Bonds

"Over long periods of time, the returns on equities not only surpassed those on all other financial assets, but were far safer and more predictable than bond returns when inflation was taken into account." – Princeton professor Jeremy Siegel from the 2014 preface to his classic book, Stocks for the Long Run

Confident Fed Raises Rates was Thursday's WSJ headline. Its subtitle: "In unanimous decision, officials signal faster pace of increases as economy strengthens." We concur with BCA Research and others that the 35-year bull market in Bonds ended in July with the U.S. 10-year Treasury yield at 1.3%. Its yield ended the week at 2.6%. As we initially wrote under Asset Allocation on our website, "While there may come a time in the future when long-term Bonds once again make sense as a part of a diversified portfolio, currently it is an asset class best avoided."

Bonds Are Riskier Than You Think

By John Rekenthaler | 12-16-16

I Guarantee It

Bonds certainly *sound* safer than stocks. They are required to pay their stated interest rates, whereas stocks can cut their dividends at any time—if they pay dividends in the first place. Bonds, of course, also stand higher on the credit ladder. Should the organization go under, bondholders will likely receive at least a partial payment, sometimes even better than that. Stock owners will get nothing.

In addition, about half of U.S. bonds come courtesy of the federal government. General Motors, Kodak, Compaq, Digital Equipment, Woolworth's, Arthur Andersen, and American Airlines went bankrupt and stiffed their stock shareholders. While those companies would have liked to have possessed printing presses with which to pay their bills, they did not. However, Uncle Sam does. And its debts are denominated in the currency that it prints. The U.S. won't be defaulting on its obligations any time soon.

This is all stating the obvious: People understand and appreciate the protections that are provided by high-grade bonds, particularly U.S. federal debt. Indeed, the term "government guaranteed" is so powerful that the SEC prohibits mutual funds from using it in their names. (The words once were permitted, but were banned when the SEC realized that many investors interpreted the term to mean that the fund couldn't lose money.)

Comparing the Records

Not so obvious is the damage that bonds can inflict on portfolios. I need not instruct this audience about interest-rate risk—but I can remind it that the concept is not intuitive. (I recall my bewilderment when learning that a security that paid its interest as promised, and that would eventually return every penny of principal to its investors, could lose money. That seemed...wrong.) Perhaps because of this lack of intuitiveness, and even more because investment returns are typically given in nominal rather than real terms, even knowledgeable investors can overestimate bonds' safety.

Bonds' decade-by-decade performance has been slightly steadier than that of stocks, when expressed nominally. In the tables, I've shaded losing performances in red, those with annualized gains of 0% to 1.9% in yellow, and left unshaded any gain of 2% of higher. (The numbers come courtesy of Research Affiliates, supplemented by Morningstar.) The first table confirms initial expectations. The lowest two decades came from stocks. However,

Nominal Annualized Returns, 1871-2016: U.S. Stocks and Bonds

	Stocks	Bonds
1870s	9.3%	6.4%
1880s	2.7%	3.5%
1890s	8.7%	3.8%
1900s	7.5%	2.7%
1910s	3.2%	2.0%
1920s	14.4%	6.3%
1930s	1.8%	4.6%
1940s	12.8%	2.0%
1950s	16.3%	2.1%
1960s	8.1%	3.2%
1970s	8.4%	4.0%
1980s	13.9%	14.4%
1990s	17.6%	9.4%
2000s	1.2%	6.7%
2010s	8.9%	3.2%
Average	8.9%	5.0%

Source: Research Affiliates, Morningstar.

the next three weakest showings came from bonds. Not outright losses, to be sure, but nonetheless not according to bonds' reputation. One would expect them to finish in the middle, with stocks sandwiching them above and below.

Still, no big deal. The typical investor may not know that from decade-long perspective, bonds have offered only modestly better protection than stocks—but this column's readers are atypical. Most are highly experienced and therefore avoid the common traps. ... However, even the savviest may be taken aback by the next table. I was.

Now, the red appears, severely.

Bonds lost 5.7% annually from 1910-19, and stocks fell 4.5%. Those were the weakest two performances out of 30—which is just as well, because they were brutal. Cumulatively, the decade's worth of investing in stocks would have turned a dollar into $0.63. For its part, one dollar in bonds would have become two quarters and a nickel. The thrifty and prudent were not rewarded.

Not only did bondholders lose the contest during the worst of the decades, but they also posted the next two lowest results, shedding 4% annually during the 1970s and almost as much, 3.9%, during the 1940s. (World wars, it turns out, are bad for asset prices... Who knew?) That makes three clattering bond-market catastrophes in 15 chances—a 20% failure rate. Meanwhile, stocks had a second losing decade of their own, but the cumulative effect was a modest 10% loss. The 2000s weren't much fun for stockholders, but they weren't a disaster for those who bought and held.

Real Annualized Returns, 1871-2016: U.S. Stocks and Bonds		
	Stocks	Bonds
1870s	12.0%	9.1%
1880s	4.5%	5.3%
1890s	9.1%	4.2%
1900s	5.6%	0.8%
1910s	-4.5%	-5.7%
1920s	16.2%	8.1%
1930s	3.1%	5.9%
1940s	6.9%	-3.9%
1950s	14.5%	0.3%
1960s	5.2%	0.3%
1970s	0.4%	-4.0%
1980s	9.4%	9.9%
1990s	14.9%	6.7%
2000s	-1.1%	4.4%
2010s	8.7%	3.0%
Average	6.8%	2.9%

Source: Research Affiliates, Morningstar.

On the flip side, stocks performed as one would expect. They had the first, second, third, and fourth highest performances, with booming annualized returns that ranged from 12% all the way up to 16.2%. (The Roaring Twenties, indeed.) Such gains would have compensated for severe relative losses. That they came accompanied not by larger selloffs, but instead by shallower downturns relative to bonds, made stocks a win/win.

The Longer View

In a sense, one can argue that this presentation *minimizes* bonds' failings. As the market historian Peter Bernstein pointed out, the year-by-year and even decade-by-decade reckonings disguise the fact that, broadly speaking, there have been only two bond regimes within most of our lifetimes: bad, then good. From the 1940s through the early 1980s, U.S. bonds were a thoroughly miserable experience. In real terms, they dropped like a stone, then barely eked out a profit for 20 years, and then once again fell. They failed not one but two generations of retirees. Then they rebounded, and have consistently been good to excellent for the past 35 years.

Viewed from that angle, bonds have been far more frightening than equities. Yes, stocks endure some very unpleasant years, and on occasion an unpleasant decade. But if the downturn occurs because of inflation, companies raise their prices, which enables them, over time, to maintain or even increase their real earnings—and thus the real cash that they can make available to their shareholders. Bonds have no such recourse. If their initial yields greatly underestimate the level of future inflation, then their prices never catch up. They lose and lose and lose.

Whether that is about to happen, and the bond regime about to flip, is for others to say. (Usually, by pouring a cup of tea and examining the leaves.) This column merely points out the issue. There are times—many times—

in which bonds can be more dangerous than stocks. That is information worth knowing, for anybody who owns a bond-heavy portfolio.

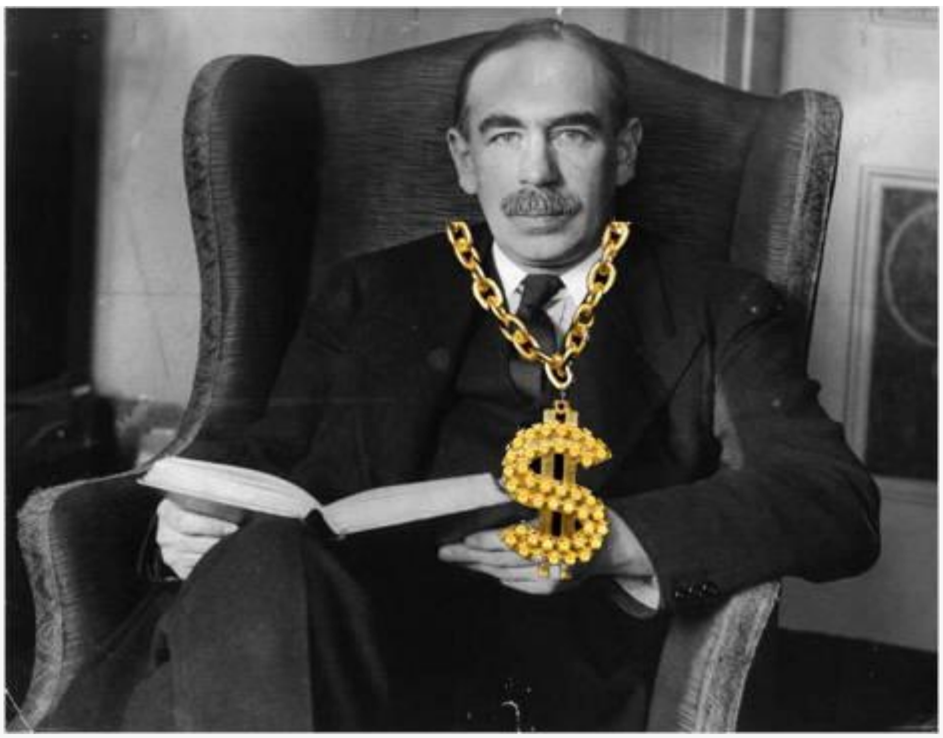
John Rekenthaler, Vice President of Research for Morningstar, has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department. John is quick to point out that while Morningstar typically agrees with the views of the Rekenthaler Report, his views are his own.

Our thoughts

Inflation was creeping higher before Trump's election. Except for less regulation, all of his proposals to "Make America Great Again" are inflationary.

Republicans are finally willing to spend on the economy — at the exact wrong time

By Steven Pearlstein December 12, 2016



The view of Keynes that Republicans suddenly seem to like best. (UPI)

It’s curious to hear Republicans suddenly talking about the urgent need for fiscal stimulus. For the past eight years, including the darkest days of the Great Recession, they tried to convince us that fiscal stimulus doesn’t work, and that the only way to really boost economic growth is to cut the budget deficit. But now that they are about to get their hands on the federal checkbook, Republicans have decided that we are all Keynesians once again.

To anyone serious about economic analysis, it should be obvious that we don’t need Keynesian stimulus at the moment. The unemployment rate is at 4.6 percent, which is about as close to full employment as it gets. The economy is producing more than 175,000 jobs each month, with many industries complaining they could add more if there were trained workers to hire. Wages are rising faster than they have in a decade, and faster than productivity is rising. Corporate profits and share prices are at record levels. And thanks to aggressive bond buying (and bond holding) by the Federal Reserve, monetary policy is still extraordinarily accommodative. Keynes himself would never have suggested that this is an appropriate time to use the government's taxing and spending powers to boost the economy. In fact, seeing the developing bubble in stock and real estate markets, Keynes probably would be recommending a budget surplus right about now.

It is true that factory utilization is still a bit below its historical average, but you would expect that in a de-industrializing economy. And while parts of the country are still suffering from that deindustrialization, there is no evidence that a burst in government or private spending will, to any substantial degree, make its way to those communities, their unemployed and under-skilled workers or their uncompetitive companies. In the jargon of economics, their problems are structural, not cyclical. That's a harsh reality, but a reality nonetheless.

At this point someone will surely point to the several million working-age males who have dropped out of the labor market and are now said to spend their days watching porn and playing video games. This has been a decades-long, secular decline that remains poorly understood. Some of the presumed causes are worrisome: low wages for unskilled workers, an increase in disability claims, more black market activities, an epidemic of drug addiction and the increase in incarceration rates. Other factors are more likely to be celebrated: more stay-at-home dads with wives who are working and earning higher pay, more people going back to college or earning advanced degrees, more Wall St. and tech millionaires retiring to the beach. None of these trends, however, is likely to abate with a sudden boost of fiscal stimulus.

I will be the first to acknowledge that this is a fine time to ramp up spending on infrastructure, given how much public disinvestment and deferred maintenance there has been, and given how cheap it still is for the government to borrow money to pay for it. But there is a real danger that if we try to build too much too fast, a good chunk of the money will be frittered away on construction cost inflation, particularly if the Trump administration makes good on its pledge to deport the very people who are willing and able to do the work. At this point in the economic expansion, the justification for infrastructure investment is not to provide short-term stimulus, but rather because the investments will make the economy more productive in the long term.

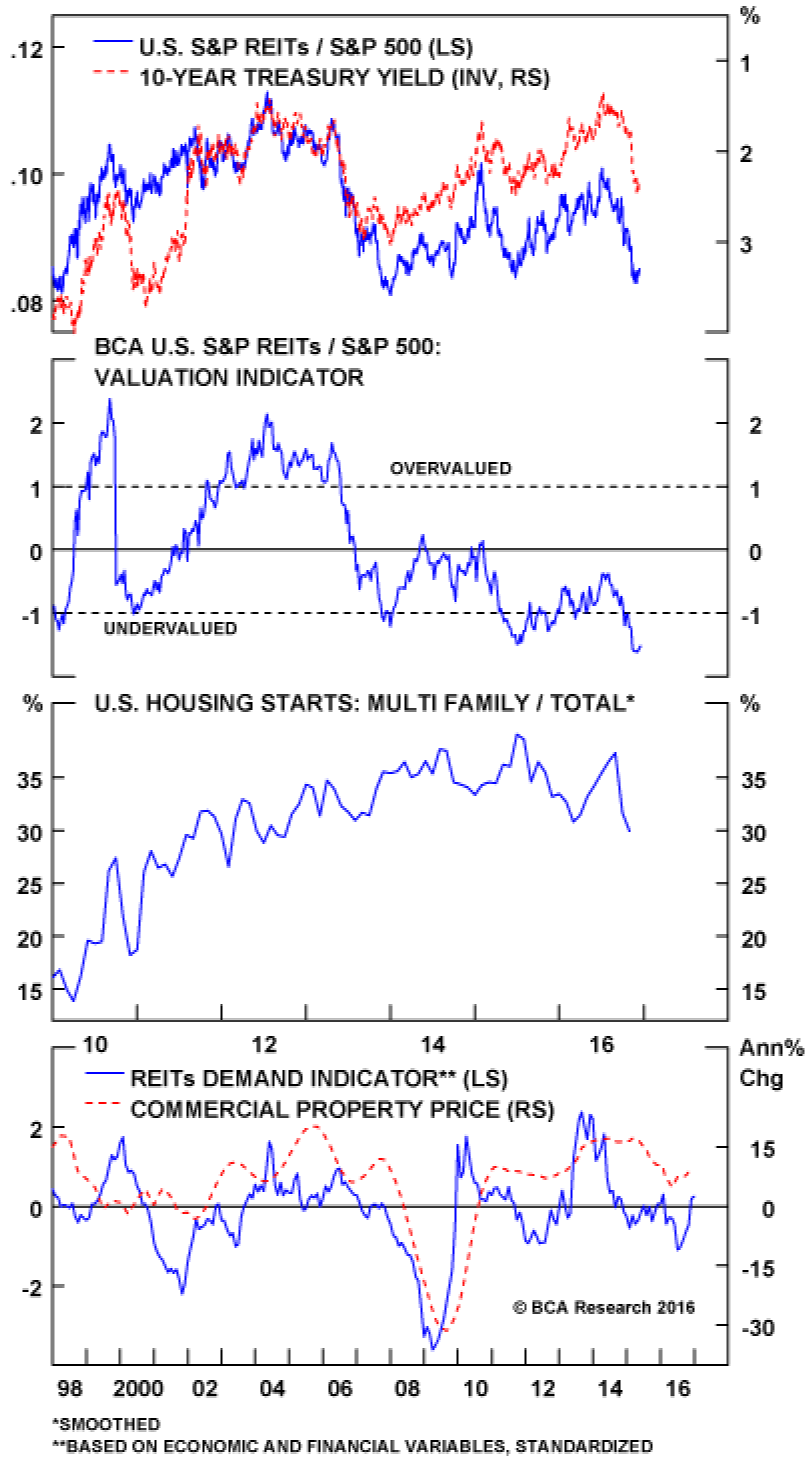
There is also no convincing case for tax cuts (other than Corporate), despite the bipartisan enthusiasm for them. Federal tax burdens have been declining for more than 30 years, and remain well below those in other advanced economies. Certainly the rich don't need a tax break—they've been raking it in big time for decades. Nor, for that matter, does the middle class. Many middle-class households don't pay much in the way of income taxes ... As for the poor, since they don't pay income taxes, they won't benefit from tax cuts unless Republicans develop a sudden itch to increase and expand the earned income tax credit.

Liberals are quick to jump in here and argue that tax cuts for the middle class and poor are necessary to offset the increasingly unequal incomes that the labor market is generating. In fact, the U.S. tax code is already about as progressive as those in Europe or Japan. To make the American *system* as progressive as those other countries, however, we would need to raise tax rates, not lower them, and use the additional revenue to provide more services and income support to the poor and middle class. Or we would need to adopt labor laws and norms of business behavior that would force markets to distribute incomes on a more egalitarian basis. There is only so much we can expect the tax code to do in offsetting the inequality generated by a market economy.

Politicians who are rushing to cut taxes or increase spending should fess up that they are doing so for political or ideological reasons and not try to justify it on the basis of a weak or failing economy. The economy is doing just fine, thank you, which is more than can be said about our politics.

More thoughts

As we note on our website, "For clients who want their portfolio to generate a steady stream of income, we dedicate an appropriate portion of the portfolio to Funds and dividend paying stocks, which will usually include Regulated Investment Companies (RICs). RICs, where at least 90% of capital gains, dividends and interest are passed onto shareholders, avoid taxation at the corporate level. There are three types: Real Estate Investment Trusts (REITs) invest in real estate through properties or mortgages, Business Development Companies (BDCs) invest in the debt and/or equity of small and mid-sized businesses, and Master Limited Partnerships (MLPs) invest in natural resources, real estate and commodities."

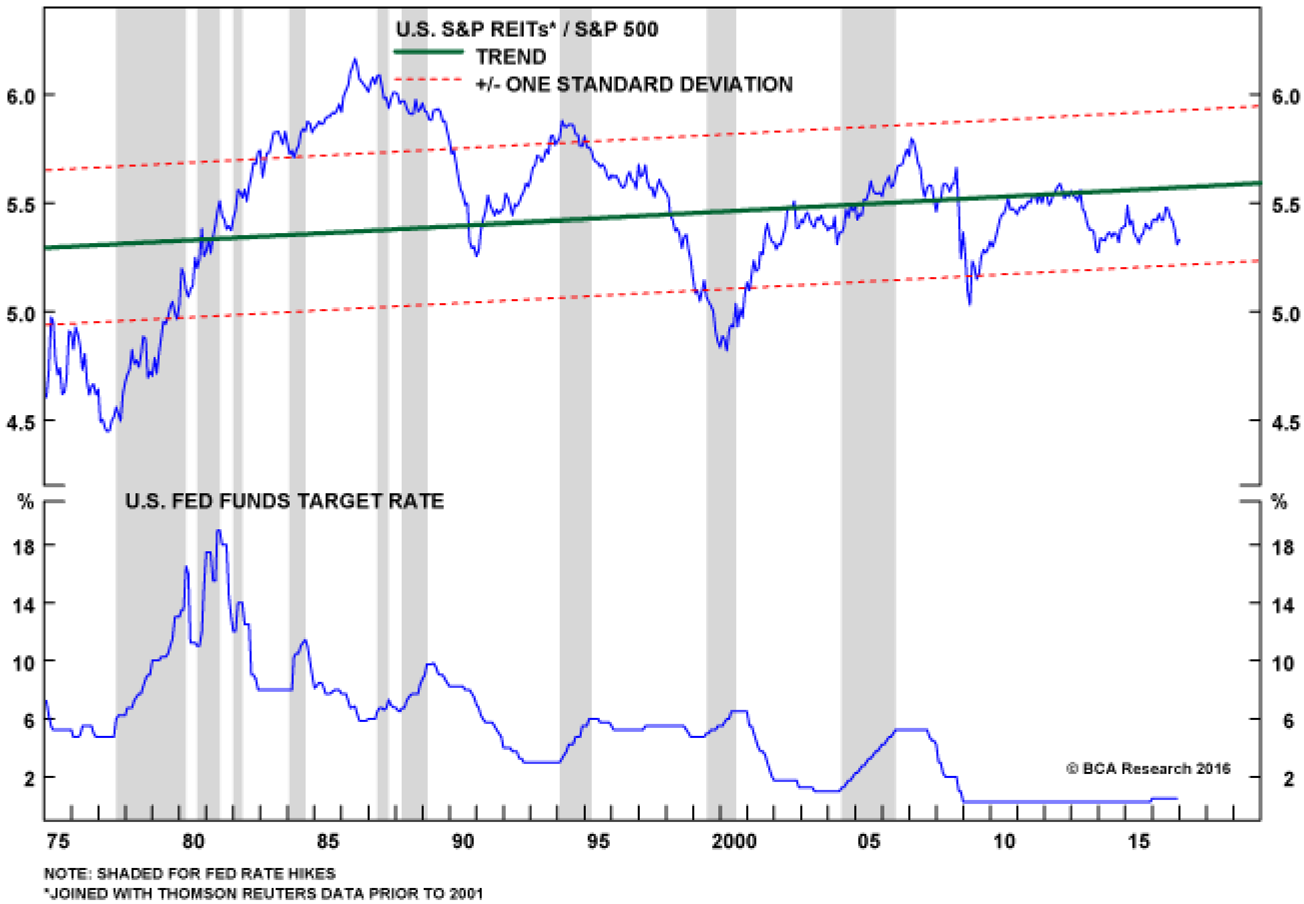


REITs

We expressed caution in our web post "The New Real Estate Sector - 10/3/2016", "we currently recommend that investors seeking Income be patient. The Fed is likely to raise interest rates at their December meeting, and the inherent volatility of REITs should provide future opportunities." In "REITs & Rates - 11/21/16" we noted "The subsequent Correction has been painful ... given the improved valuations resulting from the current Correction (or Bear Market depending on which Sector) we are now recommending the Quantitative GFMRX for new clients." BCA Research on 15 Dec 2016:

The backup in global bond yields has provided investors with an excuse to sell any high yielding sector or group, regardless of valuation. For instance, the short-term relative performance of the S&P REIT index has been highly correlated (inversely) with 10-year Treasury yields. The sell-off has pushed our REIT valuation gauge to extremely undervalued levels, on a par with previous playable relative performance recoveries. We expect a replay, as REIT fundamentals are improving. The above chart shows that our REIT Demand Indicator has popped back into positive territory, which bodes well for future rental income. The latter is also directionally correlated with commercial property prices, which are hitting new highs. Importantly, concerns about excess supply should start to wane, particularly in the residential space, given that multifamily housing starts are rapidly losing momentum compared with total housing starts. On a long-term basis, REITs are far from extended ...

Contrary to popular perception, relative performance is also depressed from a structural perspective. The chart below shows that REIT relative performance is trading well below its long-term trend. In other words, the past few years of the search for yield did not trigger a stampede into the REIT sector, suggesting that a further rise in bond yields may not trigger additional REIT selling pressure. While Fed interest rate hikes may provide some pause for potential buyers, it is notable that relative performance has a decent track during Fed tightening cycles (see the shading), especially when the starting point for the share price ratio is below-trend. The implication is that the vicious correction in the S&P REIT sector is an excellent buying opportunity. Stay overweight.

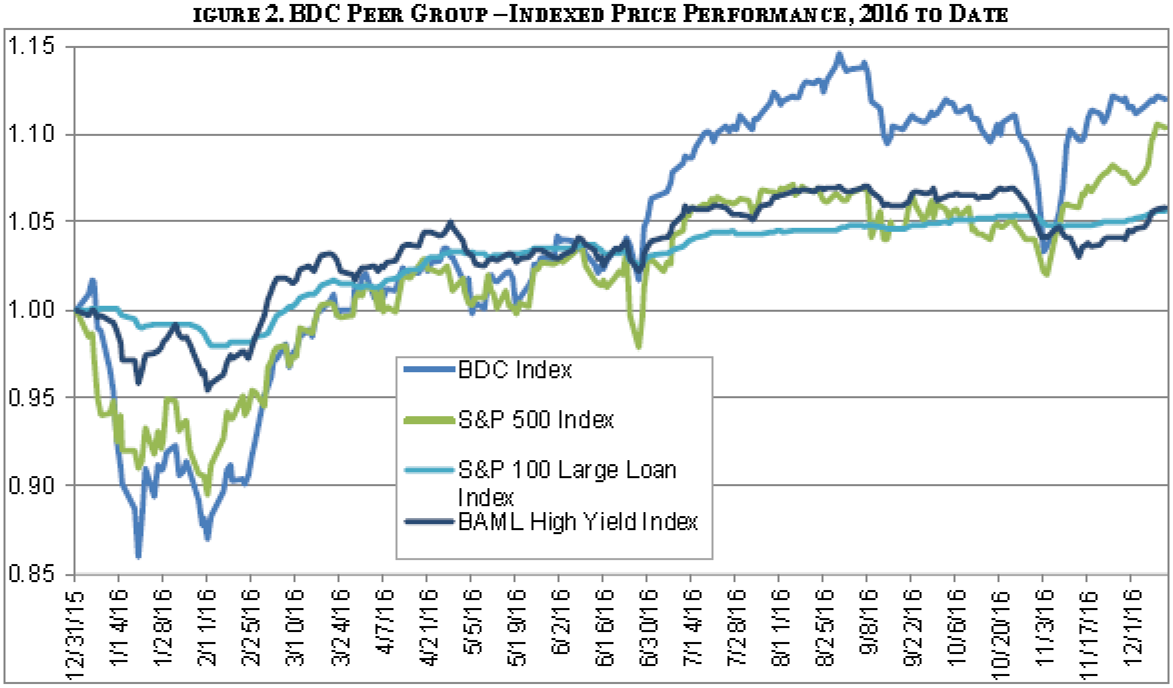


BDCs -

Wunderlich's Merrill Ross on December 14th:

The lower middle market companies that Business Development Companies (BDCs) lend to and invest in are often considered to be the growth drivers of the U.S. economy. We think that these companies could benefit from fiscal stimulus in 2017, particularly revision in the tax code. Of course, we have no way of knowing what revisions will be legislated and when they will be enacted, but we believe the incoming Administration will deliver on this campaign promise at some point. The price of oil is off its lows, which we think means that oil exposures have less downside, having been marked to valuations that were pegged to $40bbl oil. With no particular challenges in other sectors, we think credit risk will be idiosyncratic in 2017, rather than thematic. Although the capital markets were not supportive of exit opportunities through initial public offerings, that appears to be slowly changing, and the tech investments of BDCs may particularly be the beneficiaries. ...We would selectively overweight the sector for dividend income and share price appreciation.

IGURE 2. BDC PEER GROUP – INDEXED PRICE PERFORMANCE, 2016 TO DATE



Source: FactSet and Wunderlich. BDC Index is a simple unweighted index comprised of the shares of the companies listed in Figure 1, above.

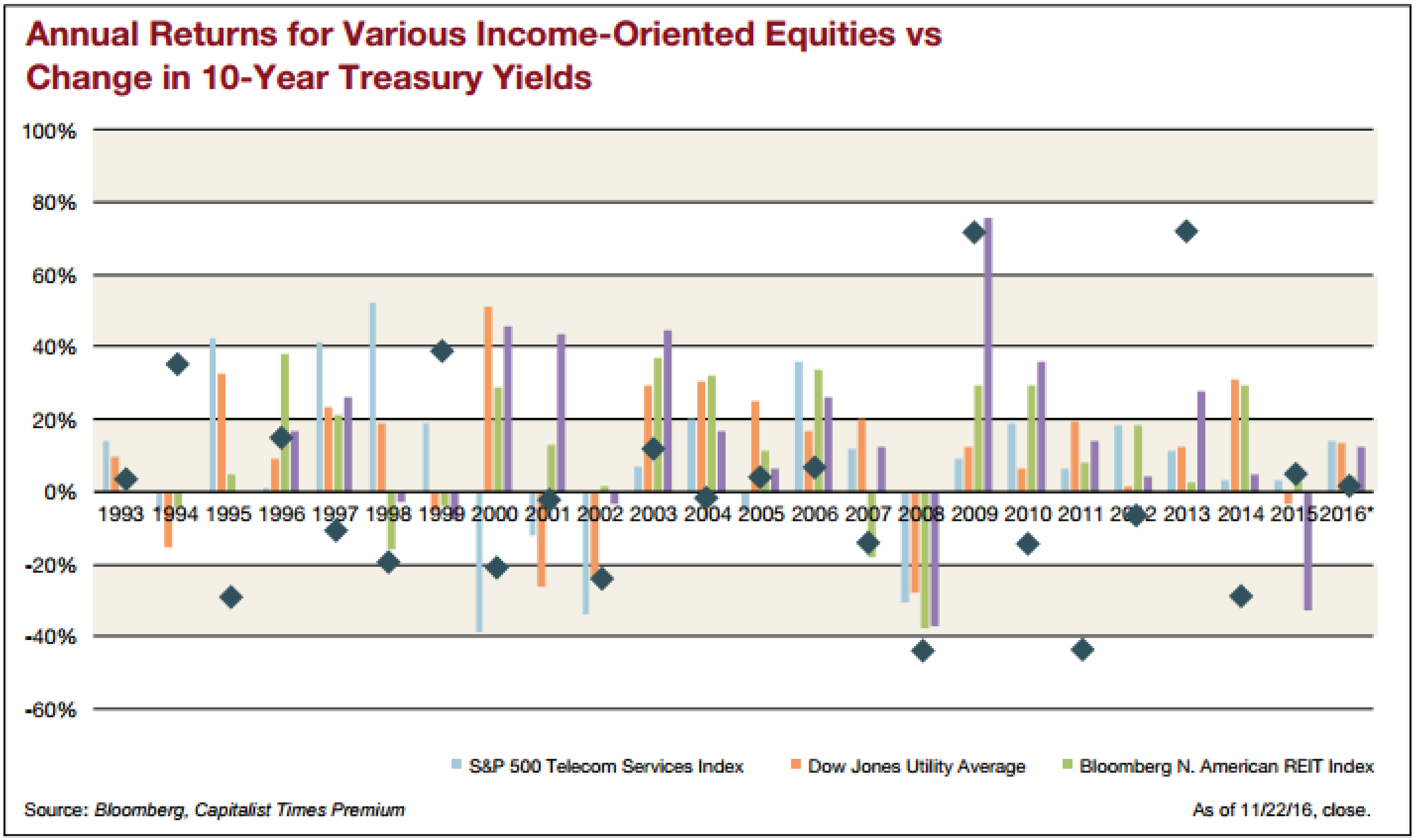
MLPs -

These stocks have moved higher with the price of oil and natural gas. Due to tax considerations MPPs should be avoided for IRAs and investing in them via Funds eliminates the tax advantages. Capitalist Times on November 30, 2016:

The blue data points in the chart below show the percentage change in the yield on 10-year US Treasury bonds. Positive readings indicate years when interest rates rose; negative numbers are years when rates dropped. Rates rose in 11 of the years shown and fell in 13 years.

Conventional wisdom holds that dividend-paying stocks rally when interest rates fall and retreat when rates rise. That’s not what the record shows.

For example, the worst year for all four of these stock groups was 2008, when the benchmark 10-year Treasury yield also fell the most. And all four sectors posted positive full-year returns in 2009 and 2013, when the 10-year yield experienced its biggest year-over-year increase, with MLPs (purple bars) rising the most.



Other opportunities

As interest rates climb other categories of Funds may become attractive for clients focused on Income. For example, GIFIX, as shown below, is one of two Bank Loan OEFs that we follow. Its **Risk**, as measured by the ratio of average historical Maximum Drawdowns to S&P 500 declines greater than 10%, is **0.4**. While we are negative on long-term Bonds, both secularly and cyclically, there are alternatives for a patient long-term investor.

Guggenheim Floating Rate Strategies Fund Institutional Class GIFIX
| ★★★★★

NAV
$26.07

1-Day Total Return
↑0.07%

USD | NAV as of 16 Dec 2016 | 1-Day Return as of 16 Dec 2016

TTM Yield	Load	Total Assets	Expenses	Fee Level	Turnover	Status	Min. Inv.
4.05%	None	$ 2.8 bil	0.78%	Average	35%	Open	$ 2.0 mil

30-Day SEC Yield	Category	Credit Quality/Interest Rate Sensitivity
4.22%	Bank Loan	Low/Limited

Growth ▾ Benchmark ▾ Event ▾ Compare to Symbol Moving Avg US Dollar ▾ Reset

11/30/2011 - 12/16/2016 Zoom: 1M 3M YTD 1Y 3Y 5Y 10Y Maximum Custom