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Bursting of the Great Bond Bubble?

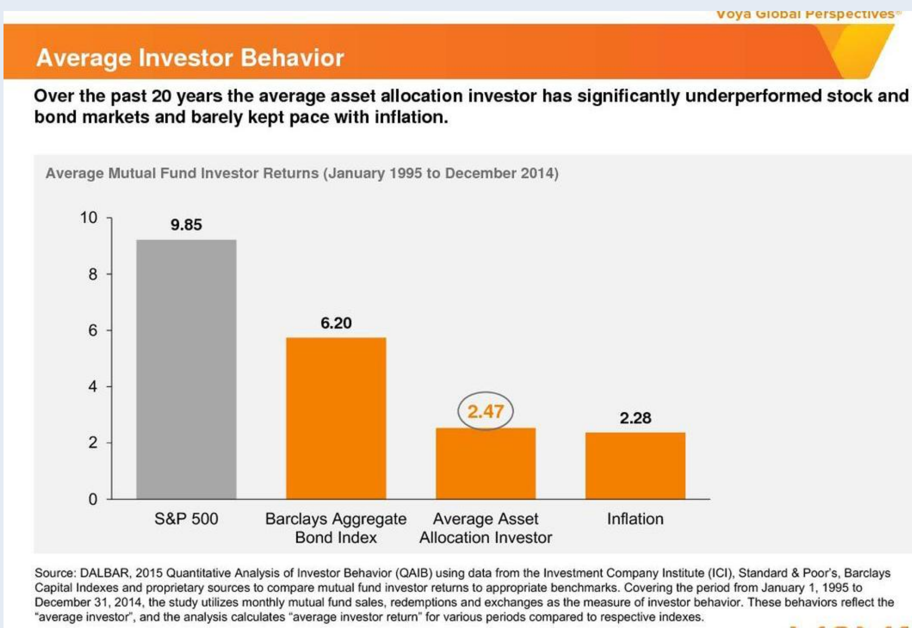
(This is your wake-up call)

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

June, 2015— If history can be trusted at all, the lesson is clear: The herd never wins. Oh sure, the herd may survive, and as well it should, but for nothing more than to ensure the survival of those who prey off the herd.

And prey they do. On May 20, 2015, six big banks were fined $5.6 billion and four were charged with criminal activity around currency manipulation on a global scale. They are Barclays, Citigroup, J.P. Morgan, RBS, UBS, and Bank of America. One Barclays trader wrote in a November 5, 2010 chat: "If you ain't cheating, you ain't trying."[1] And who do you think it is that they are cheating? You guessed it, the herd.

Is it any wonder, then, that the average investor earns barely more than inflation?



It's like those stories people tell about their trip to Vegas, and how they "won big", and "wow, was it unbelievable" and "oh, the comps were great. I didn't pay for any meals; they really like me there."

Sure, right, wink wink. They *really* like you. And that trip was the *best ever*. You were such winners—your talent *really* shone through.

[1] Financial Times. May 20, 2015. *Six banks fined $5.6bn over rigging of foreign exchange markets.* www.ft.com

And maybe you were. But in reality, it's just business as usual to the lovely ladies at the concierge desk. That trip was probably just one of many. And if not, the freebies will keep you coming back—because, well—they just like you so much. But secretly the lovely ladies know it's just a matter of time before they get your winnings back, and some of your other money besides.

Indeed, these opulent empires were not built because the casinos generally lose. Can you believe that, given enough time, their chances of winning approach 99%? Given enough time.

It makes me feel sorry for the poor suckers spending all night pulling on the one-armed bandit; but at least they're getting free drinks, and of course, the comps. Even a loser can feel like a winner.

You see, casinos know something about people that investors often learn too late, and this is key: People cannot separate money from emotion.

Control their emotion, and you control their money. Think about that stark reality for a moment.

Experts in behavioral finance have studied human emotions as they relate to the market cycle, or as Austrian Economists refer to it, the boom/bust cycle. The emotional reaction for investors to a zero- interest rate environment has never been studied—at least in this country—mainly because such an environment has never existed. After the 2008 crash, the truly fearful remained at the bank, in CDs and cash deposits earning less than inflation.

Seven years after the 2008 crash, they're still sitting there, paralyzed. They've been convinced that stocks were going to take another hit, and just now are some of them beginning to relent and put their money back in the market. I can see it in my business as more and more people walk in with tons of cash that's been sitting dormant for seven years. When this really commences in earnest, it could be a sure sign of the beginning of the end of this great post-2008 market recovery.

Why? It's the simple forces of supply and demand reacting to the human conditions of fear and greed. Once you see markets in this way, you will never wonder why again.   Investors were chased out of stocks in 2008 and sought a safer harbor: bonds.

And clearly investors have piled trillions into bonds, driving up the price, while likewise driving down the yields.

The chart below shows the price/earnings ratios of stocks relative to bonds.

A P/E of 52 ?!? That means it would take 52 years for that bond to pay for itself. 52 years. We haven't seen P/E ratios like that since 1999, just before the dot.com bust. But that was stock; these are bonds.

Thus no one can argue that this has not been a massive herd movement, and like all herd movements, a mass exodus is likely to come, and likely to be ugly.

You may remember the "taper talk" in May 2013 when then Fed Chairman Ben Bernanke (who now works for PIMCO) dropped the hint that the Fed would start "tapering" bond buying—which is, of course, simply printing money. Mortgage rates jumped 100 basis points (one percentage point) and bonds everywhere took a hit, even though the Fed didn't actually do anything. It turned into a "taper tantrum," as it's now fondly recalled.

Now that the bond buying program is over and done, the next reversal of Fed (save-the-big-banks) policy is to start the long road of rate rises until…and this is *our* takeaway…until the market crashes again.

In May, Fed chairwoman Janet Yellen said: "If the economy continues to improve as I expect, I think it will be appropriate at some point this year to take the initial step to raise the federal funds rate target and begin the process of normalizing monetary policy."[1]

So here is your first official warning. The bond market is set up for a turbulent future. If you have individual bonds or bond funds that *we are not managing*, I encourage you to come in for a review to determine their duration, maturity, credit quality, and other factors that could affect their value as interest rates begin rising. Once values actually do start to fall, we could likely see a cascade effect as the herd mentality ensues.

Are we worried about stocks? No. We believe they still have some room to run, especially emerging markets. But we do take note that as rates begin to rise, we are put on notice. History has shown that the Fed will not stop raising rates until the stock market corrects significantly.

Since 1980, the rate needed to crash the market has been successively lower, so that all that was needed to cause the 2008 crash was a mere 5%. The next crash could occur at rates as low as 3%, or even 2½%, there's just no way to know. But know this, if rates are north of 3% and the market hasn't yet crashed, then we'll be on the sidelines waiting for it.

But again, Yellen has indicated that she will raise rates very gradually, presumably slower than her predecessors. We'll see.

In any event, the Fed will spin every bit of information to delay a rate rise. Why? Our debt. This is our main long term concern. We are now over $18 trillion and counting. Another debt ceiling is coming up, which, by now, is meaningless. How much debt can we pile on? And if rates rise, then our debt service (the interest we pay on our debt) which is already running at about $30 billion per month, could likewise rise substantially.[1]

No one seems to really be talking about the debt, but I can assure you it is by far the most dangerous threat to our American way of life, which sure looks a lot different to me now than when I was growing up in the 80's.

So take a breath, turn off the news, and plan a trip to Europe. Vienna, Prague, Budapest—all wonderful destinations with the best exchange rate in over a decade.

And remember, if you are holding bonds, bond funds, or closed-end funds, or you are not exactly sure what to expect in a rising rate or bond exodus environment, give us a call to schedule a short review.

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

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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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