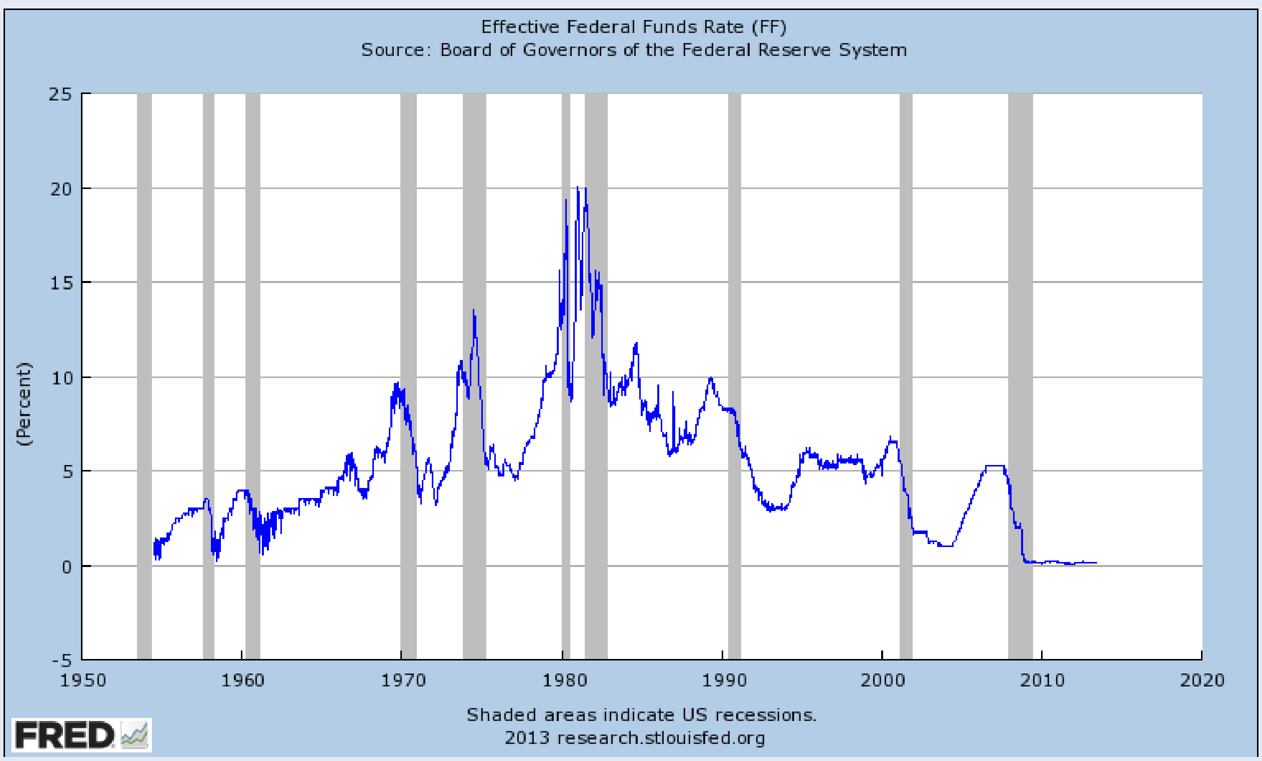
Those Safe Bonds Aren't So Safe Anymore

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

August, 2013 - If you've been reading my letters over the last four years you will no doubt remember that I have been repeatedly referencing our historically low (and artificial) interest rates. (These archived letters are available on our website: www.magellanplanning.com)

The chart below, published by the Federal Reserve, shows rates at historical lows. As you can see, since 2009 interest rates have been resting on the bottom. Despite the utter ridiculousness of negative interest rates, these charts have been restyled to allow for negative interest—a result of the fallacious Keynesian thinking that controls our economy. In the real world, no one would loan money for nothing, except to the kids, of course. But be honest—that's just a gift, really.



I've never seen a more revealing chart before in my life. The grey lines indicate recessions, or market crashes, as some people refer to them. Note that each grey line is preceded by a rate hike—a spike in interest rates. Could it be that it's the Fed itself that's crashing the market time and time again? Note that after each grey line, interest rates drop dramatically and quickly. Not naturally, mind you, but in an attempt to artificially re-start the economy after they've busted it.

As the boom/bust cycle continues with greater and greater magnitude and ferocity, the required interventionism becomes equally excessive and thus makes it impossible to gauge true economic fundamentals like Price/Earnings ratios and Return on Investment (ROI). Instead, economists and money managers hang on every word Bernanke says looking for some esoteric meaning.

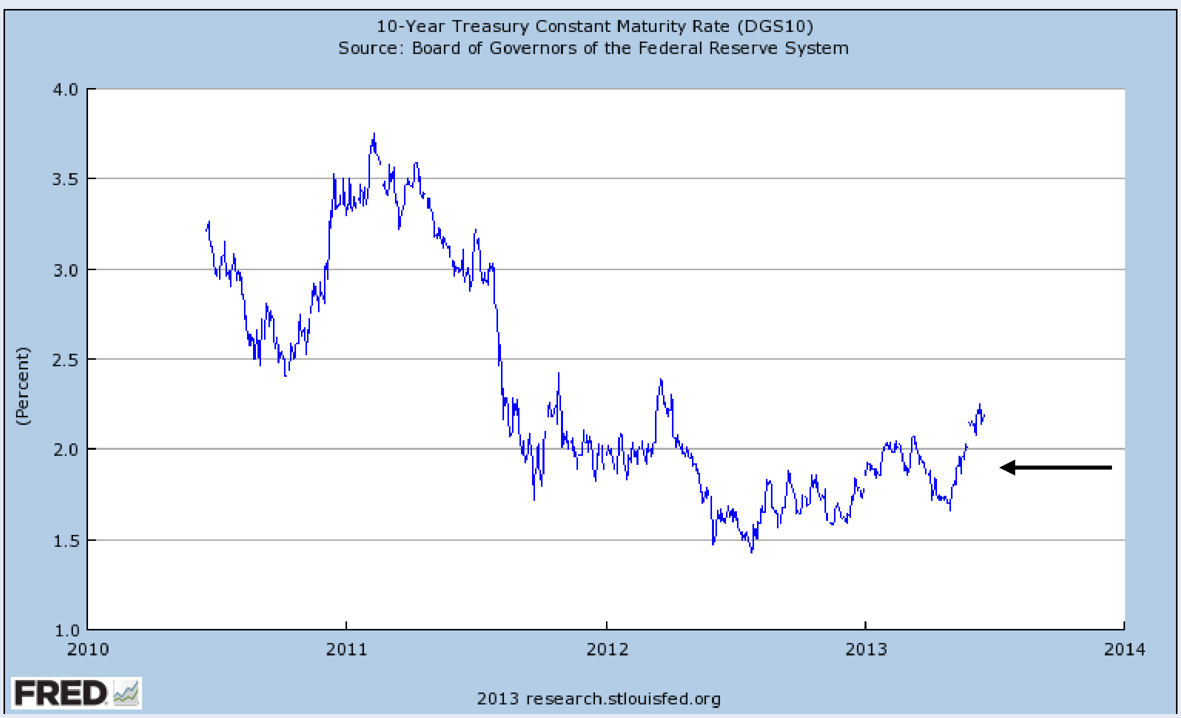
The recent comment by Bernanke that he might “taper” Quantitative Easing (printing money) sent bond yields over the tipping point. Bonds are tricky animals. They can react dramatically to changes in interest rates and credit quality. When yields go up; it means prices have gone down, and vice versa.

Think of it like this. Imagine you are going to buy a CD today at 1%. If you believe rates are going up next year, are you going to buy a 10 year CD or a 1 year CD? If rates go up to 2% next year, and anyone could get a 2% CD, who would want to buy your 10 year CD at 1%? No one. Now I know you don’t go and sell your CDs to other people, but bonds are sold to other people, and they work in a similar fashion.

If you buy a bond for $1000 and it pays 3%, and then next year rates rise to 5%, in order for you to sell your bond on the open market, you will have to discount the price to equal the rate of 5%. How much would you have to discount the 3% bond so that it paid the same amount of interest as the 5% bond? The answer: $400, a whopping 40%. Not good.

Note that Bernanke didn’t actually raise rates, or even hint that he might raise rates. All he said was that he *might* start “tapering” QE. Remember, we’ve been printing $80 Billion per month[1].

Take a look at what happened to yields of the 10-year Treasury bond since he made his remark:



Remember, yields and prices move inversely. So here, we can see a sharp spike in the yield, which of course, corresponds to a drop in the price. And like that 1% 10 year CD, no one wants it when the rates are moving higher.

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[1] Reuters, *Federal Reserve Sticks to Stimulus Plan.* May 1, 2013

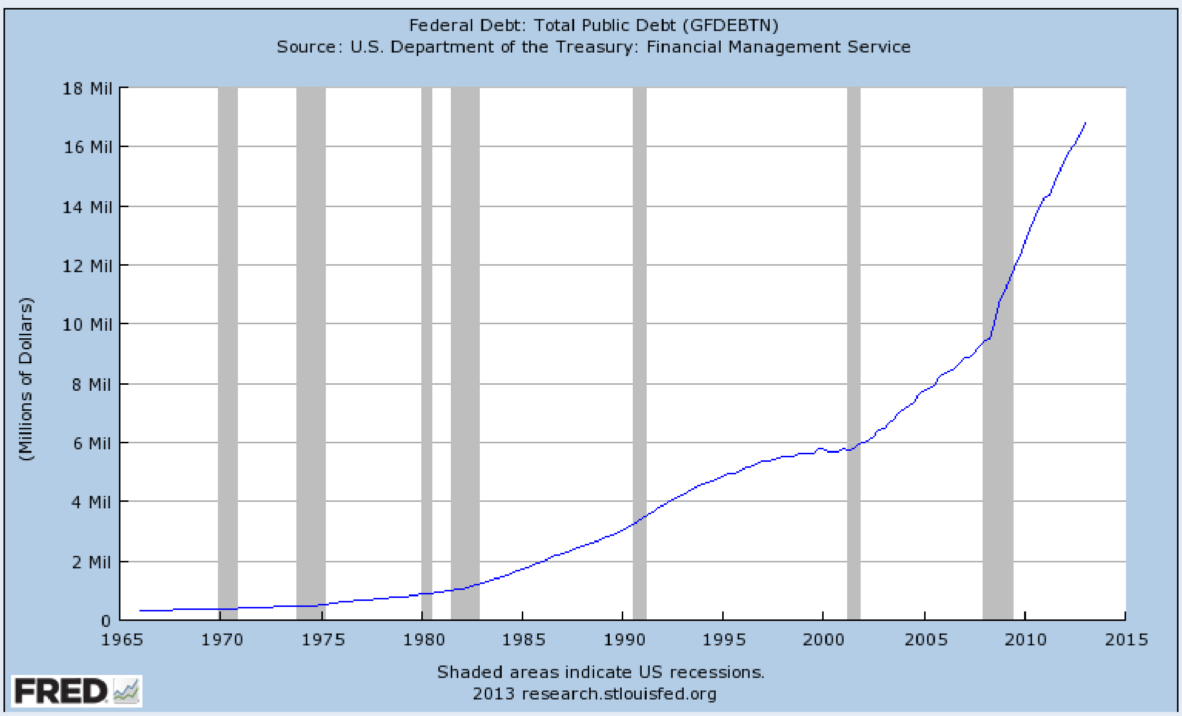
We know (or strongly believe) that interest rates can't go much lower; and in fact, we believe they will eventually be moving upward.

If you go back to the chart of interest rates on the first page, you will note that during the years 2003-2007 the Fed raised rates from 1% to 5%. We have researched many types of investment styles and managers for 'safe money' during that time period, and as expected, long term bonds performed poorly, while short term bonds certainly did much better.

Since 2008, however, everything has changed. It used to be true that bonds and stocks moved in opposite directions—when one went up the other went down. In 2008, and again in June, both moved dramatically in tandem—downward. Are good investments in the 2003-2007 rising rate period still good investments in the New Normal?

As for stocks, we are not intimidated by the recent sell-off. We are still in a monetary expansion phase and the recent reaction to Bernanke's comments surprised a good many people, including him, which should ensure that we remain on this path for the foreseeable future. And Bernanke, he'll be gone by next January to let someone else clean up his mess, just as he had to come in and patch up Greenspan's housing bubble. Someone new to blame, but the pain feels the same. The system is broken.

And speaking of broken systems, take a look at our nation's debt:



Seventeen Trillion dollars.

And counting…

What's worse, we're not just borrowing the money from China, Japan, Europe and others—more often than not, the Fed is buying it with money that is simply created electronically. In 2012, 90% was bought with newly created money.[2] My friend, this never ends well.

[2] Bloomberg. *Treasury Scarcity to Grow as Fed Buys 90% of New Bonds*, Dec. 3, 2012.

And so with all the newly created money and all the money still sitting in cash, we expect continued stock market gains to new all-time highs until…. the Fed raises rates, collapses the fiat money supply, and the cycle of pain begins anew—depression, unemployment, poverty. Except for the big banks, of course. Not to worry, they'll be bailed out, again, at the expense of your purchasing power.

Nonetheless, our plan at Magellan Planning Group is to hold the course with our stock positions, reinvest our safe money in very short term, high quality bonds, and hold this position until the Fed starts raising interest rates. As rates begin rising, we will begin selling stocks at a gain, and reinvest that money into longer term Treasuries. Once rates reach 2%, we will be on high alert for another market crash. At that point, we will start converting our short term bonds into longer term Treasuries.

In 2008, the only asset class that rallied was long term Treasuries, which were up over 33%. Pretty much everything else crashed: Real Estate, domestic and global stocks, corporate and municipal bonds, gold and silver, diamonds and pearls, oil and vinegar. We suspect the next crash will be much like 2008.

But try not to think on that right now. The concern now is that this volatility—sharp ups and downs—will frighten investors back into cash, and delay others from jumping in. If history is any guide, they'll wait until right before the crash. Remember, when things are going great and everybody really feels good about the market, we'll be plotting an exit route. That time has not yet come.

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About J. Kevin Meaders

kevin@magellanplanning.com

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 ING Financial Partners (member SIPC).

About Magellan Planning Group

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- 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)

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4170 Ashford Dunwoody Rd. NE, Suite 480
Atlanta, GA 30319
404-257-8811

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