Economic & Market Update, December 2018
The Bond Market

By Richard Morey

This month's report is focused on the bond markets. In most, if not all, stock market and financial crises, one or more areas of the bond market roars. This is most often longer-term Treasury bonds. Then following the crash, we often see one of the beaten down areas of the bond market roar, such as high-quality mortgage bonds in 2009. In this report, we'll look at two of the developing opportunities in bonds we are now actively preparing for at Secure Retirement.

A recent article from an economist named Wolf Richter highlights one of the bond market opportunities we see coming as the stock market falls. The article is entitled *Treacherous Times for Bond Funds Ahead* It describes how corporate bond investors are likely to suffer shockingly large losses going forward, caused in part by the flawed structure of exchange-traded funds which hold corporate bonds.

Before looking at the specific areas of the bond market where we expect to profit, I would like to share my personal history and performance as a bond or fixed-income investor. Lest it sound farfetched we could make the types of gains described later in this report over the next many years in bonds, keep in mind this will have been the third time in my career our clients made a lot of money in safe bonds during or right after a stock market crash. The largest gains made in bonds were, by far, in 2000-2002 and 2009. In 2000-2002, I purchased a group of individual government bonds, with 6-20 years remaining before they were maturing. Most of these bonds went up over 20% in 2002, after going up in the mid-teens the two previous years.

Between 2002-2008, my largest fixed-income investments made from 5-12% a year. This included approximately one-third of the total which I put into fixed annuities for clients. These annuities then combined to earn right at 6% annually for the next 10 years. That worked as advertised, and I would still say if investors can get an expected return of 6% a year on a core portion of their fixed-income portfolio, with never any losses, that this is a good target for fixed income investing.

After putting nearly $30 million in annuities from 2002-2007, after 2008 when Fed Chair Bernanke then Janet Yellen lowered interest rates to 0%, I stopped almost entirely. The rates were so low there was no way I would recommend tying any of my money up for 7 or more years when I knew that, as a group, the annuities started during that time period could not possibly make more than 2% a year. This was because the contracts are tied at the hip to short-term interest rates. That's how they are structured, so it's impossible for them to give much interest when interest rates are at their lowest point in basically forever.

However, with steadily-rising interest rates like we've gotten from the Fed the last two years, a few fixed annuities are now offering rates which give an expected annual return of 5%-6%. If you are interested in having Jeff Warren or myself give you a quote for the most competitive fixed annuities, please let us know. While I am very knowledgeable on fixed annuities, Jeff is in a league above me. He once supervised over 12,000 agents throughout the country who sold these annuities, and he worked hand-in-hand with top people at the largest fixed annuity insurance company in the world for many years.
The best fixed annuities are now, once again, a reasonable addition to a conservative investment portfolio, and we would be happy to share information on these very conservative retirement income vehicles with you.

Moving ahead to 2008, our bonds did not do nearly as well that year as we did when stocks were crashing in 2000-2002, primarily due to poor performance by me. My only defense is that I had not yet acquired the wealth of knowledge I have since discovered regarding how the various bond and other fixed-income markets move during times of violent losses for stocks and other riskier assets.

However, by the end of 2008 I had learned a great deal, and I knew the greatest safe opportunities for a bond investor in 2009 would be in high-quality mortgages. I therefore invested almost all our bond money into one (highly diversified) mutual fund. This was the TCW Total Return fund, where Jeffrey Gundlach ran this mortgage bond fund before starting the DoubleLine investment firm. It was paying approximately 4.5% in interest, and the bonds were selling for more than 15% below their values at maturity.

TCW owned mortgages of thousands of homeowners who had great credit, lots of home equity, and had never missed a payment in their lives. The value of their mortgages should not have gone down 15% or more because millions of people who couldn't afford to pay their mortgage were foreclosed upon. This 15%+ looked to me like almost "free money," as there was no doubt the mortgage market overreacted by driving down the prices of the best mortgages. This fund made our clients over 19% in 2009. That one was easy.

Moving to the recent past, whether you look at the bond markets, which combined have made only 1.94% a year the last five years, fixed annuity rates, or CD rates, anything anchored on interest rates/ safety has had a difficult five years. We haven't been immune to these difficulties at Secure Retirement. An investor could be prudent and average maybe 2% to 3% a year over the last five years, or you could take what was truly jaw-dropping risk and make somewhat more. That's about the worst type of scenario I can imagine for an investor whose first rule is to not lose principal through any business cycle.

Making much more than 2% safely over the last 5 years has been difficult. In fact, the path has been surrounded by some pretty serious, nasty vines that you know are going to end up bringing this market caravan to a screeching halt one of these days. Then I'm more than a little confident we can, once again, do exceptionally well in our fixed income portfolios during the coming recession. As described below, we then expect to offer clients exceptionally safe bond portfolios whose goal will be to make up to 15% a year for the 7 years following the next recession. As described below, I don't even think this will be difficult to accomplish. Rather, such high expected returns are simply the flip side of the size of the bubble in corporate debt that has been created in the United States, and around the world.

The Future for Bond Investing

Opportunities for bond investors are likely to occur in two distinct phases. The first phase involves over-weighting intermediate and, most likely, long-term Treasury bonds.

The second phase or opportunity is connected to the afore-mentioned article by Wolf Richter, *Treacherous Times for Bond Funds Ahead.* This phase begins during the next recession, as the exchange-traded corporate bond funds described in Mr. Richter's article begin to shake. Shortly thereafter, the U.S. corporate bond market will come crashing down like nothing we've ever seen.

Opportunity #1: Treasury Bonds Between Now and the Bottom of the Next Recession

Looking forward for our bond investments, I still think it very, very highly likely investors will ultimately do what they usually do when scared, which is to drive up the prices of the safest investments in general and long-term Treasuries in particular. Until recently we have had some short-term concern about this, since long Treasuries dropped in price before stocks tumbled 10% in February and then again in October. However, this may have changed on Monday, December 3. On that day, the stock market plunged, with the Dow falling over 700 points while long-term bond prices shot up. This was literally the first day all year we saw a touch of fear replace complacency among stock investors. In other words, when it started to sink in that this could be the end for the bull market for stocks, investors rushed to the safety of Treasury bonds.

Personally, I expect long Treasuries may rise up to 50% in price between now and the bottom of the next recession. Perhaps a bit more. Of course, this may or may not occur. If for some reason Treasuries are not being "bid up," we would simply replace our long-term Treasury holdings with another asset class which is benefiting as the losses begin to mount in all but the safest investments.

We reduced our allocation to long Treasury bonds (selling some of the Wasatch-Hoisington U.S. Treasury Fund) at the beginning of November. However, if Treasuries have just a few more days showing they are indeed going to rise as stocks fall, we will first sell one of our shorter-term bond funds (Catalyst Rising Rate Fund), putting the proceeds into a PIMCO Treasury Bond mutual fund. Assuming stocks continue to fall and Treasuries continue to rise, fairly shortly thereafter we will purchase more of the Wasatch-Hoisington fund.

Opportunity #2: High-Quality Corporate Bonds

In the U.S., when this hideous worldwide asset bubble bursts the destruction will likely be felt most severely in corporate debt (and, of course, stocks). Perhaps the best way to understand the corporate bond market today would be to consider it like a rubber band pulled very tightly – you're pretty sure the eventual sting will be greater the further it is pulled.

You can already see the very beginning of this process by noticing the largest exchange-traded fund that owns only investment-grade corporate debt was recently down over 7% for the year - it's worst year ever. In the U.S., the largest losses will center on corporate debt, as opposed to mortgage or consumer debt (which will, unfortunately, also suffer a great deal). The fact the largest investment-grade corporate bond ETF is down over 7% for the year seems like it should lead to some concern – particularly considering it will likely drop by *50% in one day when it ultimately 'breaks*.' In fact, the losses could easily be even larger, or as Wolf Richter calls them, catastrophic.

This next part is going to be boring to most and confusing to many, but I have to explain the problem with buying corporate bonds in an exchange-traded fund investment structure for the opportunity to make sense. An exchange-traded fund or ETF is simply a group of investments, usually stocks, but it can also be a group of bonds, oil stocks, healthcare stocks; in fact, these days almost anything you can think of. Once the stocks or bonds are purchased, the funds typically do very little buying or selling. These funds are very much like mutual funds, except they can be sold at any time the market is open, just like a stock. Mutual funds sales, in contrast, are redeemed at the prices the market closes at for the day, at 3 p.m. ET. This one little feature can lead to huge losses for owners of exchange-traded funds, whenever investors flee corporate bond funds in panic.

Mr. Richter refers to the losses owners of corporate bond exchange-traded funds will likely one day experience as "catastrophic." I certainly agree, as I have been watching the same train wreck get put into place. An exchange-traded fund is severely and dangerously flawed in that it holds relatively, and at times completely, illiquid investments in a structure that offers instant liquidity. That's impossible, so they have to someday "break." When that occurs, the corporate bond market will be flat-out crashing. There will be a forced liquidation of the best corporate bonds, at fire sale prices.

Should this occur, it will lead to the best opportunity to invest in U.S. corporate bonds ever. For example, if you buy a bond at 50% off the original value, a corporate bond that originally paid 4.5% in interest and has seven years remaining will give the buyer gains of exactly 16.14% (non-compounded) total annual returns if held until maturity, consisting of 9% in annual interest payments and 50% in capital gains the day the company pays the loan back at the original, full value of the loan. This is a certainty, *just so the company doesn't go bankrupt but pays back the loan*. You only need to know exactly two things to figure out exactly how much money you will make: 1. How much you pay for the loan and 2. That the company will pay you back when the loan comes due.

The beauty of this opportunity is that it will allow us to buy the bonds of a group of U.S. companies with strong finances at prices which should give us remarkably stellar returns for many years. We may not get them all at 50% off their original prices, but the discounts should be very, very large if purchased at the exact right time. For example, if we bought a group of the best U.S. corporate bonds at 30% off, we would make just over 10% a year for the following seven years. Whenever this opportunity arises, you will be receiving a report from me at Secure Retirement which will be quite a surprise, as it will be the voice of unabashed optimism! Yes, the coming end to this business cycle will be one for the ages, but the financially strongest U.S. corporations are not going to close their doors. Our best companies will continue to pay their debts, and the gains made if we purchase their bonds far below their fair value will indeed be realized by our clients.

We have just started to create this portfolio, as it wasn't needed while investors were pretending the economy and markets looked solid. Our plan here is fairly simple. As soon as the largest corporate bond exchange-traded funds are crashing due to no liquidity, we buy the bonds of the 20-30 "best" companies in those funds. We will then keep them for, on average, 7 years, and make very high fixed-income returns which will be *locked in the day we make the purchase* – assuming the companies don't default. To give you an idea of the type of companies whose bonds we may end up purchasing, the largest exchange-traded fund which owns high-quality corporate bonds presently holds bonds from Apple, Verizon, Medtronic, Microsoft, and Comcast, among many other good companies.

Summary

First, please note there will undoubtedly be at least one or more additional opportunities to safely profit in bonds as the upcoming, historic events unfold. Given the mind-boggling imbalances we see in the corporate bond market, we will soon be seeing some historic re-pricing of U.S. corporate bonds. They're going to crash, incredibly fast. Companies like Microsoft, which has a rating as high as the U.S. Government, are going to go on sale, and their bonds will be cheaper than at any time since Bill Gates sold his first operating system. The substantial returns on our corporate bond portfolio thereafter will be reliable and consistent.

Of course, as we approach or reach the bottom, we will also begin to purchase individual stocks or mutual funds which own stocks. We will cover the stock market in some detail in next month's yearly review.

When considering our path forward in bonds, there are three key takeaways I would leave readers with. Following these three points leads to dramatic outperformance in the bond portion of a person's portfolio:

1. Most investors never have one opportunity in their entire investing career to purchase good assets at rock-bottom prices. Instead, they lose too much on the way down every single time, thereby losing the money they would need to use to "buy low."
2. During a severe market downturn and recession, certain sectors of the bond market will crash far below their true value. These are the areas to overweight coming out of the downturn.

3. When you purchase individual corporate bonds at depressed prices, you can calculate exactly how much money you will make until that bond matures and the principal is repaid. Assuming the company is still solvent, you will have made the exact return you calculated the day you made the purchase.

   In other words, at the bottom, when other investors are scared to death the U.S. (and world) economy may practically cease to exist, and all our companies may go bankrupt, we will be betting on the strongest American companies. Yes, that sounds like quite an overstatement on the pessimism we'll see at the bottom, but in reality, the dire warnings and predictions you'll hear around the bottom from others are going to be far more negative than anything I have ever stated!

I have now spent 20 years preparing for what investors are facing. Yes, our largest bond holdings made 20% during or just after the last two recessions. Of course, you can never perfectly predict everything, and we are absolutely expecting many surprising events to unfold in the markets over the next few quarters. But we are more confident than ever we will do quite well during this next recession and bear market for stocks. And we are certain the losses coming will also uncover some extraordinary opportunities, in bonds, stocks, and undoubtedly a number of other asset classes.