



## Double 'Bubble,' Toil and Trouble

By Sam Bass  
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Shakespeare begins "The Tragedy of Macbeth" with three witches imparting their prophecies to Macbeth, the would-be king. But prophecies, Macbeth learns to his chagrin, do not always turn out as expected.

The latest economic prophecy, which has gripped investors' fears for the past three years and counting, is that a 'bubble' in US Treasury bonds is about to burst. Hyperinflation is just around the corner, the prediction goes, and US Treasury bonds, driven up in price to record levels by unprecedented policy measures, are about to crash. Here are but a few of the dire warnings that are circulating the subject. It is not my intent to label these 'seers' of the future as false prophets, but they have staked their claims to positions as forecasters, and I will treat their comments accordingly.

"When the financial history of this decade is written, it will surely speak of the Internet bubble of the late 1990s and the housing bubble of the early 2000s. But the U.S. Treasury bond bubble of late 2008 may be regarded as almost equally extraordinary."

Warren Buffett

"Ten years ago we experienced the biggest bubble in U.S. stock market history – the Internet and technology mania that saw high-flying tech stocks selling at an excess of 100 times earnings. The aftermath was predictable: Most of these highfliers declined 80% or more, and the NASDAQ today sells at less than half the peak it reached a decade ago..."

A similar bubble is expanding today that may have far more serious consequences for investors. It is in bonds, particularly U.S. Treasury bonds... The rush into bonds has been so strong that last week the yield on 10-year Treasury Inflation-Protected Securities (TIPS) fell below 1%, where it remains today. This means that this bond, like its tech counterparts a decade ago, is currently selling at more than 100 times its projected payout...

The possibility of substantial capital losses on bonds looms large. If over the next year 10-year interest rates, which are now 2.8%, rise to 3.15%, bondholders will suffer a capital loss equal to the current yield. If rates rise to 4%, as they did last spring, the capital loss will be more than three times the current yield. Is there any



doubt that interest rates will rise over the next two decades as the baby boomers retire and the enormous government entitlement programs kick into gear?"  
Jeremy Siegel and Jeremy Schwartz

Besides being overly theatrical, these prognostications have several inherent, fundamental flaws, which I will analyze in a moment. But first let's explore the damage such predictions wreak on individual investors. Today's theatrics and drama around bubbles and crashes are scaring the daylights out of the ordinary investor, who ultimately depends on the capital markets to meet life-long goals such as educating their children, purchasing second homes, ensuring a comfortable retirement, and ultimately perhaps leaving some legacy to their children or others.

In truth, over the past 75 years, the capital markets have provided sufficient returns to meet virtually all savings requirements. An allocation to all stocks has returned an average of 11.5%, while an allocation of 30% stocks and 70% US Treasury bonds has returned 7.6%. An investor saving just \$3,000 a year at 7.6% will have \$640,000 after 40 years. The problem, of course, with this calculation is that it assumes a steady return of 7.6%. The timing of capital market returns is not consistent, and losses can occur in any given timeframe. Any investor who buys bonds or the stock market accepts the risk of such losses.

But there is a second and significantly more dangerous risk that investors take, perhaps unwittingly because their trusted advisors do a poor job of explaining it to them. This is risk that is beyond systematic or market risk. This risk is known as non-systematic risk. This risk occurs when an investor seeks better-than-market returns by concentrating assets in areas he or she believes will out-perform the overall markets. Doing so adds greater uncertainty to the mix. There is the possibility of beating the market, but there is also the strong likelihood of underperforming it – significantly.

Combine the threat of under-market performance with the uncertainty of when losses will occur, and the investor has significantly increased timing risk in his plan. If underperformance adversely aligns with a point in one's life when spending must occur, like while paying for a college education or retirement, that person will wind up spending from a pool of funds that is more diminished by active management than it would be if it were simply invested in the indexes.

It is just this extra amount of risk needlessly injected into portfolios of the investing public that may very well provide the 'straw that breaks the camel's back' of their confidence. With increasing frequency, I hear people say that their friend, or their mother-in-law, or their barber has just sold out of the market "forever" and invested their money into gold or silver, stashed it in pottery jars, or deposited it at the credit union. The sad truth is that the investment industry is largely to blame. Even sadder is that these people will almost certainly pay a significant price in needlessly sacrificed lifestyles down the road for choices they make today out of unnecessary fear.



Now back to the latest fear sensation stewing in the cauldrons of the Wall Street media. I quoted Buffett, Siegel and Schwartz above because of their notoriety, but there are many others whose claims are even more dramatic. For effect, Buffett invokes the Internet Bubble of the late 90's and the more recent housing bubble in making his dire warning. Siegel and Schwartz have the audacity to compare the Treasury bond market to the NASDAQ of the late 90's, in which "tech stocks selling at an excess of 100 times earnings ... declined 80% or more." Do they really mean to imply that a 10-year Treasury bond is in any way comparable to stocks trading at 100 times earnings?

A drop of 80% in a stock price is not even remotely analogous to a drop of 3% or even 9% in a bond's price. With Treasury bonds, you are guaranteed to get back more money than you paid for them if you hold them to maturity. I know there are some who say the US government is going to default soon, but realistically that does not appear to be in the cards in the next decade or two. Japan, for instance, is operating its national affairs with national debt over twice<sup>1</sup> that of the US's relative to GDP<sup>2</sup>.

So how likely are we to see Treasury rates rise enough to cause "extraordinary" losses as the 'bubble' bursts? While the past never repeats itself, we all use it and our experience to build a framework of expectations for the future. And, simply put, such a meteoric rise in Treasury rates has never come to pass. But, many in the active management industry sell their "value" built on the premise that a good track record is an excellent predictor of future results, even while regulatory agencies make them disqualify such implications in the small print.

The 7-10 year Treasury index we use in our clients' portfolios is relatively new as an index, which means that data on it do not go back far enough to enable effective comparisons. Dave Loeper of Wealthcare Capital Management (who provided much of the data in this article) uses a blend of 40% 5-year-plus Treasury bonds and 60% 10-year Treasury bonds as a viable substitute for the 7-10 year Treasury index. From this point forward the returns mentioned will be from that 40-60 allocation.

Just how badly have holders of intermediate Treasury bonds been harmed in any one-year period during modern history (since 1926)? The worst performance for our hybrid 7-10 year Treasury was the 12-month period ended March 1980, during which it was down just under 9.0%. If you were around then, you might recall that inflation was near 10%. What the bond naysayers are not telling you is that in the three years that followed the 7-10 year Treasury index was up +11.26%, then +7.34%, and then +31.8% on a total-return basis. Does that sound like a crash, or more like a bump in the road?

What about the worst period in US economic history, the Great Depression? During the nearly decade-long contraction of the economy from 1929 to 1939, annual average monthly yields fell from 3.83% to 2.15%. By the end of the Depression, treasury yields had



dropped to 2.15%. Market forecasters were likely even more emphatic then in warning of a bubble than they are today, when the 10-year trades at 2.61%.

In the years that followed the Great Depression, and particularly in the WWII years during which the stock market soared, unemployment dropped precipitously as women came into the workforce to replace the men going to war. Commodities were in such short supply they were being supplemented from the kitchens and garages of every American family. By 1942 inflation was near 11%.<sup>3</sup> Applying Buffett's and Siegel's logic, the Treasury market 'bubble' should have burst, sending bond prices crashing to the ground. In fact, however, in the 11 years that followed the Great Depression, there was only one down calendar year, during which the Treasury index lost 0.62% in total return. Remarkably, at the outset of WWII in 1941 the average annual monthly Treasury yields dropped from 2.17% to 1.17%. Yes, 1.17% on the 7-10 year hybrid.

During the 'nifty 50's,' with post-war peace and re-construction combined with a population explosion, the well-oiled war-time economy transformed into a world-class production system. During this period, there were two years in which the stock market returned more than 45% and three additional years in which it returned more than 20%. There was only one year with a decline: 1957, which yielded a 10.05% loss. Treasury yields went from 2.14% to 4.11% during the 50's. The worst one-year decline based on total return was 3.77%.

Finally, during the period from 1960 to 1993, the highest recorded period of inflation in US history, there were only two years when the index lost money: 1967, down 3.05% (stocks were up 28% that year), and 1969, down 2.4% (stocks were down 10.9%). In the two years following, Treasury bonds rose 15% and 11%. In fact, there were six years during this period when this blend of Treasury bonds produced more than a 15% annual return.

So why would such esteemed men ignore history in their forecasts? Giving them the benefit of the doubt, one might argue that they don't think history has any relevance in this 'new normal.' But isn't that similar to the mantra of the late 90's that 'earnings don't matter because the Internet changes everything?' It was Wall Street analysts who told us to keep buying tech stocks even at 100 times earnings, because that was what they had to sell. Dot-coms were coming to market faster than the ideas behind them (if there were any) could be explained. Ideas of diversification and allocation were thrown out the window. Even Fortune magazine had on its cover a picture of Mr. Buffett (who famously sat out the tech rally), accompanied by a caption asking whether the 'oracle' had lost his way.

Just as it is in Wall Street's interest to sell what they can to make themselves money, it may be possible that these 'bubble' prognosticators have some amount of self-interest at stake. Buffett's comments come from his annual letter to stockholders, which means his comments have to be taken in light of Berkshire Hathaway's interests. Berkshire Hathaway is not being managed to confidently meet the needs of any one individual. Indeed, the volatility of shares of Berkshire has been considerably higher than the volatility of the stock



market as a whole. Siegel is an advisor to, and has a financial interest in, Wisdom Tree equity funds. He makes money selling stock funds, not Treasury bonds.

There is no way to know what tomorrow will bring. Placing outsized bets, particularly with one's lifetime savings, based on prophecies from even the most renowned soothsayers is not a sound strategy. Prophecies rarely unfold as predicted, and even more rarely do they do so completely. Recall poor Macbeth. Yes, he became king, but in the end he lost his head.

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1. Japan's Total National debt to GDP was 189% in 2009 according to the [Central Intelligence Agency World Factbook](#)
2. "President Obama's fiscal 2011 budget will generate nearly \$10 trillion in cumulative budget deficits over the next 10 years, \$1.2 trillion more than the administration projected, and raise the federal debt to 90 percent of the nation's economic output by 2020, the Congressional Budget Office reported" on March 25, 2010. [The Washington Times](#)
3. [The Federal Reserve Bank of Minneapolis](#)

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