Scarsdale Investment Group, Ltd.

All Bond Portfolios

The Bond Market Reality – Observations and Insights

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Interest rates and the bond market took a wild ride from January 2020 through the end of August, with rates rising dramatically in March, due to fear of Covid-19 and then returning rates to historic lows similar to January 2020. In this article we provide a few insights as to what happened in the bond market and why. When we refer to the “bond market and bonds” in this article we include Treasury bonds, corporate bonds, muni bonds, mortgage bonds and bond funds and ETFs that hold these securities.[i]

Federal Reserve Interventions

The economic events that occurred so far this year are well known. Shocks to the bond market were caused by fear generated by Covid-19. This resulted in massive uncertainty and panic selling by investors of all kinds of bonds to raise cash to deal with the uncertainty. The Fed’s rapid support of the bond market quickly increased the price of the bonds and interest rates declined rapidly.

The Fed’s goal was to stave off further panic selling and benefit investors by massive buying of all kinds of bonds. In an unusual move, the Fed even bought fixed income mutual funds and ETFs. This rapid buying of bonds resulted in the increase in the price of the entire bond market, and the decline in yields. The Fed’s buying of bonds and funds, resulted in putting a floor under the price of all bonds.

The size of the Fed’s purchases was astounding. In four months it purchased as many bonds as the first three quantative easing programs instituted in 2008 and 2009. The Fed's balance sheet expanded by over $3 trillion over a few months' time.

Corporate Bonds

What is particularly astonishing is that the price of corporate bonds moved back to their price earlier in the year although we currently have no vaccine or powerful treatments to deal with Covid-19.

A major problem for bonds in a crisis is the loss of liquidity. Liquidity is defined as being able to sell bonds quickly at a fair price. The Fed's actions of massive bond buying has essentially removed the liquidity risk for now. Thus, the major problem for corporate bonds currently is the default risk. We are concerned that many investors have interpreted the Fed's action as having removed the default risk. However, due to the massive damage in our economy, the rapid decline in real estate prices, the closing and bankruptcy of many business, risk must still be closely analyzed to avoid defaults, particularly in the corporate junk bond market. It is reported that more than half of the corporate bonds are rated in the triple-Bs, one category above junk bonds. The question is, which companies have issued bonds to reinvigorate their business, and which are permanently impaired and have only delayed the pain of default?

Municipal Bonds

Muni bonds make up a large share of our investments for our clients. Highly rated muni bonds historically have an outstanding record of safety. For example, between 1970 and 2018, 0% of AAA rated munis defaulted according to Moody's and only .02% of AA muni bonds defaulted in the same period. If you purchase general-obligation munis of large issuers, you are looking at a big base of support. In addition, with the yield of Treasury bonds at historically low rates, muni bonds provide a much higher return and many issues provide tax-free income.

Municipal Stresses

The Coved 19 disease may adversely impact the ability of many municipal issuers to function in their usual way. Municipalities with excellent ratings, have deep pockets and have been fiscally responsible may suffer downgrades, but we believe they will continue to pay interest and principal. More marginal issuers will struggle.

For example, New York's Metropolitan Transportation Authority (MTA) is facing dire consequences if it does not receive more federal aid. State bond covenants prohibit the MTA from declaring bankruptcy. What it can do is cut service, cut personnel, raise fares, postpone projects, sell assets and restructure their debt.

The question being raised is whether the constituencies who have benefited from the MTA will come together to salvage its operation. For example, the businesses, banks, bondholders, executives, pensioners and union members all came together in 1975 to help New York City survive its default. Now is a time for the interested parties to come together again. No surprise, but the union representing MTA employees has expressed little interest in participating.

High Potential Taxation Make Municipal Bonds More Valuable

High net worth individuals have always purchased municipal bonds as a way to reduce their Federal and state taxes. Now California is leading the way to make them even more valuable.

A state of California proposal would levy a 0.4 percent wealth tax on residents filing jointly with a net worth above $30 million. Net worth is generally defined as all assets and liabilities held world-wide, except for directly held real property. If the spouses filed separately, the tax would apply to the net worth of $15 million or more of each spouse. If you were a resident of California and decided to leave the state to escape this tax, they would levy a declining charge on your net worth for 10-years.

The proposed California Wealth tax would be levied in addition to the proposed California "millionaires' tax." If the millionaires' tax is enacted the top California tax rate would increase from 13.3 percent to 16.8 percent.

What will other states consider doing?

As we have seen with the Federal Alternative Minimum Tax, the law first applied to only a small percentage of the population, but it eventually applied to people with lower incomes as well. Remember the old ditty: Don't tax you, don't tax me! Tax the guy behind the tree!

Negative Interest Rates or Rising Interest Rates?

If you think that yields on Treasury bonds can't go much lower, consider the fact that in the future, the Fed might follow Japan, Switzerland and other countries into negative interest rates. This would result in higher prices for Treasury bonds. Consider that the yield on 10-year Treasury Inflation Protected Securities (TIPS) bonds is currently negative.

The Fed Speaks

On August 27th, 2020, the Fed committed to allow employment to run to its maximum level and stoke inflation above its long-run goal of 2 percent. The objective is to have an average of 2 percent inflation, so if inflation was running below 2 percent, they would like to err on the upside to make inflation average 2 percent.

Without firm guidelines to follow, how independent will the Fed remain? What happens when the Fed reduces or stops supporting the bond market? This uncertainty is why the Fed said that they will continue to buy Treasuries and mortgages through the end of 2021. However, someday the Fed support will come to an end and this may result in a significant rise in interest rates and fall in bond prices – or not. What we know is that we don't know what the future will bring – or when.

Conclusion

A final warning is that when yields on high quality bonds are low as we have today, many investors reach for yield by buying lower quality bonds that have a significant default risk. Remember, in times like now we believe the most important financial objective is to PRESERVE YOUR PRINCIPAL rather than reach for more yield.

Good luck with your investments and as with Covid-19, be careful and be safe.

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[i] A word of Warning: Yields on individual bonds do not compare to yields on bond mutual funds or ETFs. They are quasi-equities, even though the funds hold bonds, because the bond funds and EFTs never come due. Individual bonds use yield-to-call and yield-to-maturity to measure their returns. Individual bonds come due or can be called at specified times. ETFs and mutual funds may contain individual bonds, but since the entities are on-going the bond fund or ETFs never comes due. They are looked at in the aggregate. The closest fund yield to an individual bond is the SEC-30-day yield. This is not frequently quoted. Instead, the yields quoted are more like a current return, which reflects bond coupon sizes. Duration, which is supposed to be a sort of equivalent for a call, changes as interest rates shift. See: Hildy Richelson and Stan Richelson BONDS: The Unbeaten Path to Secure Investment Growth. Bloomberg Press/John Wiley & Sons, 2nd edition 2011.