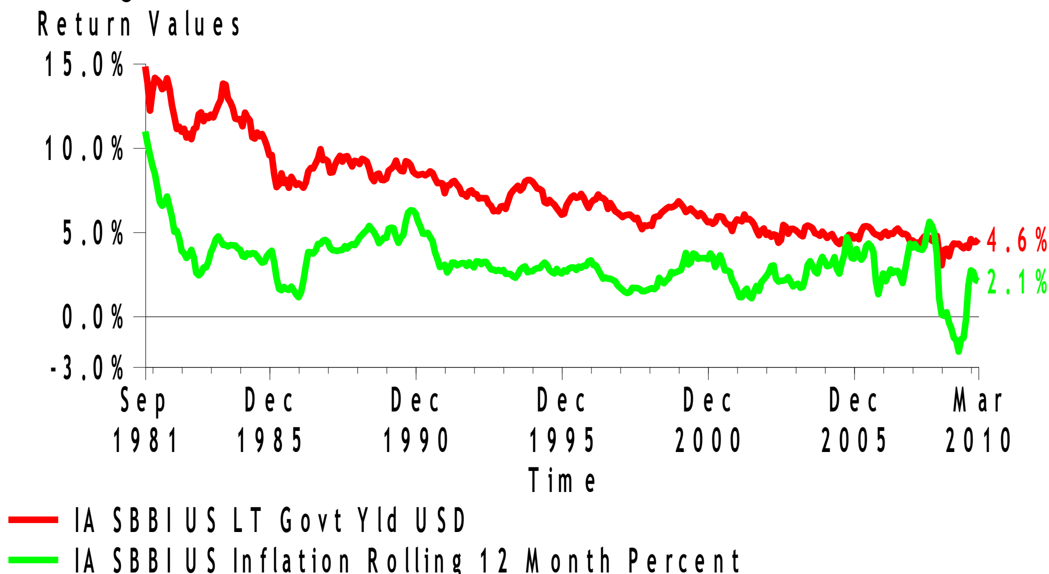
The Bond Roller Coaster

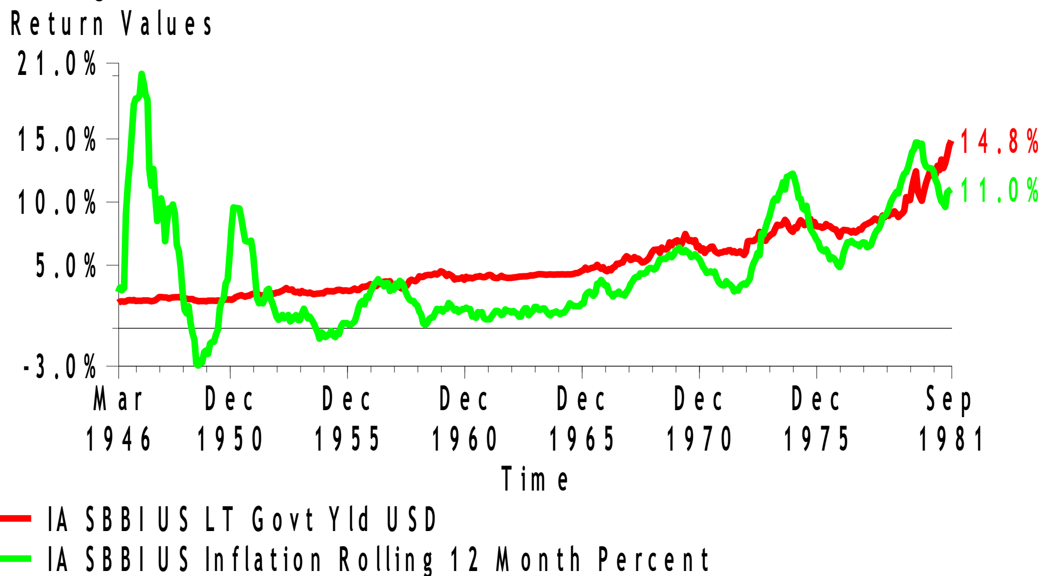
Investors have benefited over the past three decades from an unprecedented bull market in bonds since long-term government bond yields peaked at 14.8% in September 1981. Aggressive monetary tightening by Paul Volcker, Chairman of the Federal Reserve at that time, drove inflation from double-digit levels in 1981 to less than 3% in 1983. Continued vigilance by the Federal Reserve combined with deregulation, globalization and, until recent years, lower oil prices set a trend of disinflation and lower interest rates firmly in place.



As bond investors priced ever-lower inflation expectations into their return requirements, yields declined and created capital gains for bondholders. Since September 1981, the annualized returns from long-term government bonds of 10.8% rivalled the 11.2% return of the S&P 500 stocks. However, barring a serious double-dip recession, the trend of declining yields and robust gains is a thing of the past.

Many investors are not aware that the great bond bull market of the last three decades had its genesis in a devastating bond bear market that ran over 35 years from 1946 when WWII price controls were lifted until September 1981. The gradual entrenchment of higher inflation expectations, after the 1973 oil crisis in particular,

propelled yields upwards. As evidenced in the following chart, long-term government bonds yields (in red) rose from 1.98% in March 1946 to 14.8% in September 1981.

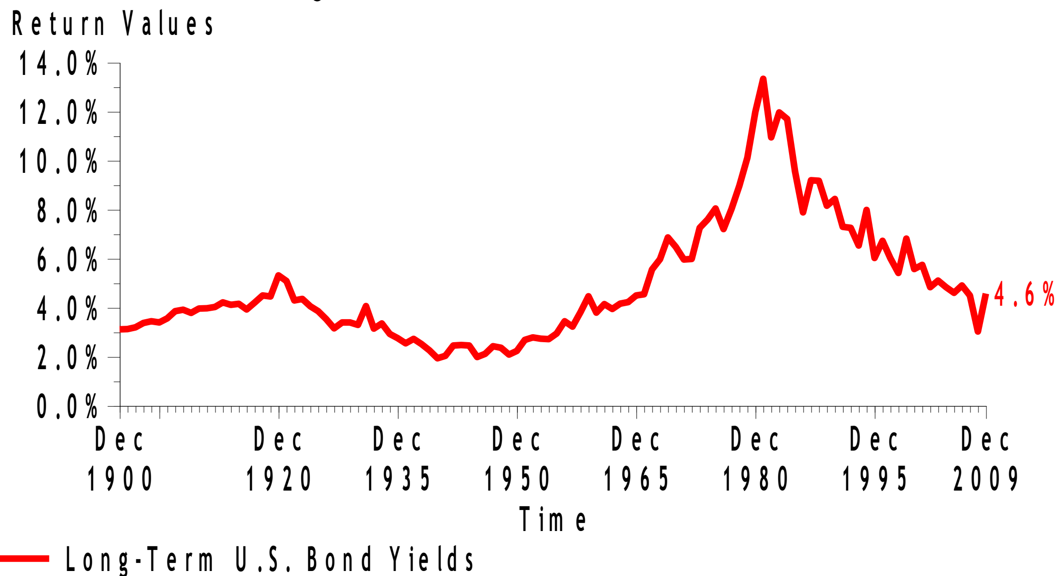


During this period, investors in long-term government bonds earned a paltry 1.6% as capital losses induced by rising rates overwhelmed the income return. Real returns (i.e. net of inflation) were negative at -2.9% annually. In contrast, stocks earned a 10.2% nominal annual return and 5.2% after inflation.

Long-term bond yields have always been subject to lengthy secular cycles. Prolonged periods of falling yields and rewarding bond returns have been regularly followed by drawn-out periods of rising yields and subpar returns. Appendix I sets out this secular pattern of yield changes over the past two centuries while Appendix II contains a chart of U.S. federal debt. With the exception of WW II when the Federal Reserve worked with the Treasury Department to maintain low yields, cyclical peaks in bond yields have often been associated with government funding stresses in times of war (e.g. War 1812-14, Civil War and WWI).

The secular cycle in bonds is evidenced in the following chart which illustrates long-term U.S. bond yields since 1900[i]. Of note is the fact that yields rose from 1900 to 1920, a period of rising commodity prices, stimulative monetary policy in the form of growing gold supply, increasing regulation and banking reform. Government funding

requirements for WWI were the final cause of higher rates. The parallels to our current situation are obvious.



Although the U.S. is under tremendous deflationary pressure from excessive leverage and production capacity, so long as some shock does not tip the economy into a double-dip recession, a new secular cycle in long-term rates is in the process of forming. The Federal Reserve, with an eye to the policy errors of the 1930's and Japan, is likely to err on the side of a loose monetary policy for years. Skyrocketing federal debt will demand a higher risk premium and the government will be tempted to let inflation re-ignite so as to reduce its debt burden in real dollars. Higher taxes and regulatory costs will be passed along to consumers through higher prices.

The good times for bonds couldn't last forever. Although some longer-term bond exposure is needed today as a hedge against a deflationary scenario, investors should recognize that in the next year or so the bond roller coaster is about to get underway.

April 30, 2010

www.tacitacapital.com

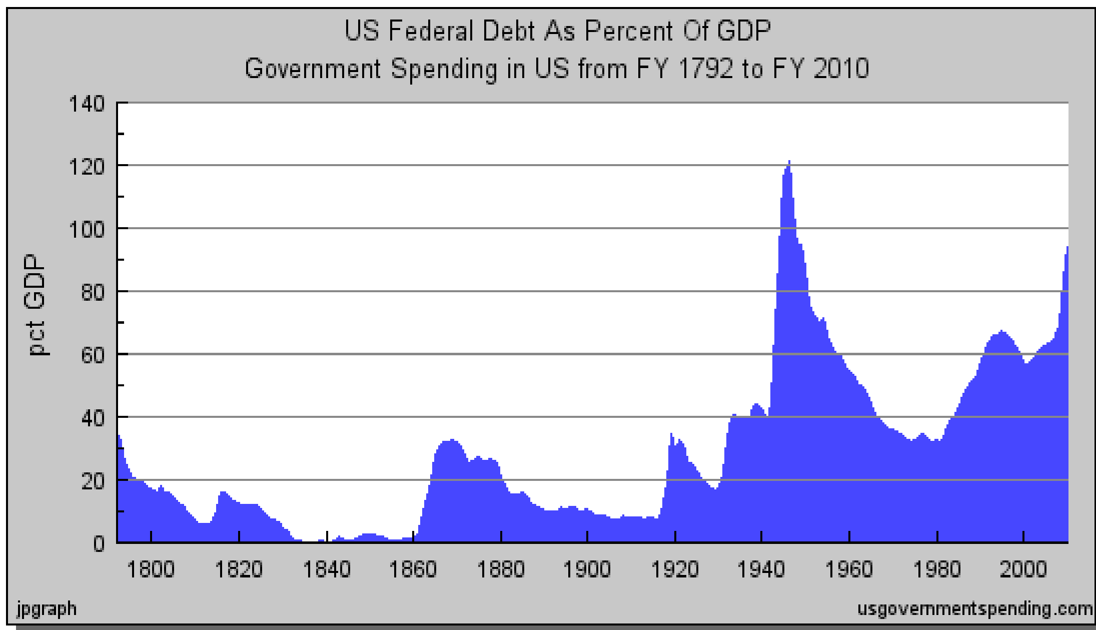
Appendix I
Long-Term U.S. Bond Yield Cycles

Period	Yield at Cyclical Turn	Yield at Cyclical Turn	Change	Duration in Years
1798 -1810	7.56%	5.82%	- 1.74%	12 - Bull
1810-1814	5.82%	7.64%	+1.82%	4 - Bear
1814-1824	7.64%	4.25%	-3.39%	10 - Bull
1824-1842	4.25%	6.07%	+1.82%	18 - Bear
1842-1853	6.07%	4.02%	-2.05%	11 - Bull
1853-1861	4.02%	6.45%	+2.43%	8 - Bear
1861-1899	6.45%	3.24%	-3.21%	38 - Bull
1899-1920	3.24%	5.27%	+2.03%	21 - Bear
1920-1946	5.27%	2.53%	-2.74%	26 - Bull
1946-1981	2.53%	14.17%	+11.64%	35 - Bear
1981-?	14.17%	n.a.	n.a.	n.a. – Bull

Source: A History of Interest Rates, Third Edition

TACITA CAPITAL

Appendix II
U.S. Federal Debt as a Percent of GDP



Source:
http://www.usgovernmentspending.com/downchart_gs.php?year=1792_2010&view=1&expand=&units=p&fy=fy11&chart=H0-fed&bar=0&stack=1&size=l&title=US%20Federal%20Debt%20As%20Percent%20Of%20GDP&state=US&color=c&local=s

Tacita Capital Inc. ("Tacita") is a private, independent family office and investment counselling firm that specializes in providing integrated wealth advisory and portfolio management services to families of affluence. We understand the challenges of affluence and apply the leading research and best practices of top financial academics and industry practitioners in assisting our clients to reach their goals.

Tacita research has been prepared without regard to the individual financial circumstances and objectives of persons who receive it and is not intended to replace individually tailored investment advice. The asset classes/securities/instruments/strategies discussed may not be suitable for all investors and certain investors may not be eligible to purchase or participate in some or all of them. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. Tacita recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial advisor.

Tacita research is prepared for informational purposes. Neither the information nor any opinion expressed constitutes a solicitation by Tacita for the purchase or sale of any securities or financial products. This research is not intended to provide tax, legal, or accounting advice and readers are advised to seek out qualified professionals that provide advice on these issues for their individual circumstances.

Tacita research is based on public information. Tacita makes every effort to use reliable, comprehensive information, but we make no representation that it is accurate or complete. We have no obligation to inform any parties when opinions, estimates or information in Tacita research changes.

All investments involve risk including loss of principal. The value of and income from investments may vary because of changes in interest rates or foreign exchange rates, securities prices or market indexes, operational or financial conditions of companies or other factors. There may be time limitations on the exercise of options or other rights in securities transactions. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. Management fees and expenses are associated with investing.

---

[i] Based on high-grade municipal bond yields from 1900 to 1919 and long-term government bond yields from 1920 to 2009. Data sources are: Homer, S. and Sylla, Richard. *A History of Interest Rates*. Rutgers University Press, 1991 and Morningstar Encorr.