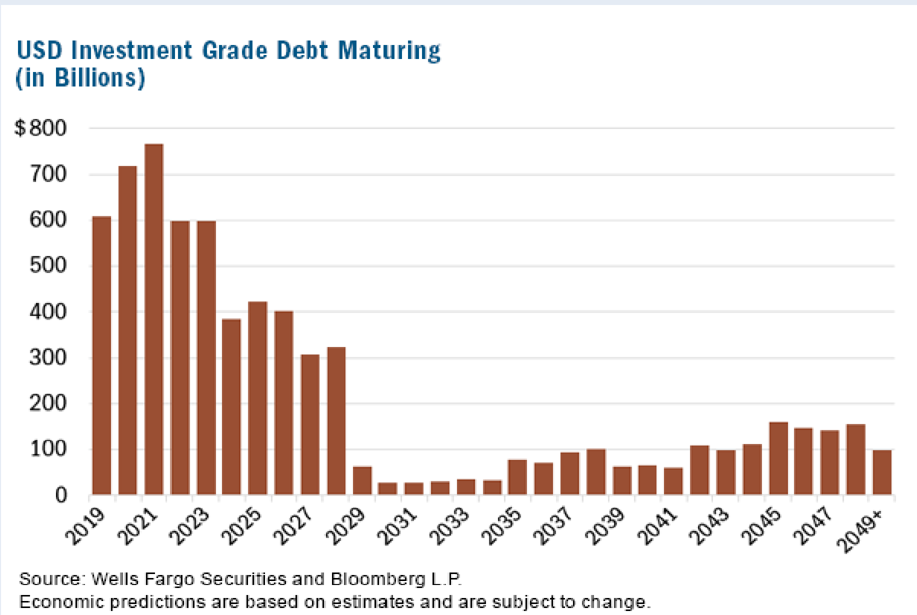
The corporate, investment grade bond market is huge, with about $5 trillion in total assets. The problem is that half of that debt is just barely hanging on to an investment grade rating. As succinctly outlined by equities analyst Robert Ross earlier this year…

> …the U.S. has been flooded with BBB-rated bonds. In the past 10 years, the triple-B bond market has exploded from $686 billion to $2.5 trillion, an all-time high. In other words, 50% of the investment-grade bond market now sits on the lowest rung of the investment-grade ladder.

> And there's a reason BBB-rated debt is so plentiful. Companies have binged on cheap credit for years. Ultra-low interest rates have seduced companies to pile into the bond market. Corporate debt has surged to heights not seen since the global financial crisis.[1]

If you've been following my letters of the past year or so, you know that our main concern was the Fed raising rates too far, too fast. Well, that concern has abated. The Fed announced that not only would it hold rates steady, it may actually drop them later this year! This is huge, and a massive turnaround from their rhetoric less than one year ago.

So that concern has more or less evaporated. Or has it? Perhaps the damage has already been done? The rate hikes that occurred between 2002 and 2005 didn't really affect the market until all those adjustable mortgages started… that's right, adjusting. I believe that is analogous to where we are today.



Look at all the investment grade bonds that are maturing in the next few years, in the chart to the left.

Most of these companies are planning on re-placing those old bonds with new bonds, the only problem being that the new rates are higher than the old rates.

And if you're just barely hanging on to your BBB rating under the old lower rates, how can you expect to fare under the new higher rates? We feel the trend is ominous.

My own research has revealed two typical examples: Ford Motor Credit and Citibank. Both are BBB; both have bonds currently maturing; and both are floating new loans to cover the old. On June 17—just a few days ago—Ford Motor Credit's most recent tranche of bonds matured, which were only paying 2.68%. To pay for the new bonds that went on sale today, Ford will have to shell out 4.3%, almost 1.5% more.

Citigroup is in a similar condition, but faring a little better, replacing their 2.4% coupon bonds with new 3.25% bonds. *And 50 percent of the investment grade universe is in the same boat*?[2] If you are barely holding on to your BBB rating with these previously low rates, how are you going to hold on when your debt service has increased by 35-60%? How can some of these companies NOT be downgraded once the new higher rates take effect? Well, so what?

[1] "Opinion: Half of investment-grade bonds are only one step away from junk status." Marketwatch.com https://www.marketwatch.com/story/half-of-investment-grade-bonds-are-only-one-step-away-from-junk-status-2019-01-07

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In the investment grade world—ratings mean a lot. But a drop from AA to A is not really that big of a deal, nor from A to BBB, though that is taken as a warning sign. The real bright line is the separation between BBB and BB. This is like the difference between the officer's club and the mess hall—the difference is "investment grade" verses "junk." They even have a name for these recently downgraded BB's: "Fallen Angels."

As many of these BBB bonds mature and are renewed at higher rates, it will put pressure on their financials. Some of them are likely to be downgraded to BB. Those that are downgraded lose value as they are sold (often by mandate) from investment grade bond funds, ETFs, pension plans, insurance companies, charitable foundations, university endowments, and banks. This domino effect spreads to other highly leveraged companies and the situation spirals. This is the potential scenario that no one is talking about right now, but which we are preparing for.

For our clients, we have already rid ourselves of all junk bonds and all corporate bonds, leaving only treasuries. And here's why:

Index	2007	2008	2009	2010
S&P 500	3.53%	-38.90%	23.45%	12.78%
DJIA (Dow)	6.43%	-33.84%	18.82%	11.02%
NASDAQ	9.81%	-40.54%	43.89%	16.91%
1-3 Yr Treasury	7.30%	4.71%	0.54%	1.77%
3-7 Yr Treasury	9.01%	12.16%	-0.60%	9.09%
7-10 Yr Treasury	10.18%	28.81%	-16.11%	10.14%

The top three are the main U.S. equity indices, and the bottom three are U.S. treasuries of different maturities. Obviously, you want to focus in on 2008 to get a real comparison. Treasuries are generally the world's "go to" position for safety. As I've said before, our intention is to have at least 60% of our portfolios OUT of stocks and IN to treasuries by the end of this year—if not sooner. In the meantime, we'll be watching for Fallen Angels.

We believe the market will continue to hit all-time highs as a China trade deal is eventually reached—maybe not next week, but likely before the end of the summer. This will be our signal to look for an exit. We plan to sell half of all the equities around that time. And even though treasuries have been higher in price since December, we are watching them day by day for a good entry point, which should occur at about the same time that stocks peak out. Currently, however, the treasury market is a very crowded space.

In any event, the next 18 months or so could be trying, so you may want to consider checking your own risk tolerance again, and perhaps make adjustments with caution in mind.

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About J. Kevin Meaders

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through Voya Financial Advisors (member SIPC).

About Magellan Planning Group

www.magellanplanning.com

Magellan Planning Group was established in 2000 to provide a service uniquely tailored to the needs of our affluent Atlanta community. We concentrate on *personalized* retirement planning through tri-disciplinary coordination:

- Financial planning with our Certified Financial Planner™ to prepare a retirement plan that takes into account your needs and expectations. We are a fee only asset management firm.

- Estate planning with our in-house Attorney-at-Law to determine and prepare the documents needed to minimize family liability and maximize privacy. (www.magellanlegal.com)

- Tax planning through a relationship with our in-house CPA to manage tax obligations throughout the year and prepare a tax return that takes into account current tax laws. (www.magellantax.com)

Our relationship doesn't begin and end with the preparation of a plan and the appropriate documents. We establish close personal relationships with our clients and their families and maintain those relationships through regular 'check-ups', market commentaries and educational Lunch & Learns.

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