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PDV *OBSERVATIONS*

Shape of the Treasury Yield Curve: Is It Trying to Tell Us Something?

When an investor buys a Treasury bond (a "Treasury"), he or she is lending money to the federal government, in return for the government's promise to pay him or her interest periodically and repay the principal at maturity. There are Treasuries with different maturities, ranging from three months to thirty years.

Under normal economic circumstances, the longer the term of the Treasury, the higher the interest it pays. This is because investors demand more compensation for tying up their money for a longer time, and for being subjected to inflationary and other economic uncertainties in the interim. Also, investors who own the longest Treasuries are likely to suffer the greatest principal loss if interest rates were to rise after their purchase.

The Treasury yield curve graphically depicts this relationship between Treasuries of various maturities and the different yields offered by those same Treasuries. Under normal economic circumstances, the shape of the Treasury yield curve is positively slopping because longer-term Treasuries yield more than shorter-term Treasuries. A typical yield difference ("spread") under normal economic circumstances between a 3-month Treasury bill and a 30-year Treasury bond might range from 1.5% to 3.0%.

However, there are times when the Treasury yield curve becomes very flat or even "inverted" (when short-term Treasuries yield more than longer-term Treasuries). Currently, the Treasury yield curve is actually inverted at certain points, and very flat at other points. For example, currently the 3-month Treasury bill is yielding around 5.09%, while the 30-year Treasury bond is yielding 5.60% (or just 0.51% more than the 3-month Treasury bill). And the 5-year Treasury note yields less than the 2-year note. What might the shape of the Treasury yield curve be telling us about future economic conditions?

To answer this question, it is necessary to understand what determines the level of interest rates (yields) along the Treasury yield curve. The U.S. Federal Reserve greatly influences short-term interest rates, principally through the "discount" and "federal funds" rates. Longer-term interest rates, however, are set by market supply and demand for bonds.

One of the most important determinants of yields for longer-term Treasuries is inflationary expectations. Since inflation erodes the value and purchasing power of a fixed-income investment like a Treasury bond, investors will demand higher yields on longer-term Treasuries (pushing up interest rates) if they expect inflation to worsen.

The fact that the 30-year Treasury currently yields only a little more than a 3-month Treasury bill reflects the market's expectations that inflation is not and will not be a problem for the foreseeable future. In fact, the concern of the market has swung from worrying about rampant inflation to Asian deflation infecting the U.S economy. The bond market appears to be

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expecting markedly slower domestic economic growth in 1998 and the disinflationary consequences that are likely to follow.

If the Treasury yield curve continues to flatten or becomes further inverted, it would signal the market's conviction that the economy will slow so much that short-term interest rates are about to drop. Inversion is a good (though by no means infallible) forecast indicator of an economic slow-down and possible recession.

It's noteworthy to point out, however, that unlike past situations when inverted yield curves correctly predicted recessions, the present shape of the yield curve is caused by long-term interest rates dropping rather than short-term rates rising. It is therefore unclear whether the current shape of the Treasury yield curve has similar predictive significance as in the past.

Still, the shape of the Treasury yield curve bears watching in the coming months, as it may offer clues as to possible economic developments down the road. *A domestic economic slow-down could be devastating for U.S. corporate earnings, leaving the grossly overvalued U.S. stock market vulnerable to a steep correction.*

Junk Bonds Are Thriving: Could an Economic Slow-down Be Far Behind?

The first article in this issue of ***Observations*** discussed the shape of the Treasury yield curve and how it's possibly signaling slower economic growth going forward. Such a slow-down would likely adversely impact corporate earnings. This would be ominous for the drastically overvalued stock market, which is discounting continued economic growth and low inflation from here to eternity.

If you want another sign that an economic slow-down may not be that far off, look at what has been happening in the junk bond market. To understand the interrelationship between the junk bond market and the economy, first we have to explain a few things about junk bonds and how they work.

Junk bonds are bonds issued by companies and sold to investors to raise money for various corporate purposes. These bonds are called "junk bonds", because they are usually issued by companies that do not have the strongest financial condition. Junk bonds (a.k.a. below-investment grade bonds) yield more than investment grade bonds of the same maturity, because investors demand the higher yield to compensate them for the increased risk of default. Despite their name, some junk bonds make attractive investments.

Unlike investment grade bonds (whose risks of default are generally minimal), the value of junk bonds tends to depend more on the underlying business fundamentals of the company that issued the bond (as opposed to general interest rate movements). In this sense, the value of junk bonds is affected by many of the same factors that determine stock values.

Junk bonds tend to be popular (and their prices rise) when the economy is strong, corporate profitability is high, and the risk of default is perceived by the investment community to be minimal. Under these circumstances, investors are willing to buy junk bonds even if they yield only a little more than investment grade bonds.

Until recently, junk bonds have been on an extended roll thanks to the strong domestic economy. This has resulted in an unusually thin yield spread between high-quality and junk bonds (meaning the latter group offers only a very slight additional yield). Here at ***PDV Financial***, we believe that investors are too complacent about the risk of default associated with junk bonds, and are being inadequately compensated by yields that are only marginally higher than those offered by investment grade bonds.

Often, asset classes become most popular shortly before they implode. Could the current popularity of junk bonds portend slower economic times ahead, which will likely depress the junk bond and stock markets? There are currently several signs that have historically signaled trouble for the junk bond market.

First, some young and unproven companies (whose shares are absurdly overvalued) have found many willing and eager buyers of their long-term bonds even though they pay no interest for a number of years. Many of these companies have no earnings yet and by their own admission they don't know when they will turn profitable. The high yield of these bonds results from the bonds being offered at a discount to their face value. ***The fact that investors were willing to buy junk bond issues with these disadvantageous characteristics can largely be attributed to Wall Street's salesmanship and investors' strained reach for high yields.***

Second, ***closed-end*** high-yield bond mutual funds are finding favor with investors again. *They haven't been this popular since the late 1980's,* ***just before*** *the junk-bond market imploded. Closed-end mutual funds generate huge commissions for the brokerage companies that bring them to market.* They are typically brought to market when demand for them are very strong (often after the asset class in question has already been on a tear for several years and may have begun running out of gas) and exuberant investors are willing to overpay for them.

Indeed, the June 8, 1998 edition of the Wall Street Journal discussed the trend of increasing default rates on junk bonds. Is this another sign of an impending economic slow-down? If so, investors may be clamoring for junk bonds at just the wrong time, just as exuberant investors chasing overvalued stocks may be too sanguine in their view that good economic times will continue indefinitely.

Buy Low, Sell High: Easier Said Than Done

The key to successful long-term investing is to buy low, sell high. It is ***not*** to buy high, and find a greater fool to buy it from you at an even higher price (though with the current investor complacency towards risk, there does appear to be a lot of people who are willing to chase stocks at ever-escalating valuations). Many professional investors (e.g. mutual fund managers) seem to be buying higher and higher. Why?

The concept of buy low, sell high is easy to understand, and yet very difficult emotionally to implement. There are essentially two ways to buy low, sell high: (1) correctly identify an untested company with promising prospects and get in on the ground floor, before the company takes off and grows to the sky (e.g. Microsoft in the 1980's); or (2) identify an out-of-favor company having some temporary problems that will recover and find favor with the investment community again.

Needless to say, method (1) above is extremely difficult to implement successfully, while method (2) requires conviction, patience, good judgment, and acceptance of delayed gratification, among other attributes. However, method (2) is also extremely difficult (both emotionally and practically) for investment professionals to implement. They are put under a microscope every day, with their performance judged according to time frames that are unduly short. For all the rhetoric, there is tremendous pressure on professional investment managers to focus on the short term because many of their clients often demand immediate gratification. ***For many money managers, resisting imprudent decisions that might boost short-term performance in the interest of building long-term results can be akin to committing professional suicide***.

If you want evidence that many professional money managers don't really aim to buy low, sell high, just examine some items in the July 6, 1998 edition of the Wall Street Journal. It revealed that mutual fund managers investing in the U.S. stock market on average are keeping only 4.4% of their portfolios in cash (near an all-time low), despite record money flows into stock funds over the past year.

Paradoxically, while present market conditions dictate a defensive posture, the thin cash buffer maintained by mutual fund managers will exacerbate any market correction, as existing cash reserves will likely be inadequate to meet any panic redemptions.

While valuations are stretched, which ought to make it more difficult for thoughtful and prudent investment managers to find attractive investments, mutual fund managers apparently have been investing the fresh cash as quickly as it has been thrown at them (probably because they fear being out-of-step with their brethren and criticized for not being fully invested in a raging bull market). Are they buying selectively and prudently or indiscriminately?

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In ironic contrast, cash levels as a percent of portfolio values are averaging over 20% in stock mutual funds investing in Southeast Asia. Those markets have been pummeled to the ground over the past year (dropping anywhere from 50% to 90% in U.S. dollar terms). Unsurprisingly, selective investment bargains have surfaced. And yet those fund managers appear to be investing with a rear-view mirror, fearful of buying though much of the investment risk has already been wrung out of those markets. They are like deer caught in headlights; nobody wants to make the first move and risk appearing out of sync. Ironically, many of those mutual fund managers were ***fully invested*** a year ago at much higher valuations before the Southeast Asia bubble burst. Do you see any eerie parallels with the current behavior of mutual fund managers in the U.S. stock market?

Refreshingly, there's the usual small group of highly disciplined and independent thinkers who are able to resist the short-term performance pressures, resolutely focusing on doing what's sensible and good for the long term. Some of the best mutual fund managers of contemporary times, such as Marty Whitman at Third Avenue, Jean-Marie Eveillard at SoGen, John Spears and Chris Browne at Tweedy Browne, and O. Mason Hawkins at Longleaf have all been investing in Southeast Asia (especially Japan). But the vast majority of mutual fund managers appear to prefer to hold cash when they should be taking advantage of attractive investments made available by the Southeast Asia debacle.

Does it strike you that some herd-following mutual fund managers have got their priorities reversed?