

# Chapter 1

## WARNING SIGNS

“What do you mean? Cut back? My wife—your sister—doesn’t do cut-back.”

El Greedo eyeballed his brother-in-law, Neo Fyte, across the hand-stitched Vachetta leather car seat. He had grudgingly hired him as a salesman at Greedo’s Partz before he sold the company. That was five years ago.

“Just what I said. Cut back. Now. Before it is too late. Like before, in two-thousand-eight.” *Do I really need to spell it out for this guy?* El Greedo wondered.

“But the portfolio is doing fine. You did that rebalance thing. You diversified into municipal bonds. The family has income.”

*My God,* El Greedo thought. *And my sister married this economic moron?* He squeezed the leather-wrapped steering wheel. He knew he would have to trade his beloved BMW for a used Kia shortly.

“Income, yes,” said Greedo. “For now. But the bonds are maturing. Too many of the issuers are in trouble; they’re scratching for cash, just like we will be.”

I need to replace those bonds. But with *what*? What is out there that is safe enough and throws off enough income—”

“So what do we do?” asked Neo. “You run the family’s money, Mr. Investment Guru. What are you going to do?”



As we write *Surviving the Bond Bear Market*, interest rates are still scraping by like an old car muffler clattering along the roadway. However, a number of economic, political, and international influences are about to exert their force in a catastrophic way. Interest rates will inevitably soar. This will launch a devastating assault on the bond market. Fixed income investors—many of them Baby Boomers and elderly retirees—will lose the nest eggs on which they live. There will be a mass redistribution of the world’s economic wealth. Much of it will be repatriated back to lenders like China, Japan, and the United Kingdom.

The pain has already started. America’s economy even now is causing untold financial hardship and economic suffering among its population. College graduates can’t find jobs. Workers with 10, 20 years of service at their companies are laid off with little prospect of finding another job. Homeowners don’t have the money to pay their mortgages. Banks are foreclosing on nonperforming loans in droves. They just hope to get their money back. But the real estate buyers aren’t coming. States, counties, cities, and other municipalities have run out of money to pay for basic services like fire and police protection. This is the start of the nuclear winter and the accompanying devastation in the bond market.

Sound like a grim picture? We agree. We’re professional bond investors. By our nature we always paint the worst-case scenario. We hope we’re wrong. However, the warning signs we see and that we’ll show you in this first chapter say otherwise. And what if we’re wrong? The worst case is that you’ll understand what can happen to your bond portfolio under the direst of circumstances and what you can do about it. After reading this book and following the tips given, you’ll have a good idea of how to guarantee a fixed income you can count on to be there when you need it.

## A Simple Three-Step Approach

Like El Greedo’s struggle earlier, you can protect your bond portfolio from disaster. It’s not that difficult. After reading this book, we think you’ll agree.

The pundits on the financial television shows make it sound unfathomable. It's really not. That's just how they make their living. Come on; follow us, we'll show you the way.

The best approach to protect your fixed income portfolio from outright disaster in the credit markets includes just three steps:

1. Know the signs that tell you when the market has become unstable and is teetering—that's in this chapter and the next.
2. Develop an action plan to insulate your portfolio as the bond bear market unfolds.
3. Identify the green shoots of recovery and develop an investment plan to take advantage of the inherent opportunities.

Taken by themselves none of the three steps are difficult. However, there is one thing that will separate the haves from the have-nots in the coming bond bear market: **believing the warning signs you see and having the courage to execute your survival plan.** We'll show you how to take the definitive actions necessary to save the value of your bond portfolio.

Now is not the time to be weak-kneed and indecisive. Pull in your belly, stick out your chin. Suck it up. Let's roll!

## **Warning Sign #1: Interest Rates**

The Air Force's 53rd Weather Reconnaissance Squadron, the famed Hurricane Hunters, assesses and analyzes oncoming hurricanes. They fly into the teeth of these mega-storms, often packing winds in excess of 100 miles per hour, to accumulate density, wind speeds, ground speeds, trajectory, and all manner of other data. Then they compute when the storm will make landfall and how severe it will be.

Like a hurricane, the bond market's coming nuclear winter without a doubt will be a financial calamity. Like the 53rd Squadron, we know this one is coming. What no one knows is the precise date it will make landfall or just how long it will last.

### ***Interest Rate Movement***

Interest rates are at generational lows. They will rise in the foreseeable future. As rates soar, bond prices will plummet. For bond investors who say they will

hold their positions until maturity, the rate hike by itself won't affect them all that much—until it happens.

The scary part of rocketing interest rates is the devastation it brings to *portfolio values*. This is a psychologically damaging event for investors. How would you like to see the value of your bond portfolio drop by half over a short period—say just three months? It could happen.

Investors will begin wondering if it will ever come back. They'll begin to feel poor, at least less wealthy. Investors are also consumers. They will consume less. And they will worry how to recoup their losses. Then the real concern surfaces: As if portfolio erosion wasn't bad enough, what happens if the bonds begin to default? That loss of principal along with the devastated portfolio value will send bond investors into pure, unadulterated panic.

Attempting to save the value of their portfolios, they'll begin selling into a plunging market—ostensibly before it goes any lower. Investors will trade bonds they know, have lived with for some time, and whose coupon payment history hasn't yet been compromised. Investors will console themselves that at least they stopped the hemorrhaging. No, they didn't.

**What if Interest Rates Don't Soar?** There's a second possibility for the nuclear winter: Interest rates remain low for some time like they have in Japan for the past 20 years. This presents an altogether different problem for bond investors. Here's how:

Let's say that you bought bonds during the days of high interest rates. Your bonds pay higher interest. If you're like most people, you've become used to that income stream. You've probably adapted your lifestyle to spend up to the level of that income stream. Like El Greedo and his seemingly economically naive brother-in-law, Neo Fyte, Baby Boomers don't know how to cut back. As interest rates remain low, bonds are called or they mature out of their portfolios. Either way, they must be replaced. As Greedo pleaded, "But with *what?*"

The bonds you replace will generate much lower income. That income won't support your current lifestyle and financial commitments. Something will have to change. Since investors can't force bond income up, it is we who must cut our spending. The good news is we have that ability. America's cash-strapped cities, counties, and states apparently do not.

People invested in bond funds will be in a worse position. The public pigging into bond funds for a few extra morsels of yield will quickly see their dividend distributions ratcheted down.



## ACTION STEP: KEEP YOUR EYE ON INTEREST RATES

Everyone seems to have their own pet ways of predicting interest rate movements. We want your assessment to be more quantitatively rigorous than just watching the evening news for their take. They don't know. Table 1.1 shows the eight primary drivers of changes in interest rates, what they mean, and where to find them.

**Table 1.1 Interest Rate Warning Signs and Where to Find Them**

Interest Rates Drivers	What They Mean	Source of Information
Unemployment rates	If unemployment falls, then consumer spending increases, driving up demand for borrowing as well as interest rates. If unemployment continues to stay the same, then it indicates interest rates just may continue at their lows.	The official government unemployment rate comes out at 8:30 A.M. EST on the first Friday of every month. Find it in the business section of any newspaper or the <i>Wall Street Journal</i> .
Housing starts and sales	Watch for the housing starts and sales to stop falling and become firm or even rise. When this happens, interest rates will start upward. If it remains the same, then look for interest rates to languish at the bottom.	The U.S. Census Bureau releases housing information every month around the 17th at 8:30 A.M. EST. Find it on the web site, <a href="http://www.census.gov/const/www/newressalesindex.html">http://www.census.gov/const/www/newressalesindex.html</a> .
Consumer Confidence Index	Watch for the Consumer Confidence Index to start rising. When this happens, interest rates will start upward.	The Conference Board releases consumer confidence information every month on the last Tuesday. Find it on their web site, <a href="http://www.conference-board.org/economics/consumerconfidence.cfm">www.conference-board.org/economics/consumerconfidence.cfm</a> .

(Continued)

Table 1.1 (Continued)

Interest Rates Drivers	What They Mean	Source of Information
Treasury yields	Movement in Treasury yields usually precedes a move by the Federal Reserve to increase interest rates.	Find Treasury yields at <a href="http://www.bloomberg.com">www.bloomberg.com</a> .
Federal debt	Increased federal debt adds to the deficit in both principal and interest. The federal government may allow the value of the U.S. dollar to fall to repay the debt in cheaper dollars. This makes foreign governments less willing to buy Treasury bonds, thus raising interest rates.	Numerous places have the federal debt. An easy web site is Treasury Direct at <a href="http://www.treasurydirect.gov/NP/BPDLogin?application=np">http://www.treasurydirect.gov/NP/BPDLogin?application=np</a> .
Bond fund flows	Indicates investor sentiment as well as their hunger for yield. As interest rates rise (or at the expectation of a rise), the value of bond funds falls. Investors scramble for the exits.	Every week, the <i>Wall Street Journal</i> (and WSJ Online) prints bond fund flow information.
Treasury International Capital (TIC figure)	The TIC identifies the amount and holder of U.S. debt owned by foreigners.	U.S. Department of Treasury, Treasury International Capital web site at <a href="http://www.ustreas.gov/tic">http://www.ustreas.gov/tic</a> . Click on quarterly analysis and results.
Corporate bond spreads	As corporate bond spreads increase, interest rates are likely to rise and vice versa.	Spreads appear in <i>Barron's</i> weekly.

Source: Envision Capital Management, Inc. Used with permission.

## Warning Sign #2: Credit Problems

Credit problems in 2010 were occurring in the municipal bond market. The problem was, you couldn't tell by the low yields. One cause of the bond bear market will be that institutions as well as individual investors who would normally buy and hold bonds will withdraw their normal goodwill. It begins simply with investors demanding compensation for the risk they take in the form of higher interest rates. El Greedo would say, "If you don't balance your budget, I won't lend you my money—the time for smoke and mirrors is over." This attitude among bond investors will make floating a new bond issue far more costly for municipalities.

Investors in municipal bonds will become very choosy. They will compete for those issues having the best credit ratings and shun those that don't. Such a credit crunch will have the effect of locking out many municipal issuers that desperately need cash. Without that money, they will literally go broke.

This started a number of negative effects that began in 2010:

- **Cutting the expense of public employees.** Massive layoffs, work weeks cut, employees going on mandatory furlough, public employee salaries cut.
- **Failing to contribute to employee pension funds.** This will continue to exacerbate the already-egregious national disgrace of unfunded public employee pensions.
- **Noticeable reduction in municipal services** like police and fire protection, and curtailed operation of city halls and libraries.
- **Cities will defer needed maintenance** on their roads, buildings, and other infrastructure because they no longer have the money to pay for it. Our cities, once a source of national pride, will become shabby and neglected.

Those municipalities not locked out of the credit markets completely will have to pay higher interest rates to the point where it becomes cost prohibitive. Some will incur such high interest costs that they will have to raise taxes and issue yet more bonds just to keep up with the interest of prior bond issues.

## Warning Sign #3: Inflation/Deflation

America's national debt stood at over \$13 trillion at the time of this writing. It was growing at the rate of \$2 million per minute, 24/7. Much of this has to do with the longest wars in U.S. history. According to the respected National Priorities Project, the Iraqi war has cost \$783 billion since inception. The Afghanistan war has cost \$284 billion since inception. As of mid-2010, that's \$1 trillion and change when combined.

Another trillion dollars or so of the national debt resulted from the bank bailouts of 2008/2009 and the stimulus package. A lot of money went to create make-work jobs and compensation for the 9.5 percent of all Americans who were unemployed. We'll never recoup any sort of return on that investment.

Paying all this money requires the U.S. Treasury to issue massive amounts of debt—to *print money* as some call it. Historically, countries that issue such large amounts of debt inevitably suffer from extended periods of hyperinflation. The inflation rate we anticipate that the United States will experience over the next decade will most certainly extend the bond market's nuclear winter.

### **Debt**

U.S. households have never been deeper in debt. According to *Barron's*, reducing U.S. household debt to a livable 65 percent of income would require Americans to repay the \$6.3 trillion they have borrowed. That would require a massive spending reduction. The fact that about 40 percent of our households live hand-to-mouth, spending every last dime they make just to keep their heads above water, guarantees little meaningful debt reduction in the foreseeable future.

When interest rates rise, those same households with adjustable rate mortgages and that live on credit card debt will suffer greatly. An even larger part of their disposable income will go toward interest payments. This will certainly not improve U.S. economic growth.

Expand the dilemma faced by America's households to her states, counties, cities, and other municipalities. Like Greece, our governmental bodies have spent just as irresponsibly. Former California Governor Schwarzenegger asked the federal government for aid twice, once in 2008 and again in 2009. Governor Schwarzenegger desperately needed these funds to pay for the federally mandated education, incarceration, police, fire, and medical care required

by illegal aliens flooding California from across the Mexican border. His pleas fell on deaf ears.

Indeed, the debt in some of America's largest cities and states is so high that it will reach a flashpoint. As soon as one of the big municipal bond issuers like California, Los Angeles, New York, New Jersey, or Illinois technically defaults on its bond payments a tsunami will roll through the bond market. Should a big city like Los Angeles declare bankruptcy (as suggested by former LA mayor, Richard Riordan), the other mayors in similar financial straits may be tempted to follow suit.

For Los Angeles, the bankruptcy strategy may make sense. During 2010, LA had unfunded pension liabilities of \$2.3 billion and a budget deficit equivalent to 10 percent of the entire city budget. In bankruptcy court a judge would likely cancel some of the ongoing obligations that are sucking up so much cash.

If this happens, the floodgates will open once the first major municipal bond issuer files for bankruptcy. Bond investments will be at extreme risk. Interest rates on new issues will spike and prices will plummet. This conceivably will be one of the explosions that starts the bond market nuclear winter.

## **Warning Sign #4: Confiscatory Tax Rates**

Tax rates are rising. They're going to go even higher. Our elected officials have no choice. The money to pay for both the unbridled spending and the debt to fund it must come from somewhere. That somewhere is taxes—personal income taxes, corporate taxes, sales taxes, property taxes, and new taxes we haven't even heard of yet. The value-added tax (VAT) is surely on its way.

Higher tax rates reduce personal consumption and increase the debt required by American households just to maintain their present standard of living. For those on a fixed income, this will jeopardize their lifestyle and living standards.

## **Warning Sign #5: Governmental Spending**

This is a sore point among an increasingly large group of Americans. Sentiment runs to the more conservative side of the boat—stop governmental spending. However, when the chief of spending sits at the top of the government, most other politicians will follow his lead. Further, that is how officials get themselves

reelected—by spending on constituencies they know will vote them back into office.

The political environment has always had a fork in the road. On the one hand, there are painful decisions that are right for the people. On the other hand, there are decisions that just kick problems down the road while keeping incumbents in office. For too many years now, America has elected leaders more inclined to get reelected rather than to make the tough decisions needed to restore fiscal health.

Unfunded pension liabilities are a growing cancer that will surely kill America's fiscal health. A 2010 *Barron's* survey estimated nationwide unfunded pension liabilities at \$2 to \$3 trillion. New York City's unfunded pension liability was \$60 billion from the same survey. Such astronomical figures illustrate the size of the crater the bond market will create when it finally explodes.

This problem occurred partly due to the type of pension plan granted to public employees. Too many public pension plans include a cost-of-living increase and lifetime health care, making the future liability uncertain and difficult to predict. Defined benefit plans, on the other hand, have no such inflation protection—bad for the pensioner, but it makes a more manageable pension liability for the public entity. This difference ensures that the unfunded liability problem will continue to increase as the Obama Administration cranks up its policy of future inflation at any cost to the next generation.

Yes, municipalities are switching to defined benefit plans for their new employees. However, the problem rests not with the newbies, but with the millions of already-retired government pensioners with undefined benefit plans. These people often draw more than their former salaries thanks to accumulated bumps in cost-of-living allowances.

There are almost as many ways to measure governmental spending as there are economists to do it. We measure governmental spending in just two simple ways:

- Outstanding debt
- Budget deficit

We figure if the debt is increasing, then spending is probably increasing, too. It's the same with budget deficits: If deficits are increasing, so is governmental spending. Find out your state's budget deficit and its total debt on your state's web site. Use that increase as a warning sign.

## Warning Sign #6: Foreign Influences

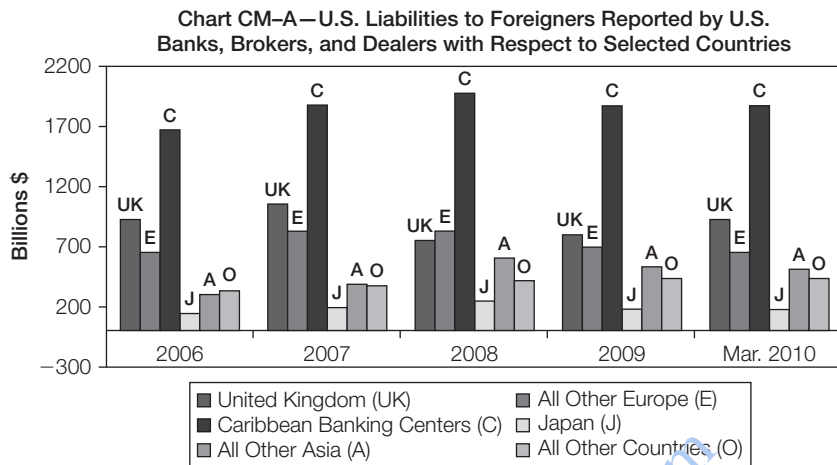
The U.S. economy is heavily dependent on the goodwill of foreign governments. Many foreign governments are not friendly to our cause. Our largest creditors are China, Japan, and the United Kingdom. As with most banking relationships, this one follows its own golden rule: He who has the gold makes the rules. In this case, the gold resides with America's creditors, not with us. China, for example, owns about \$900 billion of U.S. Treasury bonds (Reuters as of June 23, 2010). This position gives China the ability to demand greater fiscal prudence in the form of lower deficits.

Failure to comply with our banker's demands would mean economic catastrophe. China may reduce its asset allocation of U.S. Treasuries if we don't exercise greater fiscal prudence. The damage of this action would ripple through all major U.S. credit markets. It would create the following chain reaction:

- The U.S. Treasury will have to raise the interest rate offered on Treasury debt to entice buyers. This would further increase the U.S. deficit.
- The U.S. corporate bond market follows the Treasury market. This will drive bond prices down. The value of bond portfolios and bond funds will plummet. This will be a complete disaster for already-nervous bond investors. They will panic and dump their bond investments, causing another precipitous drop in the bond market.
- The market for mortgage-backed securities will plunge in value. This will drive mortgage rates up. Higher mortgage rates make it more expensive to buy real estate or refinance it. This will further reduce the number of qualified first-time homebuyers.
- The commercial credit market will raise the cost of capital to compensate lenders for higher perceived risk. This makes it more expensive for U.S. business to expand. A general business contraction will ensue.

### *Using the TIC Figure*

Around the 15th of every month, the U.S. Treasury issues its Treasury International Capital (TIC) figures. These numbers identify the amount of U.S. debt owned by foreigners. For example, the June 15, 2010 TIC report showed that net foreign purchases of long-term U.S. securities was \$83 billion.



**Figure 1.1** U.S. Liabilities to Foreigners

*Source:* United States Treasury.

The TIC is important because if it keeps on falling, it means foreigners are not buying U.S. Treasuries. If prolonged, this situation could become catastrophic for the bond market.

Almost as important as the total amount of U.S. debt owned by foreigners is *who* owns it. Are they our friends or foes? For example, Figure 1.1 shows the U.S. Treasury debt ownership as of March 2010.

## Warning Sign #7: Bond Fund Flows

An excellent warning sign for expectations of interest rate movement is the flow of money into and out of bond funds. When interest rates begin climbing, net asset values will plummet. Bond fund investors will scramble for the exits. Fund values will drop almost as fast as Tiger Woods's reputation.

If you're a bond fund investor, you have a vested interest in watching this flow of funds indicator. When the cash flow into bond funds slows down, everyone pays attention. It means the nervous money is afraid of a drop in the bond fund value due to an expectation of higher interest rates.

When you see a trend develop over a period of two or three months, you need to reduce your exposure to bond funds. Replace these holdings with the actual bonds. We don't want you to be trampled by others rushing for the exits when they realize the bond fund bubble has finally burst.

## Warning Sign #8: Bond Spreads

Spreads in corporate and municipal bonds relative to Treasury yields are called the *bond spread* (or simply, *the spread*). The spread measures the difference in yield between two bonds with the same maturities. Corporate bond spreads trade as a *percentage over* the Treasury yield; municipal bond spreads are a *percentage of* the Treasury yield. The bond spread tells the additional yield required to compensate for added risk.

As spreads fluctuate, they say a great deal about the direction of interest rates as well as investor sentiment related to risk. Fluctuations in spreads can create huge problems for companies and municipalities needing to issue bonds. For example, during November, December 2008, and January 2009, there was wild fluctuation in the spreads (perceived risk) of munis to Treasuries.

And for good reason: With the downfall of Lehman Brothers and the looming potential collapse of Citigroup and Bank of America, investors were scared out of their wits that the entire U.S. financial system was coming unglued. The flight to quality was limited to U.S. Treasuries and nothing else. The few investors willing to buy a municipal bond demanded—and received—a huge risk premium. Figures 1.2 through 1.4 are the Bloomberg charts for the three months showing the spreads (look at the right-hand column).

Notice how the spreads rose from November to December—the height of the panic—then began to settle between December and January. That's the information we want to track. Even in January the municipal bond spreads exceeded the yield you could earn on Treasuries. This has happened in the past, but not for such an extended time. It was highly unusual that it lasted so long. However, it will be repeated during the coming bond market troubles.

Find the spreads for corporates and municipal bonds appearing in *Barron's* every week.

GRAB		Muni GBY			
<TAB> to Select Data for Different Dates					
G.O. MUNICIPAL BONDS					
BLOOMBERG DAILY GENERIC OAS YIELDS					
THURSDAY CLOSE DATE: 11/13/08					
AAA MUNICIPAL AS % OF CURRENT US GOVT. 'S					
	AAA	AA	A	BAA1	
	(SECTOR 49)	(SECT.104)	(SECT.159)	(SECT.631)	
1 YR 2009	1.84	1.97	2.39	3.08	165.20
2 YR 2010	2.36	2.48	2.93	3.53	195.41
3 YR 2011	2.71	2.85	3.3	3.83	174.78
4 YR 2012	2.96	3.11	3.53	4.16	168.13
5 YR 2013	3.16	3.32	3.74	4.45	130.65
7 YR 2015	3.56	3.72	4.1	4.82	116.32
9 YR 2017	4.06	4.2	4.6	5.22	109.32
10 YR 2018	4.32	4.46	4.86	5.54	113.21
12 YR 2020	4.6	4.77	5.15	6.33	111.45
14 YR 2022	4.77	4.94	5.31	6.94	107.46
15 YR 2023	4.86	5.05	5.41	7.14	105.78
17 YR 2025	5.01	5.17	5.57	7.32	108.92
19 YR 2027	5.13	5.31	5.7	7.35	111.41
20 YR 2028	5.14	5.31	5.71	7.35	111.56
25 YR 2033	5.16	5.35	5.88	7.36	111.80
30 YR 2038	5.18	5.36	5.89	7.36	118.86

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000

Figure 1.2 Muni Spread (November 2008)

Source: Bloomberg Finance LP. © 2009 Bloomberg Finance LP. All rights reserved. Used with permission.

GRAB		Muni GBY			
<TAB> to Select Data for Different Dates					
G.O. MUNICIPAL BONDS					
BLOOMBERG DAILY GENERIC OAS YIELDS					
MONDAY CLOSE DATE: 12/15/08					
AAA MUNICIPAL AS % OF CURRENT US GOVT. 'S					
	AAA	AA	A	BAA1	
	(SECTOR 49)	(SECT.104)	(SECT.159)	(SECT.631)	
1 YR 2009	1.29	1.42	1.84	2.73	261.19
2 YR 2010	2.08	2.2	2.65	3.34	285.64
3 YR 2011	2 1/2	2.68	3.13	3.85	246.96
4 YR 2012	2.86	3.01	3.43	4.2	330.90
5 YR 2013	3.08	3.24	3.66	4.43	208.90
7 YR 2015	3.56	3.72	4.1	4.79	209.24
9 YR 2017	4.15	4.29	4.69	5.37	167.08
10 YR 2018	4.44	4.58	4.98	5.79	176.46
12 YR 2020	4.91	5.08	5.46	6.81	171.88
14 YR 2022	5.13	5 1/4	5.62	7.67	160.46
15 YR 2023	5.23	5.42	5.78	7.87	155.32
17 YR 2025	5.45	5.67	6.01	8.05	163.41
19 YR 2027	5.59	5.77	6.16	8.07	169.23
20 YR 2028	5.65	5.82	6.22	8.07	171.88
25 YR 2033	5 3/4	5.94	6.47	8.08	179.13
30 YR 2038	5.77	5.95	6.48	8.08	195.45

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2010 Bloomberg Finance L.P. SN 776233 0407-07-0 14-Jul-10 14:42:33

Figure 1.3 Muni Spread (December 2008)

Source: Bloomberg Finance LP. © 2009 Bloomberg Finance LP. All rights reserved. Used with permission.

GRAB					Muni	GBY
<TAB> to Select Data for Different Dates						
G.O. MUNICIPAL BONDS						
BLOOMBERG DAILY GENERIC OAS YIELDS						
THURSDAY CLOSE DATE: 1/15/09						
	AAA	AA	A	BAA1	AAA MUNICIPAL	AS % OF
	(SECTOR 49)	(SECT.104)	(SECT.159)	(SECT.631)	CURRENT US GOVT.	'S
1 YR 2010	0.69	0.89	1.39	2.47		178.53
2 YR 2011	1.43	1.62	2.09	2.9		195.57
3 YR 2012	1.73	1.98	2.45	3.34		171.51
4 YR 2013	1.87	2.16	2.53	3.72		179.22
5 YR 2014	2.08	2.36	2 <sup>3</sup> / <sub>4</sub>	4.04		152.05
7 YR 2016	2.54	2.78	3.17	4.65		164.17
9 YR 2018	3.18	3.36	3.81	5.49		147.64
10 YR 2019	3.54	3.7	4.17	6.01		159.43
12 YR 2021	3.97	4.17	4.61	7.14		153.12
14 YR 2023	4.11	4.45	4.69	7.88		138.62
15 YR 2024	4.21	4.53	4.85	8.08		133.60
17 YR 2026	4.45	4.65	5.1	8.28		140.39
19 YR 2028	4.59	4.84	5 <sup>1</sup> / <sub>4</sub>	8.28		143.96
20 YR 2029	4.64	4.88	5.3	8.28		145.10
25 YR 2034	4.71	4.97	5.52	8.28		151.85
30 YR 2039	4.73	4.98	5.53	8.28		164.92

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7800 Germany 49 65 9204 1210 Hong Kong 852 2377 6000  
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2010 Bloomberg Finance L.P.  
NY 762:33 6407-87-0 14-Jul-10 14:43:22

Figure 1.4 Muni Spread (January 2009)

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## Added Symptoms of Nuclear Winter in Bondland

The first symptom we'll see is a series of disturbing credit defaults and restructures. Sovereign debt is a good example. As we write this book the European Union bailed out Greece to keep it from defaulting on its debt. We see Ireland and Spain needing similar treatment. Ireland's implosion was at full tilt during November 2010.

In mid-2010, U.S. cities were collectively running over \$140 billion in budget deficits, according to the Center on Budget and Policy Priorities. To close this humongous budget gap, municipalities would cut expenses or increase borrowing if the municipal bond market were more accommodating. The complaint is usually that it is too little, too late. Nevertheless, to identify whether a particular issuer is in trouble, look for them to try a **massive worker layoff**: During 2010, Los Angeles considered laying off all nonessential city workers. It cut workweeks and also considered reducing its workers' salaries.

Watch for the first major city to default on its debt. It doesn't even have to declare bankruptcy—that's less likely, anyway. A default is the indicator

we're looking for. It might be San Diego, Los Angeles, Chicago, or New York. Default, and the negotiations with creditors that follow, will be the test case. If other cities see a forgiveness of debt and some give from the public employee unions with their iron grip on their members' pensions, then we'll see more defaults in rapid succession. This will imperil the bond holders.

### ***Muni Bond Selectivity***

The Federal Reserve reported in the first quarter of 2010 that financial institutions owned \$216.2 billion in municipal debt. By itself, Citigroup held \$13.4 billion of this. State Street Bank owned \$6.2 billion. These institutional investors were highly selective in their municipal bond purchases. Nevertheless, they will have to sell many issues when credit problems surface. Even if only 25 percent fall below their investment rating standards and they have to sell, that's \$54 billion in unwanted municipal bonds flooding the market almost at once.

This will depress municipal bond values. Investors will panic. What began as a controlled selloff of substandard bonds will turn into all-out terror.

### **Enter the Bond Vigilantes**

Economist, media pundit, and financial seer Ed Yardeni coined the term *bond vigilantes* in the 1980s. They are simply institutional investors who own enormous bond positions in concentrated issues. They sell short the bonds of governments with unsustainable fiscal policies. They'll also short corporate and municipal bonds. They'll probably also short credit default swaps. Then they wait for their dire predictions to come true. The issuer runs into fiscal shortfalls. Alternatively, interest rates on their bonds could rise so high that they can't roll over their debt. Bond values plummet and the vigilantes clean up. Then they move on in search of the next issuer to hose.

When acting together, these institutional bond vigilantes can short a particular issuer *en masse*. This action erodes investor confidence and creates a tumultuous bond market. Everything falls.

Watch the media for word of the bond vigilantes and their activities. You will see massive selling in particular bonds—like they did with Greece and like they did with British Petroleum bonds during the Gulf Coast disaster. The vigilantes have the power to force governments and corporations to change

their policies to those more to their liking. Bond vigilante actions can come suddenly. Their effects can be devastating.

China, in its insistence that the United States exhibit more fiscal responsibility, is just now beginning to express vigilante-like verbiage. If that verbiage turns into vigilante behavior, it will detonate the bond market nuclear explosion.

China sounds like any other investor worried about the stability of its bond issuer. At some point in the not-too-distant future, China will decide it no longer needs to recycle its trade balance surpluses into U.S. Treasury securities. We see this occurring when:

- Exports are less important to the Chinese economy because its middle class can finally afford homes, apartments, cars, and consumer goods and services.
- Domestic consumption becomes China's economic engine.
- China begins producing these consumer items internally in ever-increasing quantities. Quality rivals or exceeds that of any producer the world over.
- China's expanding economy will turn to buying domestic rather than foreign. This will leave discretionary investment funds in-country rather than sending them to the United States.
- Should China continue to see the United States behave in what it has said is a fiscally irresponsible manner, it will reduce the amount of U.S. Treasury it buys until it is no more than a minor buyer. The United States will then have to try peddling its Treasuries elsewhere—at much higher rates.

## Interpreting the Warning Signs

We chose just eight warning signs as our primary indicators of an imminent bond market collapse. There are many more. We felt each focuses on a particular bond market driver that is critical. Each is easily accessible in the mainstream media. Taken together, these eight warning signs provide adequate early warning of bond market problems.

Taken individually, no single sign means much. However, when you begin seeing a trend of five or more signs in the same direction, pay close attention.

If each is saying that there's a problem in its particular sector, then you should have general concern.

Most likely it is a concern not yet widely publicized. The trends of these indicators give you fair warning to take preemptive action before the masses beat you to it. From this advance warning alone, you will be far ahead of the game.

Moving into Chapter 2, "Manifestations of Nuclear Winter," you are now prepared to see how the gyrating interest rates and mounting bond defaults will affect your portfolio. We'll show you specific tactics and actions to take.

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