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The Sound Investor Series #64

What Should Bond Investors Do Now?

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Where should fixed income investors turn now? How should the money from their maturing CDs and bonds be reinvested? Should investors continue buying short-term CDs and Treasury Bills or should they buy longer dated bonds?

Over the past few years, keeping your money invested in short-term investments worked out very well. The Fed was steadily raising interest rates and investors were able to roll over their maturing investments into higher yielding securities on a regular basis.

Now the calculus of deciding the maturities of your fixed income investments is much more complicated. Last month the Fed ended its two-year streak of increasing rates and opinions are widely divergent, even within the Fed, on where rates will go from here.

The direction of interest rates is always a difficult question, but maybe even more so in today's environment. Looking at the big picture, the economy appears to be doing just fine. The employment report released last Friday was most notable in that it seemed to please everyone. Payroll employment numbers were up – but not too much. The headline unemployment rate also dropped slightly, but not enough to raise red flags.

Even the earnings numbers had something for everyone. Average Hourly Earning only rose 0.1 percent from the previous month and this relieves some of the pressure on the Fed in its battle with inflation. Liberal economists however, in the run-up to Labor Day, were comforted that wages had risen 3.9 percent over the past year and were almost keeping up with inflation, which rose 4.1 percent in the same period.

One of the big question marks about the economy is the housing sector. On a daily basis, information is released chronicling the growing troubles facing this industry. Housing prices are still up versus last year, but have shown little or no growth in the past few months. And the Housing Futures market is predicting prices will fall 6% by the second quarter of 2007.

It is no wonder most investors are confused about the dynamics of the housing industry. The head of Toll Brothers, one of the largest home builders is also dumbfounded. A few weeks ago he explained his bewilderment saying the housing slowdown "is the first downturn in the 40 years since we entered the business that was not precipitated by high interest rates, a weak economy, job losses or other macroeconomic factors."

Will the housing sector continue to deteriorate and pull the rest of the economy into a tail-spin? Or will it be just what the “Doctor” ordered to help brake the overall economy and allow it to glide in for a soft landing? Or a third choice, will housing prices bounce back this fall and give the economy a burst of growth?

The outcome will greatly influence the Fed’s actions. Under the three scenarios offered above, the Fed’s response will be to lower rates, do nothing or raise short-term rates.

The traditional advice for fixed income investors, for what it is worth, is as follows. If the Fed starts to cut interest rates, investors will want to aggressively extend, or lengthen the maturities of their fixed income investments. This will allow them to lock-in decent yields for a longer period of time.

For investors that believe the Fed will do nothing, they may want to extend their maturities slightly, while still keeping money in short-term CDs/Treasury Bills to take advantage of yields over 5%.

Finally, investors that assume the Fed will have to continue raising rates to control inflation would be advised to keep their money invested in short-term investments in order to maintain flexibility going forward.

This advice may turn out to be right, but financial markets have a way of acting a little differently from one cycle to the next. For a good example, we just have to look at how long-term rates fell in the face of the Fed raising short-term rates in 2004 and 2005.

In fact, in this economic cycle, it is not hard to imagine the performance of longer term interest rates moving in the opposite direction to the Fed’s movement of short rates. For instance, if the Fed raised short-term rates at the September meeting, long-term rates might fall as the market became more convinced the Fed will stop inflation, no matter what the consequences. On the other hand, if the Fed sits on it hands or cuts rates due to a weakening housing market, perhaps bond investors would be more concerned with inflation and demand higher long-term rates.

The bottom line recommendation is investors should keep their fixed income portfolios diversified and spread out over all maturities - do not put all of your (nest) eggs in one basket. My gut says the housing market will be a real drag on the economy and the Fed is almost finished raising rates. Long-term interest rates will probably fall slightly, but not a lot as long as oil stays around this level.

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