April 23, 2001

The Case of the Missing Bond Market Rally

Japanese Fingerprints

What To Do Now

Thanks for all the kind emails about my stomach problems of last Friday. I felt much better this weekend, at least well enough to begin to actually help my beleaguered wife with our house move which will culminate this weekend. Now let's see if I can recover from the bad neck pains due to the whiplash the bond markets have been giving us the last few weeks.

Sherlock Holmes or Inspector Clouseau?

History: I have been bullish on bonds for well over a year, as long time readers know. Government bonds have been good to us, up until about a month ago. Coinciding almost exactly with my recent and (I thought) well-reasoned letter on why you should buy bonds now, the last three weeks have been brutal for bond-holders, although today has seen some nice recovery.

So you ask, "John, what happened? Why have bond values gone down while long term interest rates gone through the roof? You sure missed that one."

Was I simply wrong? That is ALWAYS possible. The markets will be the judge of that. Hindsight is always the perfect judge. Wouldn't be the first time.

Is this a temporary problem? I think the answer is Yes. Has something fundamental changed? Again, I think Yes. I think the short term fundamentals have changed. Below, I outline who I believe are several suspects that have slipped a few jokers into the deck. **Has my long term view changed? No.**

So, last week I played Private Detective and set out to look for clues in the "Case of the Missing Bond Market Rally". You can be the judge and decide based upon what I found if this is the time to bail out of bonds (as some suggest) or sit tight or buy some more.

Clue: Missing Treasury Funds

As I understand it, the US Treasury holds "custodial funds" in US government Treasury Bills and Bonds for foreign entities. Over the last two reporting weeks, that account has dropped a huge $15 billion. That means someone is selling our bonds, therefore potentially driving our interest rates up. Who is taking such big money out of the US, especially in light of the problems I mention below?

Not anybody South of the Border. Their currencies are getting weaker by the day, which always leads to capital flight, and that means dollars. Indeed, I warned you months ago about getting rid of any Argentine bonds you have. They paid such a huge interest rate that they tempted many US investors with their government promises to keep the dollar and the peso equal. (I could write about trusting in government promises, but I will resist.)

The Argentine economy is collapsing while the world yawns. But Argentina has FAR more debt than Russia ever dreamed of having. (Remember 1998?) The Argentine government has steadfastly maintained they would never drop the “dollar-peso peg.” That means the government many years ago said the peso would always be worth one dollar, so they could stop inflation. It worked.

But they neglected to stop their run-away deficits and other problems (unions, welfare, etc.), so now, they can’t borrow money from anyone, not even their own banks. No one wants the Argentine Peso. It has dropped 45% on the open markets in the last few days. How low can it go? The Argentine banks must think it can go a lot lower, because they are not willing to buy Argentine debt, even with big government inducements like lower reserves.

Asia? Scanning the trade screens, it seem like almost all the Asian currencies are down big: Korea, Thailand, Taiwan, China – the list is long (with one HUGE exception – more below). Each country is trying to make their currency cheaper so the American consumer will buy THEIR products.

Europe? The European Central Bank is working hard to get a nomination for the International Monetary System “Clueless” Award. Normally, this Award goes automatically to Japan, but our European neighbors are making a race of it this year. I could spend a letter talking about the problems there, but can sum it up in one word: stagflation. They have inflation problems, a slowing economy, dropping exports, various countries have major deficits, etc.

There may be some selling of the dollar in Europe, but not enough to affect the Euro or to help us find our missing money.

Australia? Africa? Iceland? Russia? India? No, all those countries are trying to get as many dollars as they can.

That leaves only one suspect: Japan. Let’s see if we can find some fingerprints in the Land of the Rising Sun. (I confess to consulting fellow Super-Sleuth Greg Weldon for this clue.)

The Japanese are in big trouble. Their banks are sitting on what may be as much as $1 TRILLION dollars of bad debt, give or take a few hundred billion. Think about what that would do in the US. And Japan is smaller. It would take us down hard. I mean REALLY hard.

The Japanese are running huge government deficits. Their economy is in outright deflation. Exports are dropping. The banks have shrunk lending by about 5%. What have they done with the money? They have bought Japanese government bonds. Lots of them.

Let me see if I can cut to the chase. This is important, though, so stay with me. The Japanese government is in turmoil. Last week, it looked like the Ruling Party would put back into power the same tired old gentleman who helped create the current problem. HE promises (surprise, surprise) more government work programs. Which means more deficits, which means more bonds. But there are already more Japanese bonds than the world wants now, so the thought of more bonds drove Japanese long bonds down sharply over the last few weeks.

Recently, the Japanese finally decided to actually make banks value their assets at market value (mark-to-market or M-T-M). So, besides their mountain of bad debt, which they are trying to hide, they now have HUGE supplies of government debt, which is dropping in value and which they cannot hide.

They must keep their reserves up, so what can they do? Call in profitable loans? For a lot of reasons, they won’t do that. Could they sell Japanese bonds? If they did, that would only make their bonds drop more in value. The lock-step, good-old-boy Japanese bankers would never do that. That leaves one asset: their massive holdings of US dollars.

I think that is why when every other Asian country is trying to lower their currency against the dollar, the Japanese currency is actually rising. They are selling dollars to buy yen and shore up their reserves.

That could change, though. Over the weekend, it began to look like the ruling party would actually back a reformist candidate, who says he believes in a fiscally conservative policy. That would be good for Japanese bonds, but would mean some pain for Japan as their banks are forced to clean up their act and the government tries to balance its budget.

Clue #2: The Yield Curve

As I said it would 8 months ago, the yield curve has corrected itself prior to the onset of a recession. That this would happen is no big secret. In fact, lots of hedge funds executed complex trades many months ago which involved betting the yield curve would right itself. When that happened a few weeks ago, they began to unwind those trades.

According to my sources on the bond floor, part of the recent turmoil in bonds was the result of large hedge fund positions unwinding those bond trades. Today, on CNBC, the talking head listed several large hedge funds which were unwinding bonds trades, including the largest hedge fund in the world.

Even with the volume in the bond trading pits, it takes a few weeks to unwind billions in such complex trades.

Clue #3: The Interest Rate Cut

Greenspan cuts rate, clearly without warning. The money poured from bonds and into stocks. We had more selling pressure on bonds, as those who are short bonds had to cover their bets. Just as anyone who was short last week lost money, so those who were long bonds lost money. If you were on margin or heavily leveraged in bonds as many private funds were, you scrambled to cut your losses. That gave us more selling pressure on the long bond.

If just one of these events happens, then maybe the bond markets drop a little bit. But with all three piling on, it was just too much weight for the bond market to take. Through Friday, 30 year zero coupon bonds have fallen more than 8% since the beginning of the month, though we probably got back about 1.5% today.

When Will We Find Our Missing Bond Rally?

I had dinner with Don Peters, my favorite bond guru, last Thursday night. Then I talked with respected technicians Greg Weldon and Kevin Klombies.

Last week both Weldon and Klombies thought interest rates could go higher in the near-term, citing the connection between the Japanese and US bonds along with other technical issues. (To get two weeks of sample issues of Klombies very interesting $40 a month daily technical analysis by e-mail, write him at krk@krk-imra.com and tell him I sent you.)

Today, Greg is at least short term bullish on bonds and Kevin says he is no longer bearish. They both (neither reads the other) cite the Argentina situation. I totally agree that Argentina is a potentially huge problem. If it was just one country I could maybe ignore the situation. But there are so many countries that are on the edge that Argentina could be the proverbial straw that broke the camel's back, because so many people placed so much faith in the "dollar peg".

Why should we care? Because if enough investors get scared, we could see a world-wide flight to quality. Quality is the US dollar. Period. Not the Yen or the Euro. Not even gold is the gold standard anymore. It is the dollar.

If the dollar gets much stronger, this would be very bad for the profits of US companies who need to export. Of course, it means that we get to buy products at lower prices, but in a slowing economy, that does not offset the problems of diminishing exports.

A rising dollar would be bad for stocks and good for bonds. A world-wide currency crisis would be VERY bad for stocks and good for bonds.

Let me be clear. Am I predicting a currency crisis? No. I am simply pointing out that it is very possible. The world, as I have written about, is facing a serious liquidity problem. If Argentina defaults, it could be serious. I remember 1998 and Russia, and that happened when the US economy was strong.

After talking with traders and technicians, who look at the markets as they are today and worry about tomorrow, it is refreshing to talk with Don Peters. Don could care less what happens tomorrow. He has built his enviable record on looking WAY down the road. This makes him volatile day to day, but so far his long view approach has paid off for clients who stay with him. He calms me down with his logic and reminding me to review the fundamentals.

A few years back, I had laser eye surgery which allowed me to see distant objects, but I still need reading glasses for up close. Don is like that with interest rates. But he doesn't bother to wear his short term reading glasses.

In our dinner meeting, Don went back to all the fundamentals I discussed three weeks ago: a recession, deflationary pressures, surpluses which cut the supply of bonds, etc. which he thinks will drive rates down considerably over the next few years. His ultimate target for US 30 year treasuries is 3.5% or less.

If he is right, holding US bonds is a potentially very profitable investment over the next two years. Zero-coupon bonds could rise more than 80% if rates drop 2%+.

What To Do Now

I think that fundamentally the argument for bonds is the same today as it was three weeks ago, except they are 8% better buys today. But there is nothing to say today's rise in the bond market signals the bottom. I think we could see some short-term volatility in the markets.

If you are like Don Peters and you don't mind volatility, then you can go ahead and jump into bonds today, or stick with what you have.

If volatility makes you nervous, then either buy bonds of shorter term duration which will be less volatile or just sit on the sidelines for awhile until it becomes clear what the direction is. But I should warn you that interest rates, once they begin to move, could move quickly. Last year's big gains were done in just two quarters (the first and the last) and much of that was done in a few weeks.

As you know, we have started representing Don Peters and offering his services to current and new clients. Peters has managed bonds for 25 years, and is one of the highest rated managers in the country, (as independently ranked by Callan and Associates). He is now managing money for individual investors with a minimum account size of $25,000. Don and I have to make a decision as to when and how to deploy this new client money. Here is what we are going to do.

If you held a gun to my head and asked me today if I thought the bond market would be up or down in the next 2-3 months, I would say go ahead and pull the trigger. I could use the "clues" detailed above to argue the case for both sides. Nobody knows for sure, unless they know what the Japanese are going to do. The Japanese and the Argentine situation are the key factors now. But serious problems in those countries will tend to push the markets in opposite directions. Which will be the stronger force, or will they cancel each other out?

What this all probably means is that the markets are going to be very volatile for the next few months. Two years from now, I think today will look like a huge buying opportunity, but next month might be better or it might be worse.

For our clients, we are going to "feather in". By that I mean, we will systematically invest a client's money over the next few months, in a type of dollar cost averaging. That does not mean the volatility will be over in 2-3 months, just that I think it makes sense to establish our position a little bit at a time with our eye on the 2-3 year time frame. If rates go up, we get a better buying opportunity. If rates go down, we have locked in at least a portion at an intermediate market high. I also have the option of moving faster should conditions warrant.

In two or three years, if Don and I are right about the drop in rates, getting in today or next month or the next month may not seem all that big a deal. But Don agrees with me that investing in a planned phase makes sense, given today's conditions.

Procrastination Kills.

I don't want to wait until the bond market clearly turns around because it could drop 50 basis points just as fast as it rose. For the reasons cited above, the recent bond market lows may be the actual lows, and we will have wished we had placed all our money on the table last Friday.

What about those of you (including me) who already have bonds? I would suggest you sit tight unless the volatility is causing you to lose sleep. Then you should not be in long term bonds in any event. There are other fixed income approaches that may be more suitable for you. Long term bonds are a bet that the economy is going to get worse before it gets better.

Quick Sidebar: Some of you have written about investment advisors who use Wave Theory and say these analysts think interest rates are going to 6.5% or higher. Without getting personal, I think using Wave Theory to invest is a little like trying to drive while looking in the rear view mirror. Wave Theory can be made to explain every turn of the market in history with exact precision. It is just when it gets to the future that it has problems. Wave Theory is something to use along with sound fundamental analysis. Using it alone can result in problems. Enough said.

****

I will stop here, as going into the current stock market situation would take at least another 3-4 pages. But I will give you the last sentence: **the fundamentals suggest to me that the stock market will keep dropping. We remain short.**

For those of you who follow the gold markets, we could see a short squeeze on gold coming up, which in my view will be just another opportunity for you to sell and get out.

I will write on the stock market and the economy next. If you would like to know more about our bond management services, please call us at 800-829-7273 and I will send you my Special Report and cassette interview I did with Don Peters.

Your whip-lashed analyst,

John Mauldin
John@2000wave.com

P.S. The gentleman who offered me the gumbo for my stomach problems can send it to my office. I am sure it will cure something.