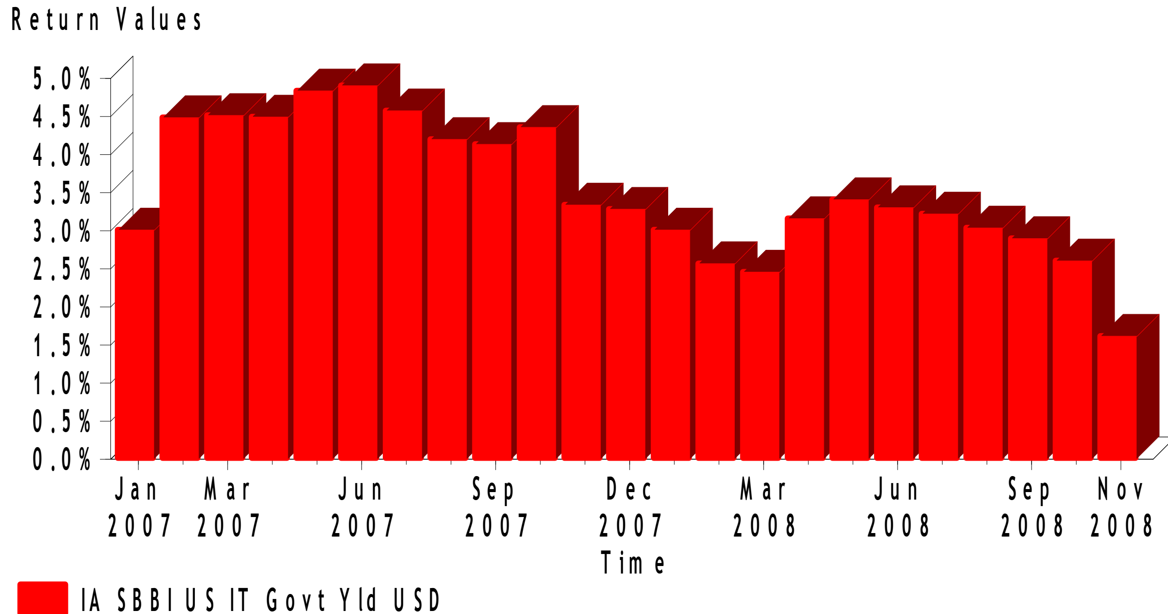
The Fear Bubble

Asset bubbles, when prices zoom to irrational levels, are typically associated with investor manias. The technology bubble of the late 1990's is a recent example where investors stampeded into tech stocks, pushing prices to extraordinary levels before the inevitable crash that followed. This cycle of bubbles and crashes has occurred in virtually every asset class over past centuries as investors, blinded by emotion, act en masse, first in an orgy of indiscriminate buying and then in a paroxysm of panicked selling.

Normally, the driving emotion in a bubble is the heady vision of fast and easy riches, an image constantly reinforced by endless tales of effortless gain featured in the media and cocktail chatter. Behavioural finance posits many cognitive biases that contribute to this phenomenon including: the bandwagon effect – the tendency to go with the crowd; confirmation bias – the tendency to seek out and interpret information that confirms one's own beliefs or preconceptions; and myopic framing – the tendency to view facts in a narrow context.

These biases are hard at work today. The difference is that instead of rapturous dreams of wealth, investor psyches are consumed with dread and trepidation about the future as a nasty recession takes hold. What other mood makes sense! One can't open a paper or read an Internet piece without enduring a flood of dismal economic news. Government officials comment almost daily on the perilous state of our affairs. The topic du jour is the odds of experiencing another Great Depression which has even got its own moniker, the Great Depression II. Investment account statements, awash in a sea of red ink, are proof positive that risk taking doesn't pay.

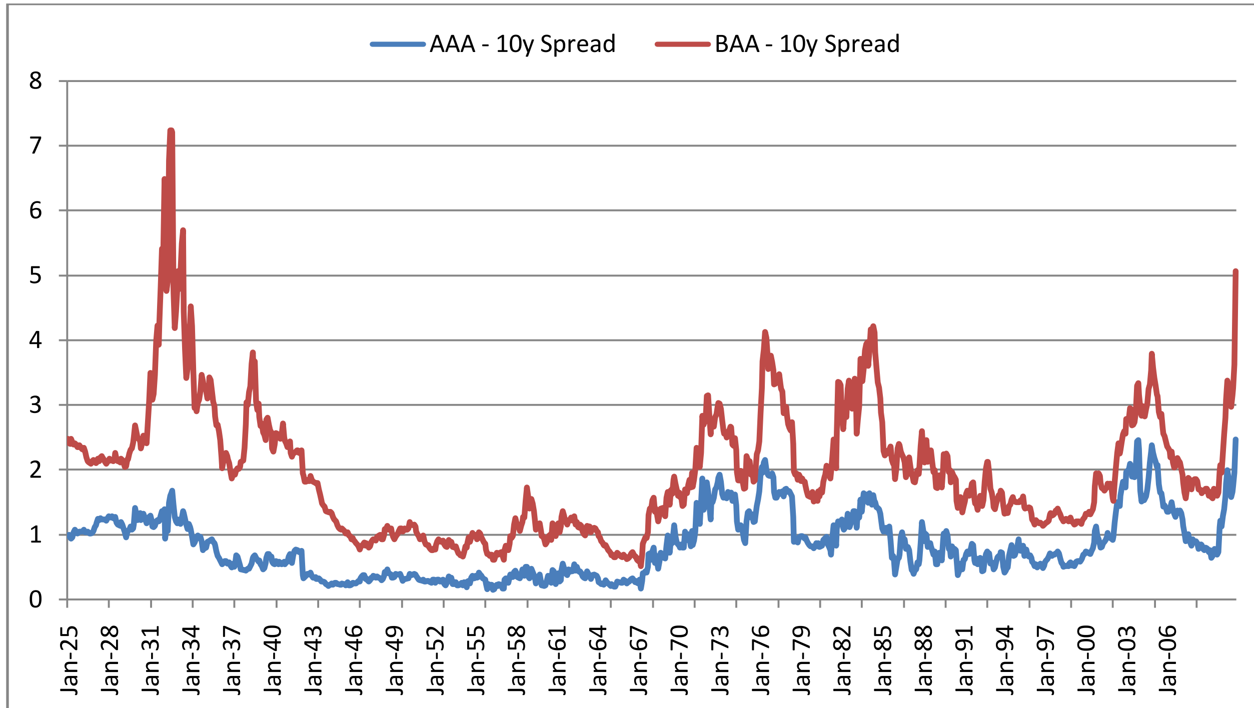
Fear is now in the driver's seat and nowhere is this more evident than in the flight to safety in bonds. Of course, this "fright to quality" has driven yields on U.S. Treasury bonds downwards – as evidenced by the following graph that depicts the falling yields on intermediate term U.S. Treasury bonds from January 2007 to November 2008.



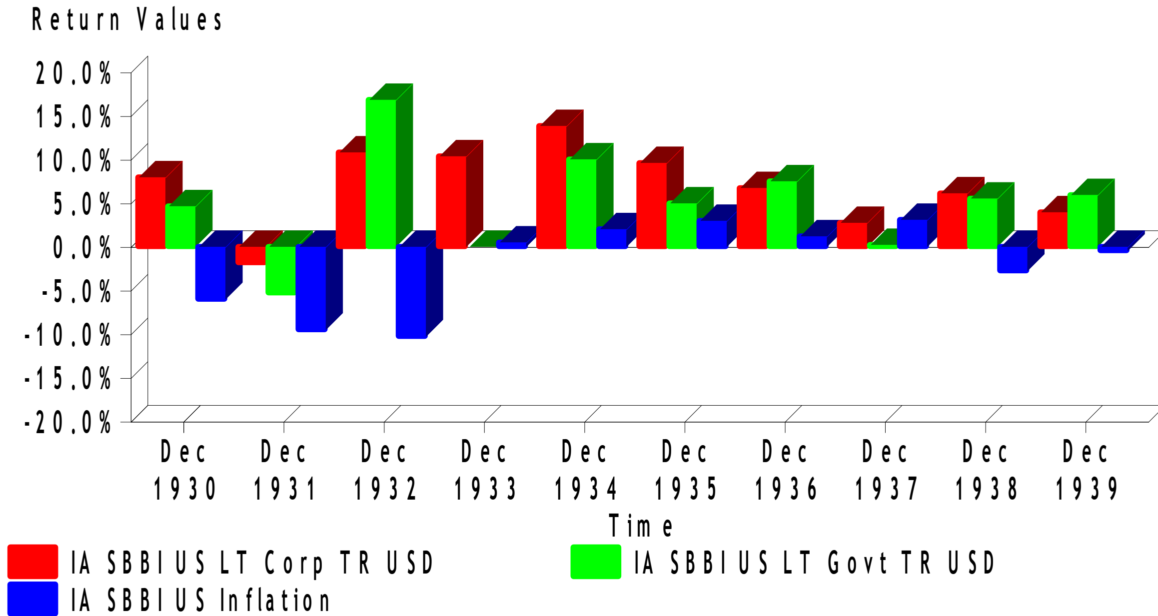
Yields on ten-year U.S. Treasury notes tumbled even further in December, hitting 2.07 percent on December 18th, levels not seen since just after WWII. Investors' tolerance for risk is so low that three month U.S. Treasury Bills offered a negative return, -0.05 percent to be exact, the lowest yield ever offered by the Treasury on this security.

Falling yields have turned into double digit gains for Treasury bond holders so far this year, a stark contrast to the nearly forty percent losses suffered in the equity markets. Meanwhile, as the "fear bubble" drives investors into an asset class that offers ever more meagre yields, investment grade corporate bonds offer high yields not seen since 2000 while preferred shares offer even higher returns.

The result is that the interest rate spread between Treasuries and investment grade corporate bonds is at levels not seen since the 1930's (See the following chart - AAA are minimal credit risk; BAA are moderate credit risk.)



In our opinion, the fear bubble has inflated "safe" assets to unsafe levels as investors forget the real lesson of the 30's – governments eventually print and spend enough money to end deflation and resume economic growth, but in doing so trigger renewed price increases. Low yield "safe" bonds in the face of inflation can then substantially underperform the much higher yield "risky" bonds. This is exactly what occurred in the 1930's, as evidenced by the following chart comparing the annual return of long-term corporate and U.S. government bonds with inflation rates in the 1930's.



Although at the height of the deflation in 1932 government bonds outperformed corporate bonds, as inflation was rekindled in 1933, corporate bonds earned a 10.4 percent return, well ahead of the -0.1 percent return of government bonds, and then outperformed over the next two years. In fact, from 1932 through 1939, long term corporate bonds achieved an annual rate of return of 8 percent, well ahead of the 6.3 percent return of government bonds and with one-third less volatility.

It doesn't have to be the Great Depression for corporate bonds to outperform government bonds. In eleven of the fourteen recessions since 1926, long-term corporate bonds outperformed long-term government bonds in the twelve months after the trough of the recession. The average outperformance over all fourteen post-trough periods has been a substantial 1.8 percent. (See Table 1 attached.)

The fear bubble has blinded investors to the lessons of previous cycles – when the crowd is pursuing safety at any cost, "safe" assets can become overvalued. This leaves the thoughtful investor with much better opportunities down the credit ladder in investment grade corporate bonds and quality preferred shares.

December 19, 2008

Tacita Capital Inc. ("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.

Table I -Comparative Bond Returns

Peak	Trough	Peak-to-Trough Return		12-months After Trough	
		IA SBBI US LT Corp TR USD (%Total Return)	*IA SBBI US LT Govt TR USD (%Total Return)*	***IA SBBI US LT Corp TR USD (%Total Return)***	*IA SBBI US LT Govt TR USD (%Total Return)*
October 1926(III)	November 1927 (IV)	7.9%	10.8%	**2.7%**	0.8%
August 1929(III)	March 1933 (I)	21.3%	22.0%	**16.5%**	5.6%
May 1937(II)	June 1938 (II)	5.2%	6.2%	**6.7%**	7.6%
February 1945(I)	October 1945 (IV)	1.1%	5.1%	**2.5%**	2.2%
November 1948(IV)	October 1949 (IV)	6.0%	6.3%	**0.1%**	0.3%
July 1953(II)	May 1954 (II)	8.0%	9.6%	**1.6%**	1.3%
August 1957(III)	April 1958 (II)	13.8%	12.2%	**-5.7%**	-9.5%
April 1960(II)	February 1961 (I)	8.6%	10.1%	**2.5%**	0.9%
December 1969(IV)	November 1970 (IV)	14.1%	13.1%	**12.6%**	11.8%
November 1973(IV)	March 1975 (I)	0.6%	4.3%	**14.0%**	11.8%
January 1980(I)	July 1980 (III)	10.3%	9.4%	**-11.9%**	-11.1%
July 1981(III)	November 1982 (IV)	49.0%	48.0%	**7.8%**	4.4%
July 1990(III)	March 1991(I)	7.8%	7.0%	**13.7%**	12.7%
March 2001(I)	November 2001 (IV)	6.7%	4.4%	**11.3%**	10.1%
December 2007(I)	November 2008 ?	-5.9%	14.8%		
	Average	**10.3%**	**12.2%**	**5.3%**	**3.5%**