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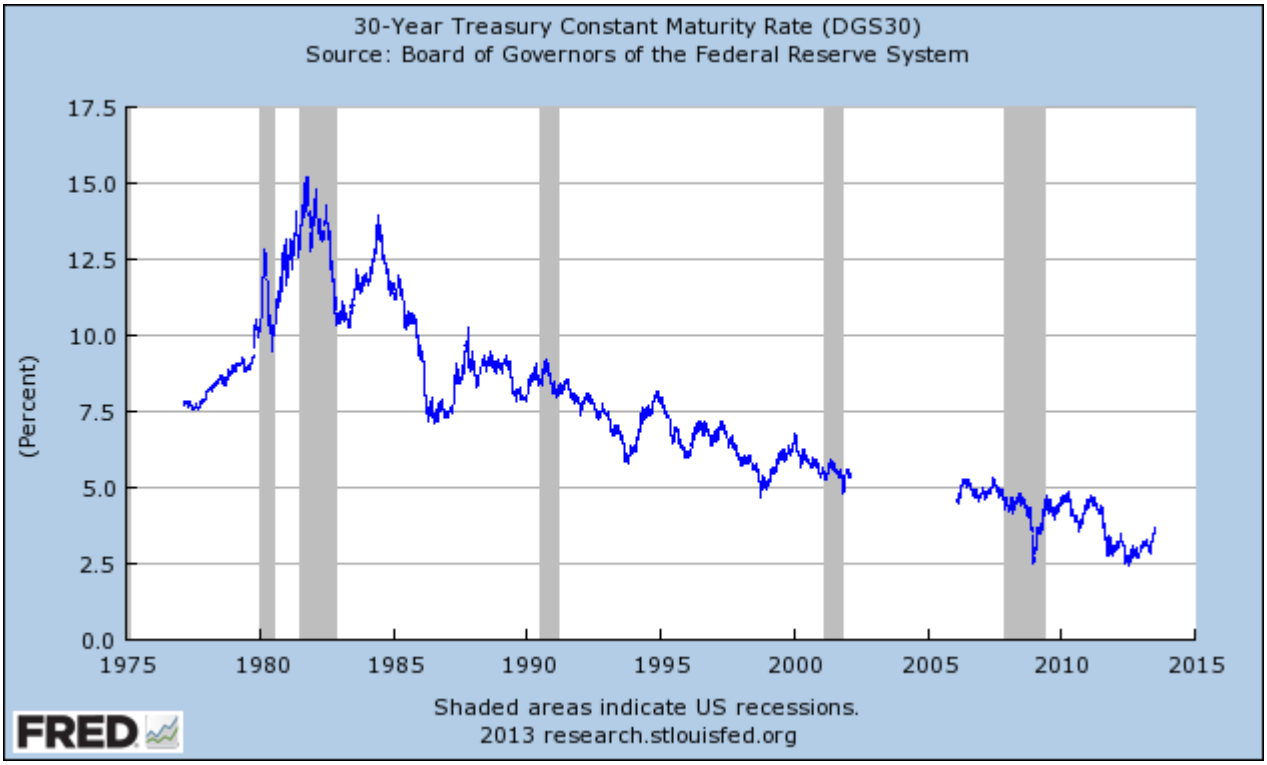
The U.S. Bond Market: Will Fed Tapering Deflate the Bond Market?

In the last decade, bonds in the United States have been trading at high prices as a result of historically low yields. The recession of 2008-2009 caused a severe credit crisis which resulted in a dramatic loss of investor confidence. The U.S. economy was on the brink of a meltdown. Drastic monetary intervention by the Federal Reserve and the U. S. Treasury Department prevented a US financial disaster and averted the global economic catastrophe such an event would have created. As a final outcome, however, the long-term bull market of rising bond prices must come to an end. What are the implications for investors should interest rates begin to rise? The previous bond market cycle provides insights into our understanding of a rising interest rate environment.



The mid 1970s was a difficult economic and investing period. In the U.S, it was a period of high inflation and low growth or "stagflation". In 1973 the global oil cartel, led by the Saudis, disrupted oil markets by limiting the global supply of oil. The price of oil increased dramatically, contributing to rising inflation. The Viet Nam War was entering its final phase. The 1960's "guns and butter" spending policy, war costs and the "Great Society" of President Lyndon Johnson had significantly added to the nation's debt. A protest vote against Democratic policies witnessed the newly elected President Nixon implementing price controls from 1971-1974 to conceptually "contain" inflation. Price controls were ineffective, and in fact, acted as a short term pressure point. When price controls were eliminated inflation soared, the economy faltered even further, as interest rates climbed relentlessly upwards. The federal fund rates peaked at 20%

in June 1981. The stock and bond markets traded at extremely low valuations as the worst recession since the Great Depression continued[1].

President Jimmy Carter was elected in 1976 as a protest vote against Republican policies, and in 1979 appointed Paul Volker as the Federal Reserve Chairman. Volker was a brilliant appointment. In order to contain inflation, which exceeded 13%, Volker raised interest rates for two years, peaking at 21.5% in 1981. The U.S. bond market witnessed corporate yields exceeding 20%, and long-term Treasury bonds yielded 14.68% in October 1981. A severe bear market ensued for bond holders from 1979-1981 as bond prices collapsed, but it was a marvelous opportunity to buy long-term bonds at bargain prices and enjoy record high yields[2].

Today it is likely that the 32-year bull market in bonds may be coming to an end. In December 2008 Treasury 30-year bond yields hit a cycle low of 2.55% and have been trading in a low yield range for 5 years. The current yield on 30-year Treasury bonds is 3.55%. The Federal Reserve's policy of quantitative easing (QE) i.e. printing money and buying treasuries to keep interest rates low and stimulate economic growth, continues as of this date. First implemented in December 2008 by Fed Chairman Bernanke, the monetary stimulation appears to have been successful. Equities have rallied for over 4 years.

Recently, international equities, bonds, and commodities have traded sharply lower on the perception that the Fed may begin to phase out their QE stimulus. How much longer bond rates will remain low remains unknown, but markets gave us a "preview" of what could happen if bond rates (around the world) suddenly were to rise, likely due to bond holders' (China and Japan) demand for higher rates. Central banks would have an extremely difficult time of implementing any kind of easing as they are already over-leveraged.

Rising bond interest rates tend to make bonds more attractive investment candidates, creating a legitimate substitute for equities (and their dividends), generally driving stock prices lower. If stock prices decline, the dividend yields on stocks will increase to compete with rising bond yields. A vicious cycle is put into play. Bond prices decline due to the current yields of newly issued bonds exceeding previous yields on older bonds. The offsetting yields price the bonds so as to seek yield parity.

Interest rate movement in one country impacts the currency rates and interest rates of other countries, impacting their markets. The estimated U.S. Treasury debt is currently in excess of $15 trillion, the largest in the world[3]. *As of June 25, 2013 the U. S. total debt was approaching $60 trillion dollars*[4]. As interest rates rise in high debtor nations, the interest cost of the debt squeezes out the funding for other programs.

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[1] Wikipedia, 1970s Energy Crisis, as of 06/25/2013. Online at: http://en.wikipedia.org/wiki/1970s_energy_crisis

[2] http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield From Wikipedia, the free encyclopedia Paul Volker

[3] The U.S. Debt and How It Got So Big By Kimberly Amadeo,
Online at: http://useconomy.about.com/od/fiscalpolicy/p/US_Debt.htm

[4] Outstanding U.S. Bond Market Debt, SIFMA Q1.2010.
Online at: http://www.investinginbonds.com/news.asp?id=3161&catid=36

Investors can protect themselves today by selling longer term bonds and shortening the duration (or maturity) of their fixed-income holdings. Short duration bonds normally are 3-12 months to maturity, and they allow the investor to re-invest the payment into higher-rate investments. Many investors are now shortening duration, because the loss of principal can be rapid when interest rates rise. From 1979 to 1981, some bond prices declined over 50% as interest rates went from 8% to 16% and then higher. Furthermore, owning companies with excellent financial strength and cash flow should provide some cushion to price declines. Consumer staples, healthcare, and even tech companies, nowadays, fall into this category. Having a diversified asset allocation strategy is a proven way of sound investing. Last but not least, develop an investment plan or strategy, commit to it regardless of market environment (emotions) and rebalance on a regular basis. This will act as a beacon to help investors stay focused.

Should interest rates rise significantly in the next few years there is likely to be a liquidation of bonds. Such liquidation would drive bond prices lower. Given the immense amount of bond debt in our nation, there is a high probability that a bond bubble is currently in place. Trillions of dollars will potentially be lost in investor's bond portfolios should prices decline. Although the future of interest rate movements is unknowable, the experience of the 1970s is a lesson to be remembered. Caveat Emptor!

- Roger L. Johnson