

# THE GLOOM, BOOM & DOOM REPORT

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## Should You Still Buy US Dollar Bonds?

### INTRODUCTION

In March 1999, we published a report entitled “Long Wave Considerations” (see GBD report of March 12, 1999) in which we discussed the outlook for bonds and equities and enclosed a study by Michael O’Higgins, a well-known and successful value investor. Michael has written two books, *Beating the Dow* and *Beating the Dow with Bonds*. He became famous for his strategy of buying the five cheapest stocks with the highest dividend yields in the Dow and holding them for a year — a strategy that became known as “Buying the Dogs of the Dow”. In our March 1999 report,

Michael wrote that “the chances of avoiding severe losses in the stock market over the next few years are extremely slim given the absurd valuation levels and the fact that stocks have declined for an average of four years in every decade since 1900”. He concluded that “US Treasury Zero Coupon Bonds should perform very well because, if we regress to the middle of the US long-term interest range which has prevailed for most of our history, long US Treasury Bond rates should drop to 4%”. Of course, it seemed absurd at the time to buy US Treasuries, which were yielding less than 6%, when the Nasdaq was gaining 100% per annum.

However, financial conditions have obviously changed somewhat since then (to put it mildly), and therefore we felt it was time to get an update from Michael O’Higgins on his current thoughts about the stock and bond markets. Michael’s views on the financial markets are set out below, followed by some of my own observations. The report concludes with a piece on opportunities in Asian US dollar-denominated bonds, written by my friends at Income Partners Asset Management whose outstanding website, [Asiabondportal](http://Asiabondportal.com), provides information on Asian bonds and allows investors to trade Asian bonds online.

## The Outlook for Bonds versus Stocks

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Michael O’Higgins manages several funds, including two offshore funds, of which a short-term trading fund was rated #2 in the world for the last four years (see Figure 1).

A little over two years ago, in the March 12, 1999 issue of the *Gloom, Boom & Doom Report*, I wrote a piece discussing the likelihood of a major stock market top, especially in the speculative Nasdaq stocks, and the relative attractiveness of long-term US Treasury bonds. Since then, the Nasdaq has lost 27.8% and the S&P 500 is down 13.2%, while my US Treasury bonds have returned 9.9% with much less risk and much more liquidity. With long-term T-bond rates now approaching their long-term average of 5% and the major US stock averages making new lows, perhaps it is a good time to re-examine the outlook for both stocks and bonds from a long-term historical point of view.

Starting with stocks, it seems to me that we need to go much lower before reaching levels which history would say offer a compelling combination of low risk and high returns. If we look at Table 1, which shows the historical levels at which stocks have sold in previous low-inflation eras, such as now, we can see that the major averages need to decline another 30–40% before they reach **median** levels of valuation, never mind cheap. Aside from valuation considerations, stock market sentiment remains all too bullish. While stock investors have experienced huge losses — over US\$6 trillion so far — there seems to be little in the way of the type of capitulation that normally prevails at market bottoms. Interestingly, until recently, the

Investors’ Intelligence Bull/Bear ratio actually rose in the face of falling stock prices. While it is logical that investors find stocks more attractive at lower prices than at high prices, it isn’t the kind of psychology that makes for a washout that can be safely bought.

Bonds, on the other hand, are still somewhat undervalued in spite of their having had an almost 20-year rise during which long-term zeros compounded at close to 22% a year. Although the 5.3% currently available on long-term Treasuries may seem like a very low rate of return to those of us who remember the 15% available in late 1981, it is, in fact, on the high end of the 2–6% range which has prevailed throughout most of the US’s 200+ years as a nation (see Figure 2).

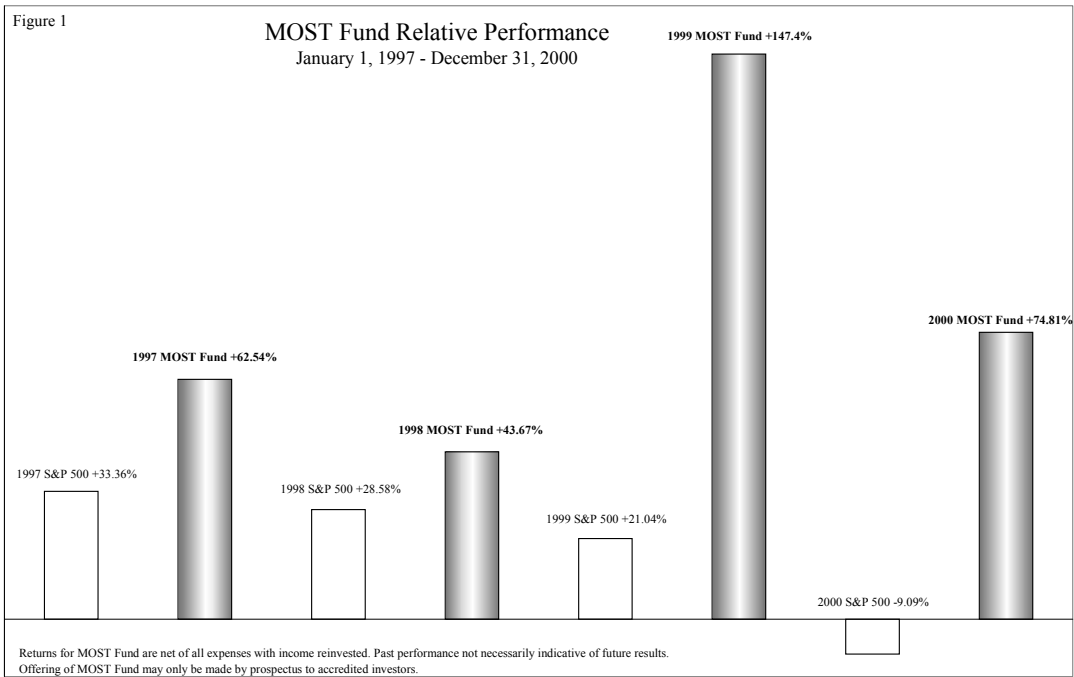
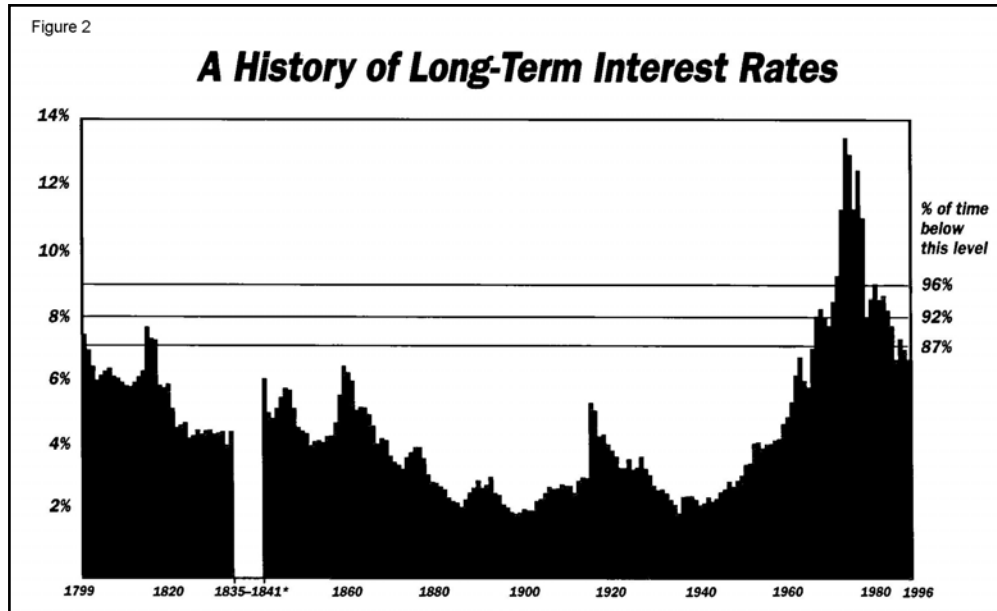


Table 1 **Back to the Medians (Low-Inflation Years, 1957 to 2001)**

S&P 500					
S&P 500	Now: 1182.17	Now	Historical Median	Implied Market Level	Gain/Loss From Here
Normalized "Adjusted EPS" P/E		25.2	20.5	984	-17%
Non Normalized Operating EPS P/E		20.1	18.8	1,110	-6%
Return On Sales Norm EPS P/E		31.5	17.6	734	-38%
Dividend Yield		1.0	3.0	537	-55%
Price to Book (Adjusted)		4.1	2.2	638	-46%
Price to Cash Flow		12.8	10.5	906	-23%
Price to Sales		2.0	1.0	592	-50%
Market Value/GDP		131%	69%	623	-47%
<b>Average</b>				<b>766</b>	<b>-35%</b>



Looking at a slightly shorter timeframe, the 40-year period from the early 1960s to the present, I have found that long-term US Treasury rates tended to fluctuate around a level 2 percentage points above the nine-year moving average of the Consumer Price Index (CPI). With the nine-year CPI currently at 2.58% (see Figure 3), it would appear that the long-term T-bond rates should approach 4.58% by year end 2001. If that happens, my long-term zeros should appreciate by another 20+% during a time when, as I indicated above, the major stock averages should drop by 30–40%.

What will I use as an indicator to signal the end of the great bull market in bonds that we have enjoyed for the last 20 years? An indicator which has correctly signalled the course of long-term T-bond rates in 26 out of the last 32 years is the price of gold (see Table 2). With the price of gold still lower than it was a year ago, it still looks safe to own long-term Treasuries (see Figure 4).

How will it all play out? If the past is any guide, and given that actions tend to bring about corresponding reactions, both markets will revert to extreme levels — meaning that stock prices will probably drop well past median valuation levels (that is, 30–40% down from here) to levels which are actually cheap. This should cause a flight into quality bonds, pushing long-term T-bond rates well below the 5% median level which has prevailed for the last 200 years.

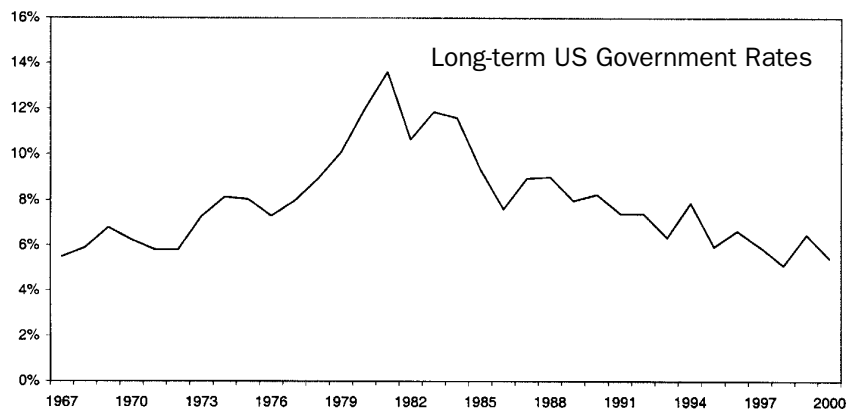
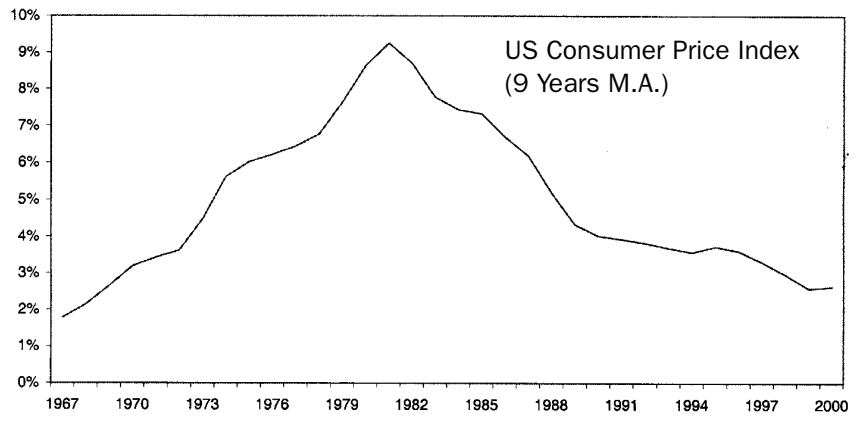
Table 2 **Performance of Gold and Interest Rates, 1969–2000**

<b>Year Ended</b>	<b>Previous Year Gold Price % Change</b>	<b>Long-term US T-bond Yield (%)</b>
31-Dec-69	14.86%	15.10%
31-Dec-70	-12.61%	-8.00%
31-Dec-71	7.17%	-7.00%*
29-Dec-72	16.47%	0.10%
31-Dec-73	48.69%	24.90%
31-Dec-74	72.24%	11.80%
31-Dec-75	66.30%	-1.20%*
31-Dec-76	-24.85%	-9.10%
31-Dec-77	-3.99%	9.20%*
29-Dec-78	22.41%	12.00%
31-Dec-79	37.01%	12.90%
31-Dec-80	126.55%	18.50%
31-Dec-81	14.45%	14.00%
31-Dec-82	-31.57%	-21.80%
30-Dec-83	13.94%	11.30%
31-Dec-84	-16.50%	-2.20%
31-Dec-85	-19.19%	-19.30%
31-Dec-86	6.94%	-18.60%*
31-Dec-87	20.41%	17.80%
30-Dec-88	21.93%	0.60%
29-Dec-89	-15.11%	-11.40%
30-Dec-90	-1.95%	3.40%*
31-Dec-91	-2.52%	-10.20%
31-Dec-92	-10.07%	-0.10%
31-Dec-93	-5.63%	-14.10%
30-Dec-94	17.54%	24.10%
29-Dec-95	-2.39%	-24.50%
31-Dec-96	1.19%	11.60%
31-Dec-97	-4.64%	-10.80%
31-Dec-98	-21.44%	-13.50%
31-Dec-99	-0.75%	26.56%*
31-Dec-00	-0.25%	-16.10%

\*Gold Indicator Failed

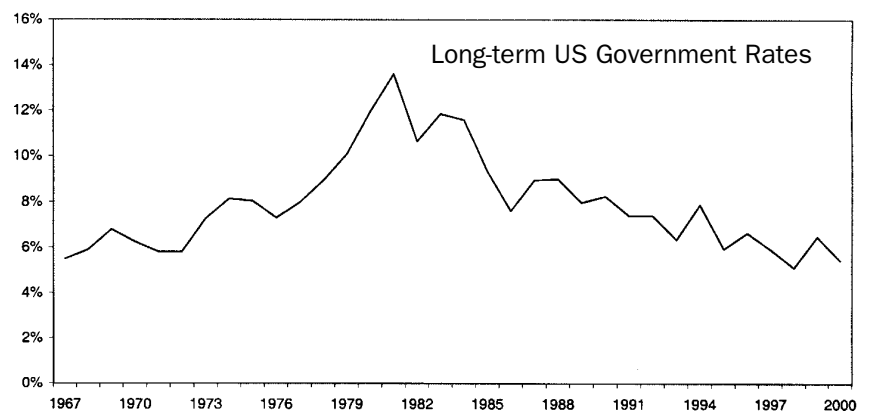
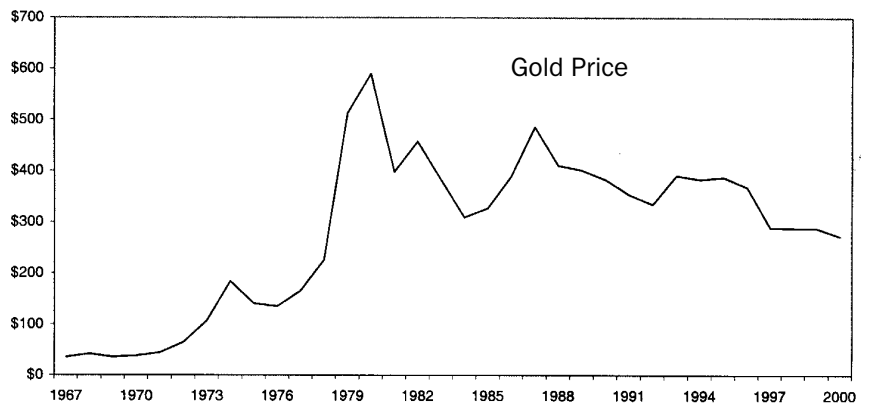
Source: O'Higgins Asset Management, Inc.

Figure 3  
**Long-term Rates versus Inflation,**  
**December 31, 1968 to**  
**December 31, 2000**



Source: O'Higgins Asset Management, Inc.

Figure 4  
**Long-term Rates versus Gold,**  
**December 31, 1968 to**  
**December 31, 2000**



Source: O'Higgins Asset Management, Inc.