

Maybe “bubble” is not the most appropriate word when talking about the current state of the bond market. The word conjures up an image of an inflating balloon or a fragile bubble of gum which will inevitably pop if the rush of air doesn’t stop. Maybe in the case of the bond market we should be thinking more along the lines of a boat with a hole at one end. When the boat’s passengers discover the hole, they run away from it and all rush to the opposite side of the boat. This achieves exactly what they had hoped to avoid: the end of the boat with all of the people starts to sink, while the end with the hole manages to stay above water.

Unlike the 1990’s technology stock bubble or the 2000’s housing/credit bubble, the flight to bonds is more a sprint away from something (stocks) than a rush toward it (fixed income). We have repeatedly stated that investing is a relative game, and capital must find a home. Two severe bear markets in a single decade have left many investors disillusioned with stocks, and feeling that 10-year yields in the neighborhood of 2.6% are a more palatable alternative. Equities may be full of holes, but the crowd on the fixed income side is keeping yields under water.

Also unlike the previous two bubbles, we believe that this one is difficult to call a “bubble” in advance. The correct terminology probably depends a lot on policy decisions that have not yet been made. If the economic data continue to weaken, inflation falls, and the Fed keeps interest rates low, then locking in a 10-year yield of 2.6% will probably look like a wise decision a year or two from now. Meanwhile, if policymakers manage to push through more stimulus, there will likely be a rush back into riskier assets like equities, just as we saw in March 2009. Further stimulus measures would probably be postponing the inevitable crunch imposed by the consumer’s deleveraging process, but regardless it could turn the tide for bonds.

The current predicament comes as no surprise to us at MMA. In our June 2009 publication, [\*“Can the Consumer Get Back on Track?”\*](#) we questioned whether the stimulus measures would be sufficient to **sustainably** reinvigorate consumer demand. We wrote, *“Once the consumer finally slammed on the brakes, the federal government stepped in to try to bridge the gap to the other side of the recession. This situation, however, is not sustainable. The question before us now is, what if the consumer is neither willing nor able to reclaim the top rung of the spending ladder before the government’s life line runs out?...We are concerned with whether the stimulus is structured in a way that its medium-to-longer run impact will be effective in sparking economic growth.”*

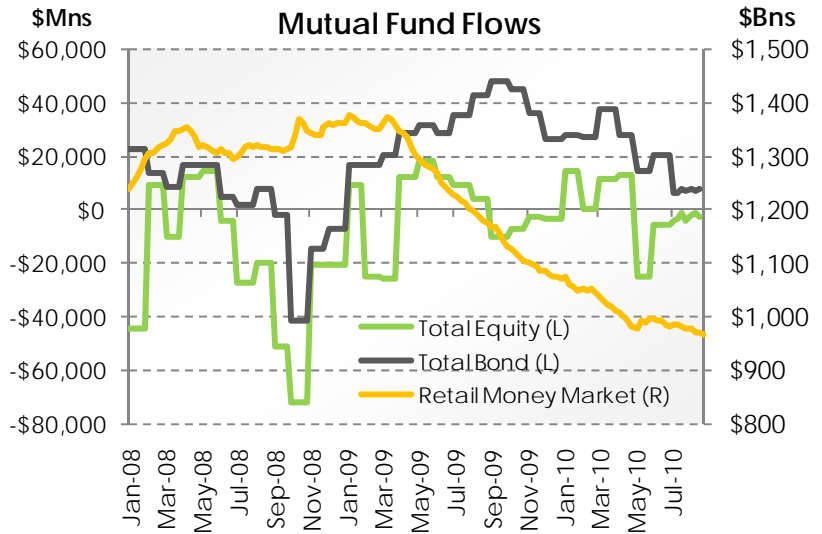
The Federal Reserve has made it clear that it wants to see a shift toward higher-yielding assets at the expense of Treasury yields. On the heels of Chairman Bernanke’s speech in Jackson Hole last week, the likelihood of additional stimulus grows with

every soft economic release. We believe that this reduces the attractiveness of Treasuries relative to equities given the government's proven track record of taking steps to prop up the recovery, at least in the short run.

### The Lifeboats

Retail investors have led the charge for the equity exits. June was the 30th straight month in which bond mutual funds attracted more money than equity funds, according to data from the Investment Company Institute. During this period equity funds racked up \$232 billion of outflows while bond funds gained an additional \$559 billion. This bonds-over-stocks mentality has not lasted so long since the period from 1984 to 1987.

The trend certainly has much to do with investors' fears of equities, but it may also be exacerbated by the near-zero rates on money market funds. This means bonds are attracting capital from both sides of the risk spectrum – stock are too hot, cash is too cold, but bonds are just right.

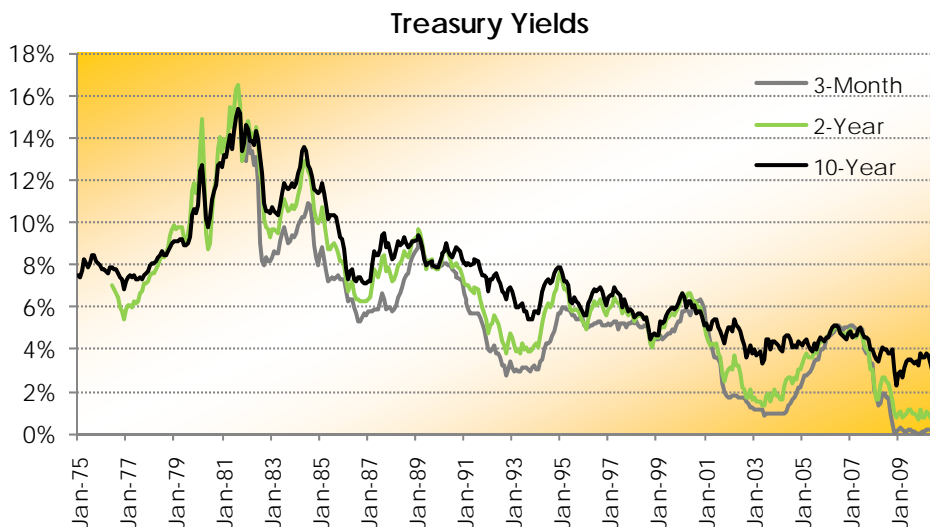


Source: Investment Company Institute

### The Mirage

The safety of bonds may be somewhat of an illusion. Investors are confident that Treasuries are the most conservative investment they can hold, but this depends on how one defines "conservative". If it is defined by risk of default then U.S. bonds are conservative, at least in the short-to-medium term.

If, however, conservative is defined by risk of loss of capital then this may not be true. Currently (Aug. 30<sup>th</sup>), the 10-year Treasury yield is 2.54% and the two-year note is at 0.50%. Unless investors intend to hold these bonds until maturity,



Source: U.S. Treasury

there is significant risk of capital losses in these securities. Even from a longer-term buy and hold perspective, locking in rates at these low levels could prove detrimental if things such as additional stimulus, increased inflation expectations, or fiscal deficit concerns prompt higher rates.

### ***Treading Water***

We want to be clear – there are significant risks to both the case for bonds and the case for equities. This kind of “middle of the road” markets are often much more difficult to navigate than clearly defined positive or negative trends. Given the balance of risks, however, we believe that high dividend-yielding equities present a more favorable risk-reward profile.

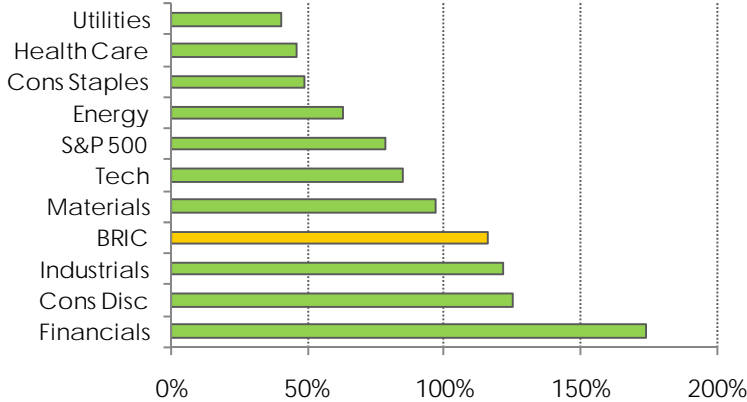
A recent example highlights the opportunity for investors. A few weeks ago Johnson & Johnson sold \$1.1 billion of AAA-rated debt. They sold \$550 million each of 10-year and 30-year securities at rates of 2.95% and 4.50%, respectively. The spreads on these bonds were 43 basis points and 68 basis points above Treasuries. Citigroup data shows that these coupons are the lowest on record for these maturities since 1981. Meanwhile, an investor could obtain a dividend yield of 3.6% by owning the stock, *which is equivalent to a 22% premium over the 10-year bond yield*. We believe this epitomizes the safety-at-all-cost mentality of many investors. A similar example occurred with an IBM bond issuance in early August. The company raised \$1.5 billion in 3-year notes at a rate of 1% – a 30 basis point spread to similar-maturity Treasuries – while the stock is yielding more than 2%.

### ***The Rescue***

As proponents of risk-controlled investing we do not advise taking on the company-specific risk of individual stocks, but a similar result may be obtained through owning sector ETFs. These vehicles also allow investors to hone in on the areas of the equity market which are outperforming at this phase in the economic cycle. For our clients, we combine a top-down macro view with a focus on income to boost the portfolio’s total return.

Earlier this year, we made a change in our Opportunistic portfolio holdings. We saw the global economic picture weakening as stimulus measures ran their course, and consumers no longer had the wind at their backs. We sold out of our country-specific emerging market positions and bought the Consumer Staples and Utilities sector ETFs. We like both the yields on these ETF’s (currently 2.76% and 4.04%, respectively) and their defensive nature.

**Equity Performance - Trough to Peak**  
3/09/09 - 4/23/10



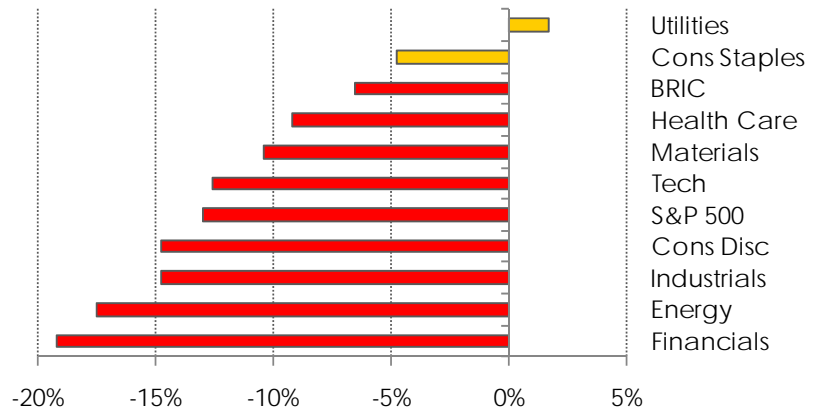
Source: Yahoo! Finance, SPDR Select Sectors  
All data represented by ETFs

During the early stages of an economic recovery, cyclical sectors like Financials and Consumer Discretionary tend to outperform. This is what we witnessed from the bear market trough in March 2009 until the recent peak in April 2010. The sectors that fell the most during the 2007-2009 bear market experienced the greatest pro-cyclical bounce. We owned these sectors through our broad U.S. equity exposure, and also owned

some of the fastest growing emerging market countries, as represented by the BRIC index (note: we owned only Brazil, India and China due to the ongoing political risks in Russia. BRIC is a proxy.)

Once the recovery began to weaken, we rotated into more defensive, counter-cyclical holdings. As mentioned above, we sold our positions in Brazil, India and China and bought Utilities and Consumer Staples. During that period, not only have these been the top performing U.S. equity sectors, but they have provided the highest amount of dividend income.

**Equity Performance - Peak to Present**  
4/23/10 - 8/27/10



Source: Yahoo! Finance, SPDR Select Sectors  
All data represented by ETFs

Should these economic trends reverse due to additional stimulus, we would expect a temporary return to the outperformance of pro-cyclical sectors. If the recovery continues to weaken, however, we will likely remain invested in high-income, defensive equity sectors. Of course if economic conditions deteriorate even further, we would once again reevaluate the risk-reward trade-off between bonds and stocks.

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