

Bonds Nowhere To Go But Down

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It is better to do thine own duty, however lacking in merit, than to do that of another, even though efficiently. It is better to die doing one's own duty, for to do the duty of another is fraught with danger.

Bhagavad Gita, BC 400-, Sanskrit Poem Incorporated Into the Mahabharata

A lot of noise is being about the economy improving and even if things do continue to get better, there is a rather strong head wind building in the horizon. Interest rates have been slowly but surely rising over the past few months and given the current trend, it appears that the bond market has nowhere to go but down.

Our ballooning debt and inflation are labelled as the main culprits.

"Americans have assumed the roller coaster goes one way," said Bill Gross, whose investment firm, Pimco, has taken part in a broad sell-off of government debt, which has pushed up interest rates. "It's been a great thrill as rates descended, but now we face an extended climb."

The housing market which experts state has just started to recover (our personal opinion is that it's a long way from mounting a sustainable recovery) is going to be the first one to get knocked down and dragged down for years to come. Mortgage rates are trading close to 52 week new highs and given that the Fed has ended its \$1.25 trillion program to purchase mortgage debt, rates will be subject to even more upward pressure.



The above chart clearly illustrates that bond yields have been rising for quite some time and one can quite confidently state that mortgage rates have bottomed. The Green circle represents the madness that hit the bond markets when investors panicked and flocked into bonds in the late 2008 to the early 2009 period. If rates can stay above the 4.75-4.90 ranges for 12 days in a row or close above this level twice on a weekly basis, it will mark the beginning of a new bull market in rates and long bear in bonds.

Christopher J. Mayer, a professor of finance and economics at Columbia Business School goes on to state "Each increase of 1 percentage point in rates adds as much as 19 percent to the total cost of a home". Thus any hope of a long term recovery in the housing sector is going to be short lived as higher rates will effectively lock out more and more individuals from purchasing a home.

Factors that will create further pressure on bonds and the economy

Auto loans are going to become more expensive; in fact, rates have already been rising. Higher rates here will in turn have a negative impact on the auto industry and this short lived spurt of higher sales could soon be followed with a prolonged drought.

The credit card industry is another sector that is going to take a hit. Rising rates are going to make already skittish consumers even more reluctant to take on new debt. As our economic growth is based on consumers taking on more debt, this will knock the fragile recovery right of its feet.

Washington will soon have to pony up more when it tries to borrow the money it needs for the social programs it has in mind. The outflow of funds from the bond into other investments is also contributing to the rise in rates. If bond investors were to panic and run out of bonds as they dove into them back in the 2008-2009 time period, it could have a massive impact on rates. China has been a net seller of late, and if China started to aggressively unload its holdings, it could result in a complete meltdown.

Bill Gross the bond king has reduced US bond holdings by a significant amount; 9 months ago PIMCO total return fund had invested over 50% of its assets in US debt, today the ratio has dropped to roughly 30%. This is the lowest level in the fund's 23-year history.

2 weeks ago the US Treasury auctioned of \$82 billion in debt at a rate of roughly 4%. This is twice as much as they paid towards the end of 2008 and early 2009 when investors flocked into Bonds looking for safety.

Mortgage rates peaked in 1981 at 18.2%; this works out to a monthly payment of roughly \$3100 in comparison the current payment of 1100 on a \$200,000 mortgage.

Total household debt is almost 10 times what is back in the early 80's and yet the percentage of disposable income that goes to servicing ones debt has not increased much over this time period? The current household debt is \$13.8 trillion and disposable income is roughly \$11 trillion; a deficit of roughly \$2.8 trillion.

Gross debt by the end of the first quarter was almost 88% of GDP. Our gross debt has increased at a rate of roughly \$500 billion every year since 2003, and then it went ballistic in 2008 and 2009 where \$1 trillion and \$1.9 trillion were added respectively.

Richard Fisher The president of the Dallas Federal reserve stated in May 2008 that the National debt was close to \$100 trillion; an excerpt of the full speech is pasted below.

Why is the Medicare figure so large? There is a mix of reasons, really. In part, it is due to the same birthrate and life-expectancy issues that affect Social Security. In part, it is due to ever-costlier advances in medical technology and the willingness of Medicare to pay for them. And in part, it is due to expanded benefits-the new drug benefit program's unfunded liability is by itself one-third greater than all of Social Security's.

Add together the unfunded liabilities from Medicare and Social Security, and it comes to \$99.2 trillion over the infinite horizon. Traditional Medicare composes about 69 percent, the new drug benefit roughly 17 percent and Social Security the remaining 14 percent.

I want to remind you that I am only talking about the unfunded portions of Social Security and Medicare. It is what the current payment scheme of Social Security payroll taxes, Medicare payroll taxes, membership fees for Medicare B, copays, deductibles and all other revenue currently channeled to our entitlement system will not cover under current rules. These existing revenue streams must remain in place in perpetuity to handle the "funded" entitlement liabilities. Reduce or eliminate this income and the unfunded liability grows. Increase benefits and the liability grows as well. [Full Story](#)

One should definitely pay attention when one of the Fed heads starts to talk especially when what they have to say actually makes sense. It is now 2010, so the figure is now definitely well above \$100 Trillion. Add in the \$1 trillion health package, and all the other social programs announced since and the number goes up even more.

Conclusion

Bonds have only one place to go - and if one is kind, one will use the word down. But the fact is that the bond market is a disaster waiting to happen. At some point in time it is going to experience a horrific correction/crash as the only way this government will be able to borrow the billions and trillions of dollars it will need one day is by paying huge interest rates to bond holders.

Long term players can use rallies in the bond market to short bonds via TBT. **Precious metals** perform very well in a high rate environment so an even better option would be to have a position in **Gold and Silver bullion**. **One must also seriously consider the possibility of hyperinflation; under this scenario having a stake in precious metals is an absolute must, for they will at least prevent you from ending up in the dog house.**

If I had a formula for bypassing trouble, I would not pass it around. Trouble creates a capacity to handle it. I don't embrace trouble; that's as bad as treating it as an enemy. But I do say: meet it as a friend, for you'll see a lot of it, and had better be on speaking terms with it.

Oliver Wendell Holmes, 1809-1894, American Author, Wit, Poet

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