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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

The bond market is not investable. Even the safety of U.S. Treasury's is not investable. It does appear that investors realize that the bond market offers them very little return, but they don't seem to realize it will provide lots of negative surprises. Treasury bonds are not a place to park money waiting for clarity in the economy either. Before you consider this a communist manifesto, consider the following.

One week ago, you were paid the sum of $500 per year to invest $100,000 in 10-year Treasury notes. Today, that bounty has increased to $690 annually. Yields have increased from .5% to .69%. What everyone seems to be missing is that if the market stays at .69% through August, that bond will show up on your statement with a $1,900 loss at the end of the month. Why? Because to pay the next investor $690 per year for 10 years, the bond must sell for $1,900 less than you paid for it, or $190 times ten years. That small little interest rate move, which can happen in one day, wiped out three years of interest the first investor who earns .5% receives. If you think the shorter two-year treasury note is any better, think again. One week ago, they paid .10%. Today, we are at .16%. That small .06% increase yield wipes half of the two-year bond's interest. Yes, if you hold it to maturity you do make .1%, however, if you do not the interim losses can mount fast. When you are down scraping the bottom of the interest rate barrel, any increase in interest rates becomes costly. Is it any better in the corporate or municipal bond market?

LQD is a mutual fund that is designed to track investment grade corporate bonds. The fund has an average maturity of about 10 years. Here we have two problems, not only does the 1.9% yield offer little protection if interest rates increase (an increase of .2% wipes out one year of interest), we also have credit risk. This is defined as the risk that the bonds might default. We experienced credit risk in March of this year when investors became very nervous that a significant recession was in the making. In two weeks LQD declined to a low of $105. It is at $137 presently. Is it worth investing for 1.9% when the slightest problem will erase your entire annual return? Surely, investing in your home state bond is better.

If you turn on your television, you know the answer. MUB is the fund that tracks the municipal bond market, the average maturity is six years and the fund has a yield of 1.04%. Local governments are having real issues with tax revenue currently. It is the small business owner that is a part of what these municipalities depend on, and some of them have been devastated. RTD light rail in Denver a few weeks ago had about 20 cars in the parking lot when there are normally 500. It is probably not even worth discussing the risk here, the point is that 1.04% does not even begin to compensate investors for the risk they are taking. It is not hard to figure out how we got to this point.

The Fed has been putting trillions into the economy. M1 money supply, which are funds readily accessible for spending, has grown by 30% since February. In 2008 it grew by 20% over a two-year period. The Fed has gone directly into the markets and bought bonds with some of this money. Is it sustainable? The Fed can spend money longer than you can stay solvent. The bigger issue is that there is virtually no room for error, and at some point, error always shows up. Another scenario to consider would be the choice of buying Johnson & Johnson stock that pays a 2.7% dividend or buy the J&J bond maturing in 2029 that yields 1.1%. The extra 1.6% you earn on the stock over nine years equates to about 15%, and J&J raises their dividend every year. If we have inflation, they can also raise the price of band aids which may allow them to increase dividends faster. The 1.1% interest from the bond never changes once you buy it. This is one reason the stock market is doing well despite all the challenges we currently face; investors are opting for the growing income of the stock as opposed to the fixed almost zero income of the bond. Even though money market funds earn nothing, sometimes nothing is more than something.