Redstone Advisors

Economic and Market Review

First Quarter 2012

"Bonds promoted as offering risk-free returns are now priced to deliver return-free risk."

James Grant, Editor of Grant's Interest Rate Observer

"They **[bonds]** ***are among the most dangerous of assets. Current rates do not come close to off-setting the purchasing-power risk that investors assume. Right now, bonds should come with a warning label."***

Warren Buffet, 2012 Berkshire Hathaway annual shareholder letter

This quarter we have decided to interrupt our more normative philosophical approach to all things financial in favor of a more pragmatic approach. In so doing, we want to address a single question which we feel would be of great interest to both our clients as well as to our broader readership. Specifically the question we would like to address is, ***why invest in bonds at these historically low yield levels?*** Or to state the question another way, ***is there any value in bonds?*** That this is a question worthy of attention is underscored by at least two important factors. First a plethora of **"experts"** have decreed that at current yield levels, far from offering a compelling value proposition, bonds as an investment class are a sure loser. Second this very question has been posed to us by more than one of our clients and as such, it is clearly a question of some import to those whose confidence we seek to retain. For these reasons, surely it is prudent that we devote this Market Review to a full hearing of this, the most urgent question of the moment for any active bond manager.

First by way of background, consider the sheer **"star power"** of those who have joined hands to characterize bonds as mere **"certificates of confiscation."** From the infamous utterance made in February 2010 by the author of 'The Black Swan', Nassim Nicholas Taleb, that *"every single human being should bet U.S. Treasury bonds will decline,"* to hedge fund chairman Leon Cooperman's October 2011 animus that he *"wouldn't be caught dead owning a U.S. government bond,"* to Warren Buffet's February 2012 warning that *"they* [bonds] *are among the most dangerous of assets,"* to the recent admonition by Larry Fink, the CEO of the world's largest money manager BlackRock, Inc., that *"investors should be 100 percent in stocks,"* to Princeton economist and author Burton Malkiel's counsel that *"bonds are the worst asset class for investors,"* to revered bond guru James Grant's decree that *"bonds are now priced to deliver* ***return-free risk****,"* it is clear that the **"smart money"** is not in bonds. But then again, the smart money has never been in bonds. According to research by Jim Bianco of Bianco Research, **the experts have always been bearish on bonds**. According to Bianco, since the monthly Bloomberg Survey of Economists began in December of 2002, there have been 107 monthly surveys completed and of those the consensus has predicted interest rates would rise in 104 of those surveys, or **96 percent of the time**. In other words the experts have ***always predicted*** that interest rates will rise and bond prices will fall. Talk about a denigrated asset class. And what of the efficacy of those predictions? They were ***"directionally correct"*** 51 percent of the time. Can you spell r-a-n-d-o-m? That is the equivalent of a coin toss, the worst possible outcome for a professional prostitute er, prognosticator. If they were right most of the time, we could follow their advice, if they were wrong most of the time we could fade their advice. But when they are fifty-fifty (i.e., random), there is no predictive value whatsoever. As someone once astutely observed, ***"economics is the one profession where you can gain great prominence without ever being right."***

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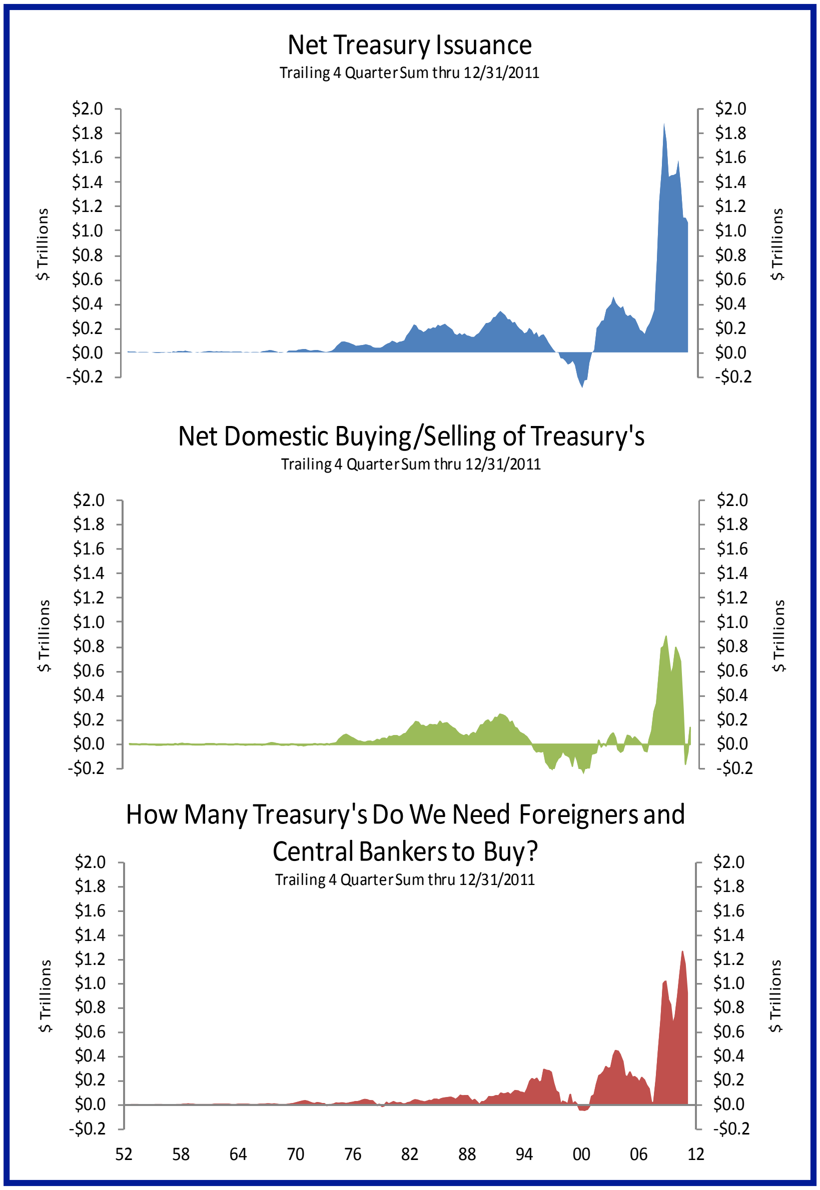
Nevertheless, the abysmal track record of the dismal science aside, what all those who loathe bonds have failed to apprehend is that **there are no *"real investors"* in bonds**. As we have maintained for years and as Jim Bianco has recently popularized, *"the only buyers of Treasury bonds are those that speak Chinese, those that speak Japanese and those that print money."* And the Chinese, the Japanese and the central planners are not about to walk away from this market anytime soon.

Excellent analyst though he may be, rather than simply taking Jim Bianco's word for it, let us be good "Bereans" and *"search the data"* to verify our underlying contention regarding just who's buying all those Treasury bonds. For verification we need to review flow and holdings information from both the "Treasury International Capital Movements" or TIC data and the Federal Reserve's quarterly "Flow of Funds" or Z.1 report. Referring to **Figure 1**, we can see that it consists of three panels. The top panel (blue area chart) graphs total net US Treasury bond issuance obtained from the Fed's Flow of Funds report. The middle panel (green area chart) graphs the total net purchases of US Treasury's from domestic buyers, also from the Fed's Flow of Funds Report. The bottom panel (red area chart) graphs the difference between the top panel and middle panel and represents the nominal amount of net US Treasury issuance which must be purchased by foreign buyers and central banks. All series are presented on an annualized trailing four quarter basis. As we can see our dependence upon the **kindness of strangers** has increased to staggering proportions as the amount of Treasury issuance has soared.

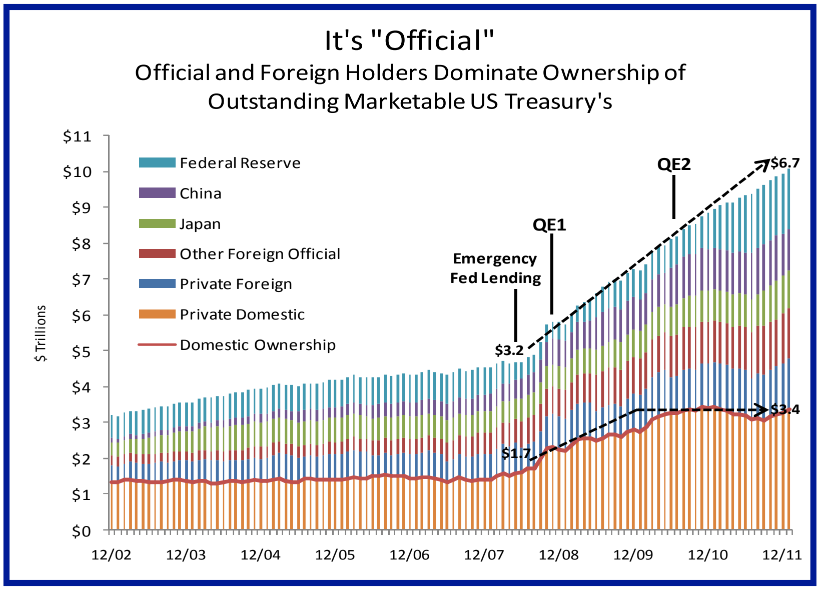
Figure 1



In fact, since the collapse of Lehman and the initiation of the Troubled Asset Relief Program or TARP, marketable US Treasury's have more than doubled, increasing **$5.2 trillion**, from $4.9 trillion in August of 2008 to $10.1 trillion as of January 2012. And of this increase, **$3.5 trillion**, or fully **67%** were purchased by foreigners and central banks. This is reflected in **Figure 2** which breaks out the ownership of all outstanding marketable US Treasury debt. As we can see, foreign and central bank ownership of US Treasury's increased from $3.2 trillion in the fall of 2008 to $6.7 trillion while domestic ownership increased from $1.7 trillion to $3.4 trillion as of September 2010 and has remained effectively unchanged since. This means that 100 percent of the $1.6 trillion in net issuance of US Treasury debt since September of

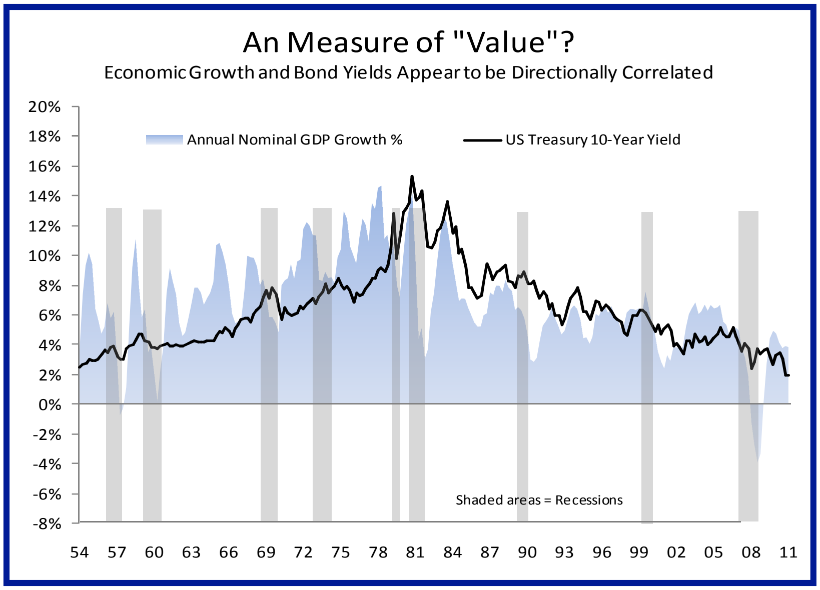
2010 has been purchased by foreigners and central banks. More noteworthy still, of the $6.7 trillion currently held by foreigners and central banks, $3.6 trillion is held by foreign central banks and $1.7 trillion is held by the Federal Reserve. Altogether, fully **$5.3 trillion** or **53 percent** of the $10.1 trillion in outstanding marketable Treasury debt is held by central planners. Therefore, anyone who blithely suggests that pricing in the current US Treasury market, where over 50 percent of the marketable issues are held by central planners, foreign and domestic, is representative of a freely tradable market where some metric of **"value"** may be distilled, has clearly allowed their education to interfere with their learning. This is a market dominated by the **self-interests of nonmarket participants**, namely the central planners. As the preceding data confirms, the predominate buyers of US Treasury debt *"are those that speak Chinese, those that speak Japanese and those that print money."* And these "investors" are completely immune to Wall Street and academia's siren song regarding "value". The central planners are buying US Treasury debt, not because they are priced to offer good value, they are buying US Treasury debt because they must! For this reason, the **"information content"** of the resultant bond prices is completely distorted and unreliable as a viable input to any valuation metric. As we have maintained for years, the financial markets in general and the Treasury market in particular, is being disproportionately influenced by the unprecedented actions of the central planners. In short, **this ain't your daddy's bond market anymore**.

Figure 2



Many of the bond naysayers maintain that a primary measure of **"value"** for bonds flows from a relatively stable and predictive relationship between economic growth and nominal bond yields. This relationship is fairly straightforward suggesting that as economic growth accelerates or decelerates so will inflation expectations, thereby causing bond yields to rise or fall in order to maintain the **"real yield"** demanded by investors. **Figure 3** illustrates the proposed relationship between economic growth and nominal bond yields and as we can see, based solely upon a visual inspection of the data, there does appear to be some **directional correlation** between nominal GDP growth and US Treasury bond yields. However, the actual statistical correlation for the entire period of time period covered in **Figure 3** has been quite weak, running at around **62**

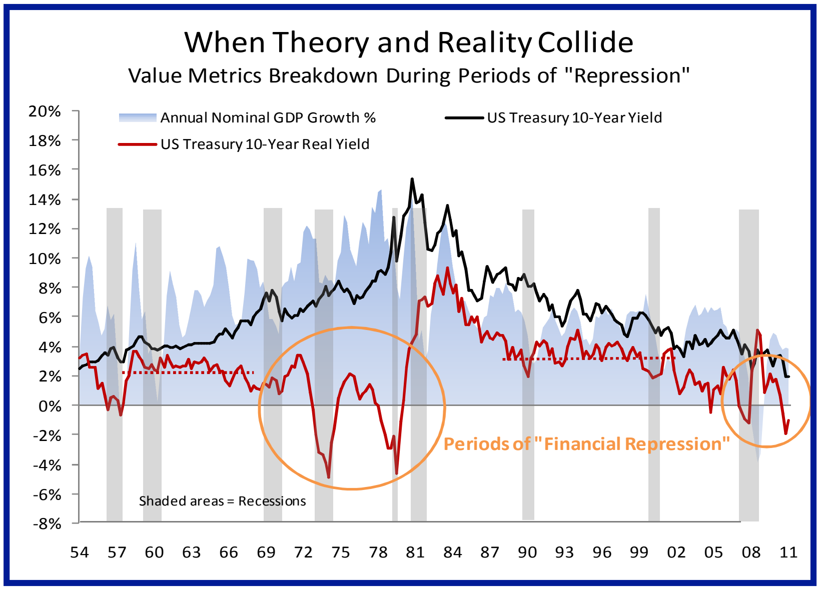
Figure 3



percent when calculated on a **rolling 5-year basis**. When calculated on a **rolling 1-year basis**, the correlation falls to **48 percent** or nearly random. So while over long periods, one might suggest that nominal GDP growth and nominal bond yields have tended to move in the same direction, clearly there have been extended periods of time when they did not, particularly over the short-run, severely diminishing the potential efficacy of any valuation metric which insists that bond yields must rise with an increase in economic growth.

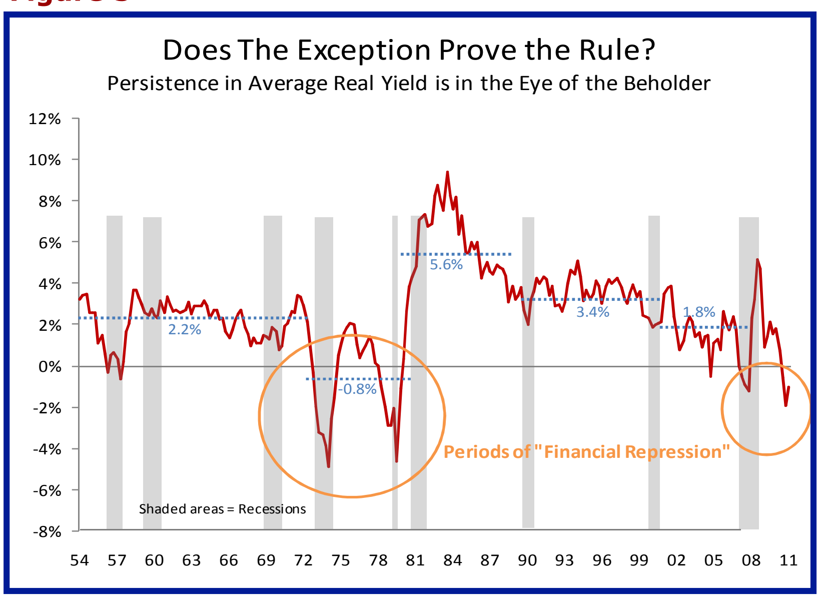
But just how does this theory of valuation work when we introduce the principal object of interest for this exercise, the **real yield or return** that is supposedly demanded by the **bond vigilantes**? The answer provided in **Figure 4** would strongly suggest that the vigilance of the 'vigilantes' must be of the **tidal kind** – '*it comes and it goes.*' Referring to **Figure 4** we can see that any conviction regarding the existence of a stable or predictive real yield on bonds based on the relationship between economic growth and nominal bond yields must be quickly disabused. Even a cursory review of the historical real yield for the period under review underscores the fact that it has been at times extremely volatile and anything but stable or predictable. However, by way of rebuttal, many would find statistical solace in the two periods denoted by the red dotted lines, one in the 1960s and the other occurring in the 1990s when real yields were **relatively stable**, averaging approximately 2.2 percent and 3.4 percent respectively, as representative of the normative level for the real yield. Therefore they would insist that whenever real yields deviate from these more normative levels, they are subject to the irresistible pull of mean reversion due to the actions of the bond vigilantes.

Figure 4



Specifically, a primary conclusion drawn from statistical research in this area has been that these intermittent periods of relative stability against a background of extended periods of observed real interest rates significantly above or below some mythical average, actually demonstrate **substantial statistical persistence** for the existence of such an average. In other words, we must look to the **exception to confirm the existence of the rule**. **Figure 5** isolates the real bond yield with calculated sample means for particular periods. A recent research paper published by the St. Louis Federal Reserve in November of 2008 considers an almost identical time period, 1953:Q1 through 2007:Q2, and concludes that *"real interest rates demonstrate long-memory behavior"* and while *"**shocks are***

Figure 5



***very long-lived**, the real interest rate is **estimated** to be mean-reverting."* Importantly the authors also qualify their work and admit the *"tentative nature of their claim that US real interest rates are a persistent but ultimately mean-reverting process."* While any discussion of statistical persistence is beyond the scope of this discussion, suffice it to say that such properties, if they do exist are highly dependent not only upon the statistical model selected and the specific techniques employed, but also the time period studied and the philosophical bias applied in the determination of appropriate "regime periods". Any honest appraisal of the claim regarding the persistence of real interest rates to revert to a persistent average is at best an exercise in Keynes' well-known **'Beauty Contest Problem'**. The best strategy, Keynes noted, isn't to pick the face that you believe is the prettiest. It is to select the one that you think others will think is the prettiest. To quote Keynes; *"We* [now] *devote our intelligences to anticipating what average opinion expects the average opinion to be."* And what is true about beauty is true of value also – it's in the eye of the beholder.

In our opinion, the only thing persistent about the behavior of the mythical real interest rate has been its all too persistent absence. Referring again to **Figure 4**, we can see that for the period under review, periods of relative stability in real rates were the exception rather than the rule. In fact a closer look at **Figure 4** reveals a bond market that has spent far more time in **transition** than in equilibrium, if such a condition can even be said to exist. What then is the cause of the *persistent* breakdown in a theory which postulates what many consider to be an intuitive relationship between real interest rates and economic growth? Ultimately the answer is bound up in a quote attributed to Einstein; *"Theory is where you know everything, and no one knows why."*

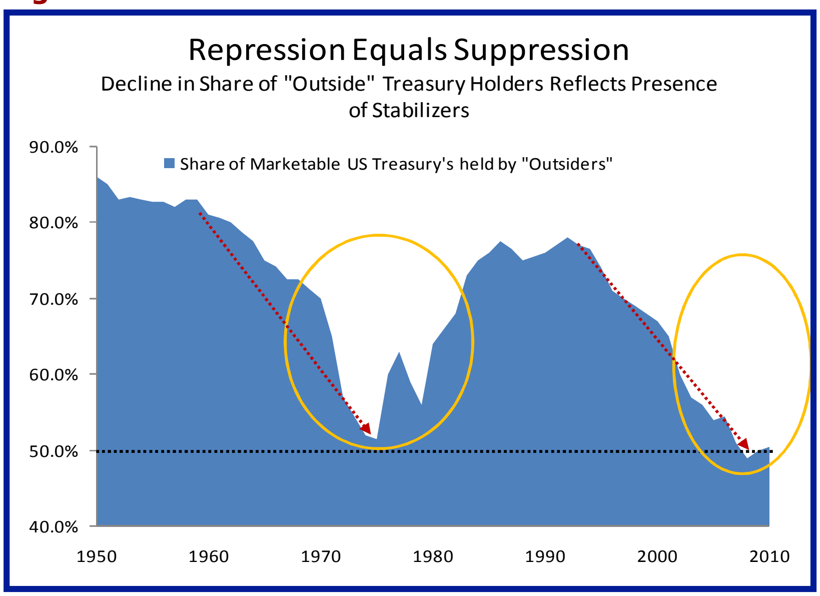
A key assumption underlying this proposed relationship is that the resulting real yields are representative of a market process whereby the supply of bonds offered for bid are purchased by value seeking investors. However referring again to **Figure 4** we can see that during the last 60 years, there have been two extended periods of **negative real yields** as denoted by the gold circles. Both occurred during periods of extreme monetary crisis and the subsequent interventionist policies of the central planners, resulting in what economist Carmen Reinhart has called **"financial repression."** According to Ms. Reinhart, *"financial repression is a form of taxation that helps liquidate the huge overhang of public and private debt and eases the burden of servicing that debt."* As such, financial repression is an intentional policy whereby one of the primary goals is to keep both nominal and real interest rates lower than they otherwise would be if market rates prevailed. All things being equal, by keeping interest rates artificially low for an extended period of time, the stabilizers are able to reduce the governments' interest expense for any given level of debt, thereby contributing to deficit reduction. More importantly however, when such heavy handed **tactics of necessity** produce **negative real interest rates**, it actually serves to **liquidate existing debts** through an insidious **wealth transfer** from savers to borrowers. *"Necessity"* as Milton observed, *"is always the tyrant's plea."*

The first period occurred during the 1970s following the abandonment of the Bretton Woods monetary system and the near collapse of the global monetary order. After World War II, the allied nations negotiated a post-war monetary system which was to be anchored by the US dollar. The US would commit to maintain the value of the dollar at a fixed rate of $35 per ounce of gold and in return, the other nations would maintain or "peg" their currencies at a fixed rate of exchange relative to the dollar. As the US dollar was the dominant reserve currency and the anchor of the system, the US was the only country able to unilaterally determine its own inflation rate. All other nations would be compelled to import the US inflation rate automatically via their fixed exchange rates with the US. This arrangement was in place between 1948 and 1971 and for much of the period up to 1965, US monetary and fiscal policy was operated to maintain the annual rate of inflation at between 1 and 2 percent. However, with the rise of **statism** came the intentional diminution of our monetary standard in an effort to underwrite the perpetual expansion of the nanny state and facilitate the illusion of permanent prosperity. During the mid-1960s, the US was determined to have both guns and butter by prosecuting a war in Vietnam and simultaneously launching President Johnson's massive new social program, the Great Society. In response, the fiscal condition of the US tipped from one of balance to one of permanent deficit. The resulting inflation from the US monetary expansion was exported to the rest of the world through the rigid system of fixed exchange rates. Massive amounts of excess reserve dollars were accumulated by **foreign central banks** (FCBs) in the form of Treasury debt during this period. In time, many FCBs exercised their convertibility option under the Bretton Woods agreement, demanding gold in exchange for their excess dollars rather than Treasury's in an effort to mitigate the destructive impact of the imported US inflation on their domestic economies. In an act of **"financial repression"** known as the "Nixon Shock", President Nixon closed the gold window in August of 1971, refusing to allow FCBs to exchange their dollars for gold, effectively **"defaulting"** on US debt obligations by "stealthily" reducing the value of foreign holdings of US debt through the ensuing devaluation of the dollar. This unilateral action on the part of the US evoked a charge of "exhorbitant privilege" leveled by those nations who were the recipients of the recalcitrance of the US. This is turn gave rise to US Secretary of Treasury John Connally's infamous reply; *"The dollar is our currency, but your problem."*

The second period of **financial repression** and resulting **negative real interest rates** is the current period which began with the unprecendented level of intervention following the onset of the Great Recession and the ongoing global financial crisis of 2007. Regarding this period and the degree of intervention imposed by the stabilizers, we have written extensively over the past 4 years. Suffice it to say that it has been and remains our steadfast contention that the financial markets in general and the bond market in particular, are to one degree or another, **creatures of the Fed**. This contention, we suggest, is ably borne out by a reasoned consideration of what has been presented thus far. First, non-market [read central bank] holdings of US Treasury debt have risen to over 50 percent of all marketable [tradable] debt outstanding. Secondly, the history of real interest rates strongly refutes the existence of a stable and predictive minimum required rate of real return and instead reflects a market dominated by transition, punctuated by periods of substantial divergence and negative real interest rates. In our opinion, these two observations are causally related.

Referring to **Figure 6**, we can see that during both periods of negative real interest rates, there was a dramatic decline in the share of **outside holders** of marketable Treasury debt. The most recent bout with negative real interest rates which began after 2007, has occurred in an environment where several sovereign borrowers [think Europe] have been teetering on the verge of outright default. Such an occurrence is completely counter-intuitive to any theory postulating a mandated minimum real return by ever vigilant market investors. In our opinion, the most critical factors in explaining the disconnect and resulting negative real interest rates in the wake of the crisis are the expansive stance of monetary policy and the presence of heavy-handed intervention by the stabilizers in both markets and economies.

Figure 6

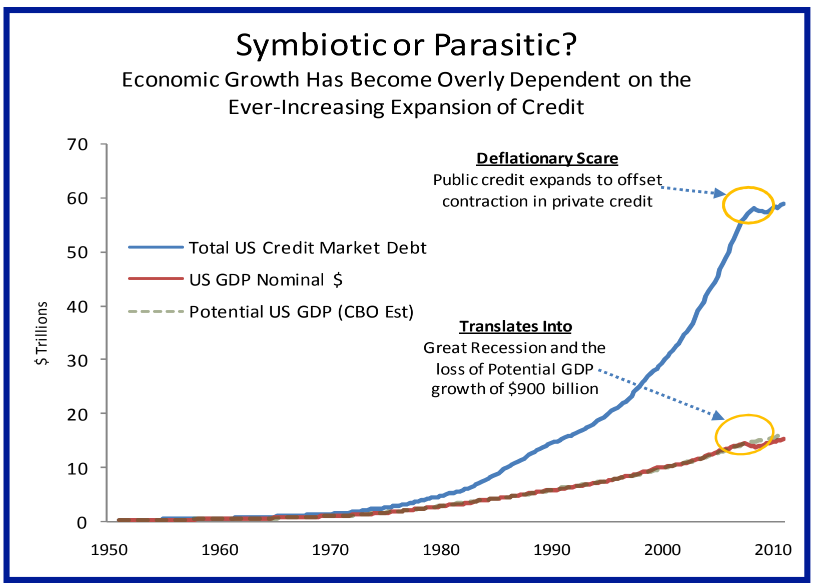


Despite the standard tag of ***"risk-free return"*** which has been forever lavished upon the government's solemn obligations, the truth is that no investment asset is inherently safe or valuable. Risk or safety, like value, is an attribute of price. Underpinning this proposition is an old bromide that has held sway in the bond market for many generations; ***"There is no such thing as a bad bond, only a bad price."*** At the right price, a lowly convertible bond may be a safer and more valuable proposition than an exalted Treasury. The rub of course lies with the question of whether current prices [read interest rates] reflect freely tradable market conditions or whether they are disproportionately determined by the actions of the stabilizers in financial markets. According to Reinhart, *"a large role for non-market forces in interest rate* *determination is a central feature of financial repression."* This "large role" played by the "official players" is made abundantly clear in **Figure 6**. With the combination of the Federal Reserve's two rounds of quantitative easing and operation twist, combined with the record level of purchases of US Treasury debt by foreign central banks [most notably China and Japan], the share of marketable Treasury debt held by **"outsiders"** has fallen **below 50 percent**. As already noted, these are the lowest shares since the expansive monetary policy stance of the US associated with the breakup of the Bretton Woods monetary arrangement in the early 1970s. And they also coincide with the last two periods of sustained negative real interest rates. Coincidence? We think not.

Central planners on both sides of the Atlantic (and Pacific) have become the predominant players in the purchase of government debt. In pursuit of their own self-interests which include the necessity of securing unobservable debt reduction and unseen tax increases, interest rates will continue to be disproportionately determined by non-market forces. And this is a situation that is not likely to change materially for the foreseeable future. Why? Because as we have oft stated; ***"Atlas cannot shrug."*** Given the massive level of intervention and debt creation put in place in the pursuit of a strategy of **"extend and pretend"**, the consequences of a sharp rise in interest rates and the attending debilitating debt deflation that would inevitably accompany it are politically unacceptable and as such, the stabilizers will continue to pursue the path of least resistance, reflation and financial repression. At the same time, we would take issue with those who would have us believe that China or Japan are preparing to *"dump US Treasury debt"* in an effort to drive domestic interest rates higher and so displace the US dollar as the global reserve currency. Aside from the obvious implications of their existing **'Prisoners Dilemma'** stemming from their already massive holdings of US Treasury debt, both China and Japan, and to a lesser extent most of the emerging economies of Asia, have built economies that are entirely dependent upon continuing export trade to end consumers in the US and Europe. As such, fear of currency appreciation, not rhetoric about displacing the *"parasite on the world economy"*, will continue to drive foreign central planners to purchase US government bonds on a large and continuing scale. As we noted last time, we now live in a Keynesian world unmoored from the confines of scarcity, a world of planned economies and managed currencies, a world in which economies have become overly dependent on a ***"persistent drip line"*** of monetary intervention to prevent the all-important but fragile financial sector to wilt and die, dragging the rest of us into the *"mother of all"* debt deflations. As someone once trenchantly observed; *"When the cure is worse than the disease, the addiction is likely fatal. So it is with drugs and alcohol. So it has always been with governments that have overdosed on unlimited paper money."*

It is that addiction to the perpetual expansion of credit and its' debilitating impact on wealth formation and allocation, as well as economic growth that we have long chronicled. The exponential growth in this dependence can be clearly seen in **Figure 7** which graphs the total credit market debt of the US against actual US GDP as well as Potential GDP as calculated by the Congressional Budget Office. Potential GDP is simply an estimate of the amount of output the US *could* produce if it were running at **full capacity**. Our purpose in reporting this data is not to confirm the accuracy of the calculation of potential GDP. It is rather to highlight the massive degree of **leverage** in the US economy and its' overdependence on an ever

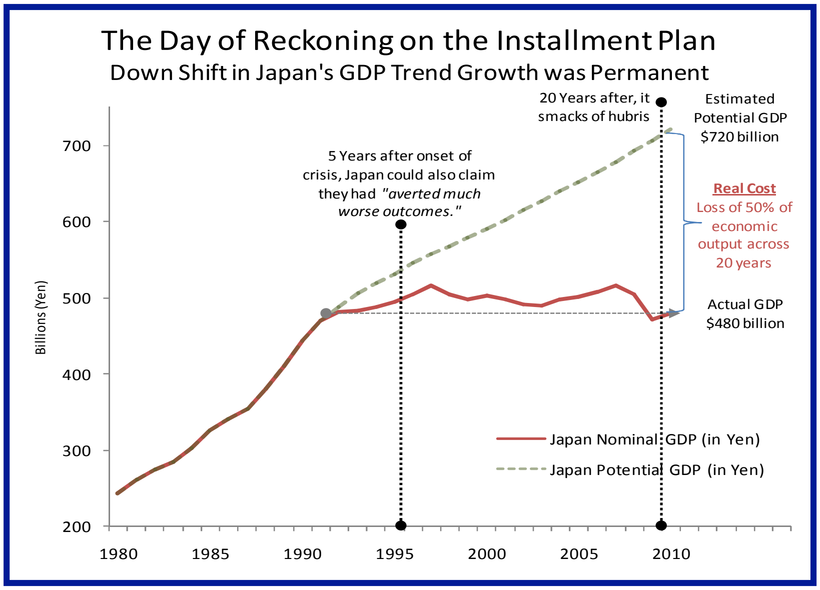
Figure 7



increasing volume of credit for a decreasing rate of economic growth, i.e. the **diminishing marginal return on debt**. That this relationship should be characterized as parasitic rather than symbiotic is reflected by the dramatic reduction in Potential GDP ($900 billion or roughly 7 percent) in response to the interruption, not outright contraction, in the growth rate of credit. It was in reaction to this **deflation scare** that the stabilizers responded with an unprecedented level of intervention. Defending the Fed's unprecedented intervention at one of his recent stops in the Fed's public disinformation relations campaign, Chairman Bernanke was quoted as saying; *"The forceful policy response to the recent financial crisis and recession likely averted much worse outcomes."* While on its surface, the statement is certainly true, we would humbly submit congratulations would be premature at this time, as we believe the **final reckoning** for this **"successful failure"** is still future.

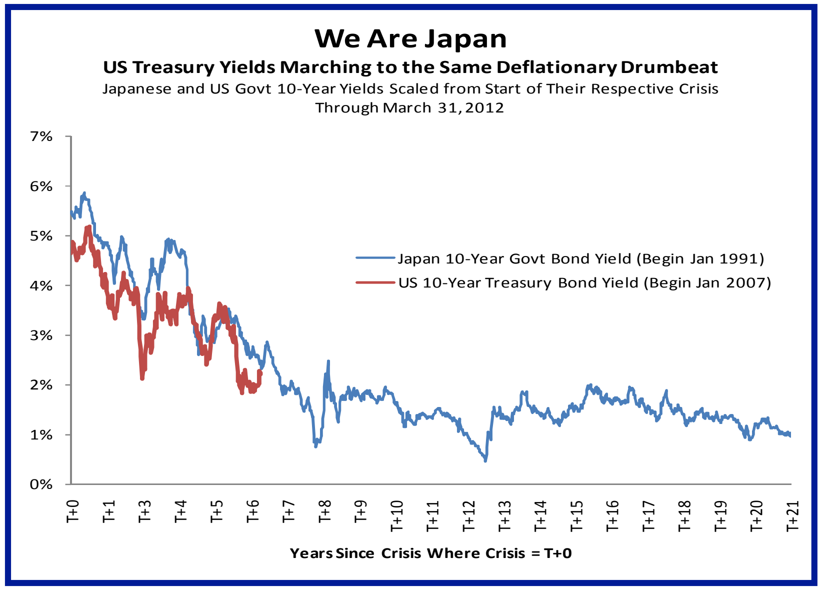
And just what might that day of reckoning look like? One aspect that we have repeatedly emphasized is our possible solidarity with the Japanese experience of **economic sclerosis**. Subsequent to the collapse of their housing bubble in 1990, Japanese central planners also pursued a *"forceful policy response to the financial crisis"* in an all-out effort to *"avert much worse outcomes"* by subjecting their country to a beta-test case on the long-term effects of massive intervention replete with perpetual quantitative easing (QE) and an extended zero interest rate policy (ZIRP). And what of the results of that test? **Figure 8** clearly illustrates the long-term impact of perpetual intervention via monetary expansion on Japan's economic growth by plotting Japan's actual and potential GDP on an annual basis. Since the collapse of their housing bubble and the onset of the financial crisis in 1991, economic growth has all but stagnated into an economic malaise that we have oft referred to as a **"rolling depression."** This, we have long contended, is the real price of the central planners **"successful failure."** As can be seen in **Figure 8**, the difference between Japan's actual GDP and estimated potential GDP 20 years after the initiation of the perpetual intervention program currently stands at a **gaping 50 percent!** That is Japan's GDP 20 years after the inauguration of a *forceful policy response* is fully **one-half** the size it would have been had economic growth remained on trend. It is interesting to note that 5 years after the crisis, Japanese officials could have made the same boast statement Bernanke recently made regarding the success of their policy response. However upon mature reconsideration 20 years after the event, reasonable people can disagree with the characterization as a **"success".** To be sure, without intervention Japan would have suffered a severe recession and a contraction in economic growth. Still the question remains as to whether a severe but likely short duration depression followed by a return to trend growth would have been optimal relative to the permanent loss of nearly a generation of economic output. The answer of course, may be found in the words of King Henry II; *"There's no sense asking if the air is good if there's nothing else to breathe."*

Figure 8



Another area in which our experience has thus far been remarkably similar to that of Japan has been the trend in long-term interest rates. **Figure 9** compares the trend in 10-year government bond yields since the onset of the respective financial crisis in both Japan and the US. For Japan the start date is January of 1991 and for the US the start date is January of 2007. The bottom axis on the chart denotes the time periods in years since the onset of each respective crisis with t=o being the crisis start date. As such **Figure 9** illustrates nearly 21 years of yield history for Japan while the US is still less than 6 years from the start of its' crisis. Yet when laid on top of each other, they show remarkable correlation. Of course we are not arguing for *causation from correlation*, but rather causation from a common cause – unprecedented monetary and market intervention. And though we do not insist on infallibility regarding any prognostication of the future path for long-term US interest rates from this chart, we nevertheless offer this as anecdotal evidence against the prating of the sophists who insist that interest rates must only and always go up.

Figure 9



So to wrap this up, is there any value in bonds? That depends on how you chose to define "value". If by value you mean the value defined the academics who hold to such ivory tower constructs as the "efficient market" and "rational expectations", [both of which presume unhampered, freely tradable markets] and insist that over long periods of time, stocks will *always* outperform bonds due to the existence of a **"persistent"** [and therefore guaranteed] equity risk premium [better look again at stock versus bond performance over the last 30 years], then clearly **there is no such value in bonds**, at least not in Treasury bonds. Articulating this view, perhaps no voice has been louder in their denunciation of bonds and their uncritical adulation for stocks than Wharton School finance professor and author of the best-selling 'Stocks for the Long Run', Jeremy Siegel. Earlier this year Dr. Siegel succinctly put forth the position of this camp of **"value investors"**; *"The bond outlook is extraordinarily bad. After 30 favorable years of declining yields and rising prices, the best case for bonds over the next couple of decades is a return of zero after inflation – and more likely a negative outcome."* There you have it. One of the most prominent prognosticators has pronounced the end of the bull market in bonds and by extension, the **death of value in this asset class**. Interestingly, Dr. Siegel made the same pronouncement back in 2010 in a Wall Street Journal op-ed piece entitled 'The Great American Bond Bubble.' In that piece Dr. Siegel stated; *"What is happening today* [2010] *is the flip side of what happened in 2000. Just as investors were too enthusiastic then about the growth prospects in the economy, many investors today are far too pessimistic. As a result, they're plowing money into Treasuries and Treasury mutual funds. This will almost certainly end badly."*

How did that call work out for Dr. Siegel? With bonds not only ***not imploding***, but instead racking up an annualized rate of return of 19.7 percent versus 11.8 percent for stocks since his prognostication of doom, clearly not as well as his **one-and-done** mega call in March of 2000 that made him a household name and frequent guest on the *bid-em-up* financial market infomercial circuit. On March 13, 2000, The Wall Street Journal ran an op-ed piece from Dr. Siegel entitled 'Big-Cap Stocks Are a Sucker Bet.' The column shocked the investment community. However that very month, the Nasdaq – home to these tech giants – hit its all-time high of 5,132. From there, it imploded. Even today – more than 10 years later – the Nasdaq is 40% below its high. Does this one-and-done experience sound familiar? It should. Dr. Siegel, like Meredith Whitney, are among the ranks of those who made names for themselves with one spectacularly successful [if not dubious] call, only to be followed by a litany of very bad ones. Consider for example, a couple of other past predictions by "value expert" Dr. Siegel: He predicted that *"the economy will avoid a recession"* in 2008. NBER, the official recession dating committee, dates this last recession as having started in December 2007 and having ended in June of 2009. Oops, strike one. His crystal ball also revealed that *"the stock market will have another winning year in 2008."* The S&P 500 lost 38.5 percent in 2008, its worst year since 1937. Strike two. And finally he predicted that *"financial stocks"*, which had already plummeted 18 percent at the time of his prediction, *"will outperform the S&P 500 index next year* [2008] *as the credit crises fades."* Financials underperformed all market sectors, losing 56.95 percent. Strike three. [Actually that's a two-for as the credit crisis clearly has not faded either] Commenting on these one-hit wonders, legendary hedge fund investor David Kass was quoted as saying; *"Quite frankly, the streets of Wall Street are paved with geniuses who have made one great call in a row."* We would throw in another Wall Street chestnut about professional soothsayers; **Even a stopped clock is right twice a day.**

Our desire here is not to single out Dr. Siegel for persecution, it is rather to put their bombastic prognostications regarding value into proper perspective. And in our opinion, Dr. Siegel's view is representative of the expert opinion proclaiming the death of value in bonds, a view that for the last two-plus years has not only been wrong, it has been spectacularly wrong. In our opinion, the primary reason that this opinion of **"no value"** in bonds has been so wrong has been due to the fallacy of evaluating data without giving proper place to the market context – this is a not a market in which prices [read interest rates] are determined by free market forces, this is, as we have chronicled in this review, a market dominated by the **self-interests of the stabilizers** who are hell-bent on keeping interest rates low and the yield curve steep for an extended period of time in order to save the banking cartel and so avoid the abyss of a **debilitating debt deflation**. And what continues to stupefy us is the fact that despite the extraordinary efforts of the central planners in proclaiming this story by both *word and deed*, the bond haters still don't get it. What more must they do in order to convince these naysayers that they mean what they say and despite the absence of value as defined by the academic investing world, **they will not allow** bond yields to explode upward, triggering a bear market in bonds and tipping the US and the world into a **global deflationary nuclear winter**. Faced with the ongoing prospect of debilitating debt deflation due to a private and public debt overhang of historic proportions, central planners of all stripes will continue to be preoccupied with debt reduction, debt management, and, in general, all efforts, fair or foul, to reduce debt servicing costs and avoid the impairment of capital in the banking system. To accomplish this, a substantial tax referred to by economist Carmen Reinhart as **financial repression** will continue to be levied on **savings** in an effort to help liquidate the huge overhang of debt through the heavy-handed implementation of below market interest rates and negative real interest rates for an extended period of time, effectively negating the academic calculation of value. In this environment, value like risk, is now completely dependent upon the money printing operations of the central planners. The necessity of keeping interest rates abnormally low through financial repression creates the investing equivalent of the **'hunger games'** whereby market investors are pressured into entering the risk-laden jungle of investment options in search of a subsistence level return. Parroting the cry of the stabilizers to abandon the assessment of risk in the name of value, these "experts" recommend shouldering ever increasing levels of risk of loss by going down the credit quality scale or overweighting stocks to "pick up value".

So to return to our question, is there any value in bonds? Our answer is if you define value as Benjamin Graham and David L. Dodd did in their 1934 magnum opus, 'Security Analysis', that *"bonds should be bought on their ability to withstand depression"* – and to this we would add *"to withstand the stabilizers* ***cure*** *for depression, ie.,* ***repression****"* – in short if you define value as the avoidance of loss in an extended period of market dysfunction and extreme volatility, then the answer is a resounding "yes". Returning to James Bianco, president of Bianco Research who recently said; *"The investing world is telling you there's no value in* [Treasury] *bonds; why own them?"* And Bianco's answer; *"Because there's this entity in Washington printing money to buy them,"* and like it or not, ***"this is Ben's World and we're just investing in it."*** So while there may be no value in bonds as Wall Street defines it, we still believe strongly that there is **great value in avoiding the loss of one's money**. And for those who own Treasury bonds that is something the Fed will not allow to happen. We close with perhaps the oldest and most *"persistent"* bromide in the bond market: **"Don't fight the Fed!"**