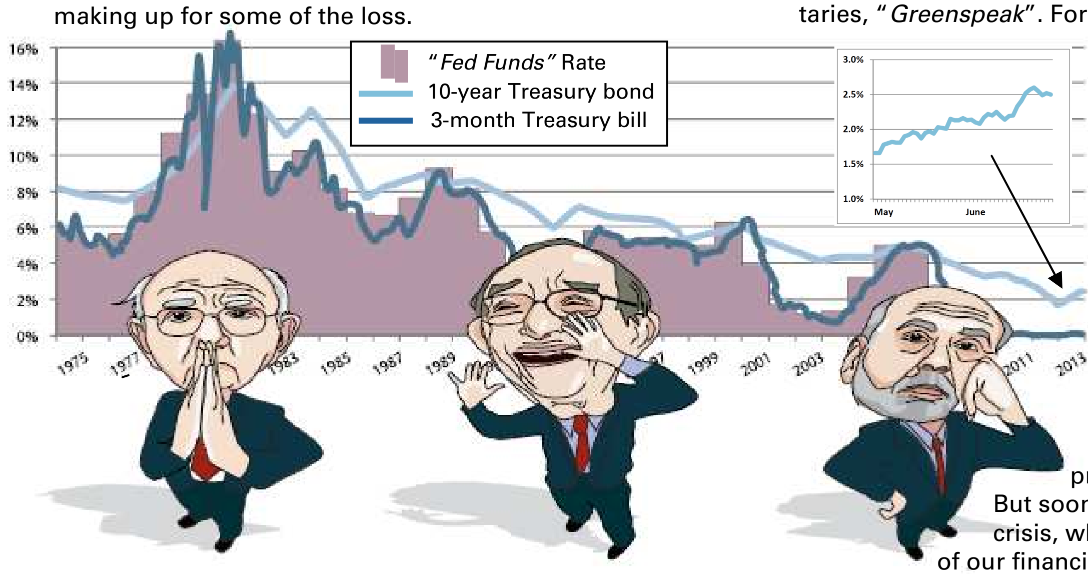
Investment Watch

2nd Quarter, 2013

The End of the 30 Year Run?

Just nine short months ago our Federal Reserve said that they would do *"whatever it takes"* in announcing **QE3**, the most ambitious stimulus program ever aimed to hold down mortgage and long-term interest rates. Until now, bond values had skyrocketed due to the historically low interest rates orchestrated by the Fed. This month, Bernanke laid out plans to slow bond purchases which roiled the markets, sent interest rates soaring, caused bond prices to tumble, and may have ended the three-decade bull run in bonds.

Interest rates have steadily dropped since their 1981 peak marked by a 15.84% yield on the 10-year Treasury bond to the recent low of 1.66%. Bill Gross, dubbed the *"Bond King"* by Forbes, predicted that April 29th was the bottom for interest rates and thus the end of the 30-year bond rally. Because bond values decline when interest rates move up, last quarter's negative bond returns may just be the start. However if bond values decline, their future yields increase making up for some of the loss.



The end of any 30 year trend deserves to be viewed with a historical perspective, and this record is largely linked to the actions of our Federal Reserve. The Federal Reserve's dual mandate is to *"maintain long run growth...with stable prices."* The Fed's main tool is to raise or lower the "*Fed Funds*" rate, the short-term interest rate at which financial institutions can borrow. As can be seen in the chart, short-term interest rates depicted by the 3-month Treasury bill in dark blue have very closely tracked the Feds action of setting the "*Fed Funds"* rate shown by the bar chart. However longer-term rates, as depicted by the 10-year Treasury bond in lighter blue, are not as easily influenced.

In the 1970s, monetary policy was driven by politics. Wage and price controls and unnecessary monetary expansion, exacerbated by OPEC's quadrupling of oil prices, resulted in the 1973-74 recession and the ensuing stock market crash. "*Stagflation"* was born, the paradox of runaway inflation in the face of slow growth periods and rising unemployment.

Paul Volker was appointed as Federal Reserve Chairman in August 1979 to tame the inflationary spiral. Volker knew that economic actions to bring down inflation would increase unemployment. Yet the only way he could end the misery of *stagflation* was with tough action to suppress spending by limiting the money supply and raising the *Fed Funds* rate. He courageously raised the *Fed Funds* rate which peaked at 20%. The *"misery index"* (inflation rate + unemployment rate) continued to rise. The *"misery index"* peaked at an unbearable 21.98% in June 1980. Volker's policies, although painful, are widely credited with taming inflation and leading to a sustained period of economic growth.

Alan Greenspan took over the helm at the Federal Reserve in 1987. Just two months later stock markets around the world crashed and the Dow Jones plummeted 22.6% in just one day, **Black Monday**. Greenspan immediately vowed to provide *"liquidity to support the economic and financial system."* The media lifted Greenspan's image to near rock star status and they branded his illusive wordy commentaries, "*Greenspeak*". For his ability to use monetary policy to deftly steer the economy, Greenspan is attributed partial credit for the longest expansion in US history (1991-2000) . However, his easy money polices after 9/11, advocacy of financial deregulation and failure to curb subprime mortgage security formation are blamed for the global financial crisis and our Great Recession.

Ben Bernanke was appointed as Federal Reserve Chairman on February 1, 2006. He encouraged a more transparent Fed than his predecessor's cryptic "*Greenspeak*". But soon the inherited subprime mortgage crisis, which precipitated the near collapse of our financial systems and the Great Recession, claimed all of his attention. *"Helicopter Ben*" embarked on the most dramatic and unprecedented Central Bank response in history pinning the *"Fed Funds"* rate near zero since 2008, injecting billions of dollars of liquidity into the system followed by several rounds of **Q**uantitative **E**asing. Last month seeing some *"Green Shoots"* of recovery, Bernanke signaled a possible slowing of the stimulus measures. Long-term interest rates spiked and the stock market shuddered leaving no place to hide.

Recent indicators have pointed to steady growth, but it will be a long bumpy road to achieve a self-sustaining economy. The Fed's experiment with near zero interest rates and massive stimulus will take years to unwind. The economy's strength will determine their timetable.

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