The Future Economy Can Destroy Fixed Income Investments

The Feds drive the values of your fixed income investments:

You may think that the Feds are keeping interest rates low and using Quantitative Easing (QE) to improve the economy by making it easier for people and industry to borrow more money. There's actually a more important reason for public officials: Their jobs political depend on it.

The economy changes at a snail's pace. Its most important contributor is whether people are spending or saving. If they spend, the economy booms because industry has something to sell, so people get jobs producing the goods and services. If people save instead, industry cannot sell its goods and services, so employment goes down. For two and half decades we've been on a consumption binge and saved very little. The economy did better than it would have otherwise. Now things have to change as our population gets older and realizes it does not have enough savings to support retirement and the elderly. Money that's saved is money that is not spent.

It's true that savings eventually finds its way into industry, thus providing the capital necessary for growth, but industry can have all the capital in the world and not grow unless people buy its products and services. Right now, industry has a surplus of cash, but is unwilling to spend it until markets improve.

In contrast to slow economic changes, political winds can change quickly. The public is starting to recognize that now is the time when we have to pay more attention to the deficit and employment. There are almost instantaneous measurements of these. That's why low interest rates are so important now to the Feds. The younger part of the populace wants low interest rates because they can borrow more and spend more, to the delight of politicians. Conversely, the older part of the population is unhappy with low interest on their savings and their reduced retirement income. Neither group is really aware of the problems with quantitative easing, but they will be when prices start to go up faster.

So what are the unspoken reasons for low interest rates and QE? If interest rates are low, then the amount of interest included in the deficit is low. Interest on the public federal debt now is approaching $300 billion a year. That doesn't count the over $200 billion of interest on the money borrowed from the Social Security Trust and other internal borrowing because the government considers that a bookkeeping thing and can kick that can down the road until the Social Security Trust can't afford to make its payments. If interest rates increase to historical averages, the annual interest on the national debt could easily double the deficit by itself even if the debt itself did not increase. But increase it will.

The Congressional Budget Office says that in the most likely scenario, our federal debt will grow from about 75% of GDP now to almost 195% of GDP by 2035*—and they are talking only about the public debt, not the debt it has promised to pay to the Social Security Trust and other internal borrowing. That's worse than Greece. So even though inflation helps reduce the apparent size of the debt, the debt itself is growing exponentially as entitlements grow faster both from the automatic inflation adjustments as well as the fact that politicians keep offering more entitlements.

Quantitative easing is more subtle. QE promotes inflation, because it prints more money. The government needs inflation to pay off its debts and interest with cheaper dollars. It also allows it to collect more in taxes of almost every kind. The government projections for the future depend on inflation. The Weimar Republic in Germany got into so much debt it had to print money like crazy. You may have seen the picture of the man behind a wheelbarrow of German marks to be used to buy groceries.

Greece is in very difficult times because it has let its debt increase so much—due largely to lots of government spending and little industry. It has reached the point where it has had to increase interest rates on the bonds it sells to get foreigners to buy them. But it cannot print money because it is tied to the Euro. This exacerbates their problems. Greece has so much government employment that it must reduce the pay and benefits of its public workers. It must also reduce its entitlements to the rest of the

populace. Hence strikes and riots—and loss of elections to politicians who promise continued wages and benefits without ever addressing where the money will come from.

So QE increases inflation by printing more money. If our country has 3% inflation for ten years, then the ten year treasuries can be redeemed for about 74% of what a dollar used to be worth. So the government made a 26% reduction in old debt by using inflation alone. If inflation goes to 4.5% (which represents a long period in our past since the Great Depression), then the bonds can be redeemed for 64% of the face value, and the government effectively reduced the size of the that part of the debt by almost a third within ten years.

For the decade from 1974 till 1983, inflation averaged 8.5% due to the oil crisis and the Carter years. That would make a ten year old bond worth only 44 cents on the dollar. That kind of inflation would reduce the value on redemption by 56%! Even 3% inflation wracks holders of 30 years bonds which will be redeemed at 42 cents on the dollar, and, heaven forbid, a 4.5% inflation rate knocks the value down to less than 27 cents on each dollar invested.

Neither political party is saying that it can reduce the actual debt within ten years. They are saying that they can get the annual deficit to zero within that period—and since most people don't even know the difference between debt and deficit, they can get away with thinking this is a solution. Deficit is an incremental addition to the debt every year, so the debt itself will actually rise as will the amount of interest to be paid annually. Only inflation can make it look like they are making some progress for those that quote debt as a percent of Gross Domestic Product, GDP.

One problem with inflation reducing the apparent amount of debt is that it also makes it harder to find buyers of our debts. Our government debt used to be owned by our citizens, but now we are approaching the point where almost half is owned by foreigners, ironically because they think we have a better situation than their own. In order to make more debt attractive to foreigners, we will have to increase interest rates. That makes our own debt funding more difficult at the expense of all of our other government programs.

What we should be thinking about is what our actions today will do the economy a decade or more in the future. Those are not good thoughts for a politician! Until the public gets more familiar with the linkage between federal debt, deficits, interest rates, taxes and inflation and the consequences for the future, a near-term political focus will win the day. "Promise me more" will get more votes than "We've got to cut spending and increase taxes." Nevertheless, the day will come when it's very apparent that those are the obvious solutions--even for politicians. Then we too will see public union strikes and riots, just as Europe is seeing today. This will be the greatest strain on democracy that we have ever seen.

Retirees, like me, can't look at inflation and low interest as good things no matter how much it improves the view of the national debt and the deficit. We have a larger share of our investments in fixed income securities, so low interest rates give us lower income. High inflation compounds the problem because it means that we have to pay more for our goods and services with lower income—a double whammy! So even though we are destined to have low interest rates for a period, ultimately the government will resort to increase inflation to make it easier to pay its obligations with cheaper money. Once higher inflation starts, it's hard to contain because labor starts putting even more pressure on wage growth.

The Value of Your Fixed Income Securities:

So how does all of this affect **YOU**?

The answer is BIG TIME! Let's look at an example. First let's assume that you bought a $1,000 ten year bond paying 2% interest. You paid a broker's fee of only $2. Five years have passed and now you want the money. Let's see how much it will be worth. You will have accumulated $98: 5 years x $20 interest less $2 fee. But interest rates have crept up to closer to their historical average and are then 4%. A buyer will pay only $911 for a bond with only a 2% coupon if the prevailing rate is 4%. The broker collects another $2. You net $98 plus $911 less $2 or $1,007. (You made 0.7% before-tax return.)

But that $1,007 will now buy less because we have had five years of 3% inflation. The value is only $786 in terms of dollar values five years ago. You invested $1,000, and after five years you have netted $786 of purchasing power. That assumes you paid no taxes on the interest. If this were a taxable bond, you might have lost another $30 or so to taxes. If the rating of the bond dropped, you would lose more. If the source of the bond went bankrupt, you would have lost all except whatever is the current purchasing power of the interest you collected less the fee to buy the bond.

There are lots of lessons here. Bonds are not necessarily a safe investment. They are great when interest rates are dropping. That's why bond funds have done so well in recent years. But bond interest rates are now at record lows, and you have to wonder if they can go much lower and how long it will take for the government to use inflation to help take care of the debt and increase tax revenues.

Generally, as people age, they want less of their investments in the stock market and more in so-called fixed income securities. Inflation may be a boon for national debt reduction, but it is a killer for older people facing ever increasing prices. Low interest rates are great for reducing the size of the national deficit but are deadly for retirees relying on interest payments for income. So what may be good for the goose can be bad for the gander.

There are several fixed income investments that may be more attractive. One to consider is an inflation-adjusted immediate annuity. The initial investment in these is higher than for a fixed payment immediate annuity, but can end up producing more net income over the years. You are making a double-edged bet against the insurer who issues the annuity. Like with all immediate annuities, you are betting that you will live longer than the average person. But you are also betting that inflation will actually be higher than the insurer assumes. A 65 year old may have a very long time to see how this plays out, but if in good health, it could be a good bet and better than trying to live on bond income.

Another investment is a government Savings I Bond. These pay an interest rate that is equal to inflation plus some base rate. Currently the base rate is 0%, so you only keep up with inflation less the income tax you will pay on the accumulated interest when you cash the bond. Unlike other bonds, you will always be able to get your principal back no matter what the prevailing interest rates are and whenever you want to cash them after the first year. The feds realized that Savings I Bonds were too good a deal several years ago, so they put a limit of $10,000 purchase amount per person per year and stopped letting people buy them at their local banks. Now they have to be purchased on www.treasurydirect.gov.

Another investment to consider is a Treasury Inflation Protected Security or TIPS. These can be purchased through a broker. I buy them on their auction dates to avoid broker's fees and hold them to maturity. These pay a fixed coupon percentage each year, but the principal increases each year with the consumer's price index, CPI. These are best held in an IRA or Roth so that income taxes don't reduce the return on your investment. You can ladder these with different maturities so that you hold them to maturity and don't take a loss in a rising interest environment. Go to www.treasurydirect.gov to get more details on both Savings I Bonds and TIPS.

So what if you are already in lots of fixed payment, fixed income securities? You don't have to spend all of the payment. If you only spend the after-tax amount of your fixed income payments multiplied by your age over 100 each year and invest the remainder for spending later, you will have something that approaches what an inflation adjusted security will do.

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6/10/12, R6/28/12
www.analyzenow.com

* http://en.wikipedia.org/wiki/United_States_federal_budget