

FEB. 24, 2010

**OBSERVATIONS ON THE MARKET** No. 224*By Greg Denemiler, CFA*

If you were an investor back in 1981, you may remember that the market had finished a decade of low returns, and money market funds were paying 21%. Thirty-year treasury bonds were paying a much less appealing 13% at the time. If you purchased a portfolio of either stocks or thirty-year bonds, you made a lot of money over the next twenty years. Picking the higher yielding money market fund resulted in a tremendous opportunity cost. The decision was not easy at the time because if inflation had not been tamed, the outcome would have been far different. It appears that investors are at another fork in the road. However, this time interest rates and inflation are at the opposite end of the curve - near record lows. As you stand and consider which road to take, the choice is not easy.

Everyone assumes six-month CD's and treasury bills will not stay at .25% indefinitely. Proof probably came last week when the Fed began the process of moving short-term rates above zero. Though the discount rate only affects banks, the Fed wants to encourage banks to borrow from each other, which is how the market normally functions. They can raise the discount rate another ½% before the interest rate market for banks is back to its normal relationship. This should be considered a positive for the market because it is another indication that the credit markets continue to improve. The discount by itself does not affect the borrowing costs for consumers. The Fed has stated that it will be a while before the economy can withstand an interest rate hike for consumers. The question is obvious; is now the time to prepare for higher interest rates?

Interest rates have always been a function of the perceived level of inflation that is in the economy. One reason rates have remained so low is that the economy has a tremendous amount of excess capacity in it, so it is very hard for companies to

raise prices. It appears that it is going to take several years to get the economy back to its full capacity. This becomes the major case that interest rates will remain low for some time. Another fear is that the world economy is in a deleveraging mode, and it could be a decade before leverage is brought down to a sustainable level. If this scenario plays out, owning 10-year or greater maturity bonds will be a wise investment.

It is quite possible that interest rates will go up, not because of inflation, but because there is just too much demand for money. There is a tipping point where our government must start paying higher interest rates to entice investors to continue to buy treasury debt. There is no shortage of 'experts' who think they know where that point is, but nobody really knows. The real concern is that once the tipping point is reached, the transition to higher rates won't go smoothly because a herd mentality will then set in. The markets have little experience dealing with higher interest rates in a low inflation environment.

If you own a 10-year treasury and interest rates rise to 6.2% in the next two years, which is the 50-year average, you will experience a loss of 7.5% on your 'low risk' treasury investment even after receiving your annual interest payments from the bond. According to the Investment Company Institute, investors pulled \$536 billion out of money market funds in 2009. Bond funds captured much of that money which was double any previous year's inflows.

The stakes are high regarding the future of interest rates because there are several different scenarios that could develop. When faced with a decision of which path to take, you are usually best served to not follow the path everybody else is taking. Lately, investors have been fleeing money market funds and buying longer-term bonds in droves.