Harry's Take

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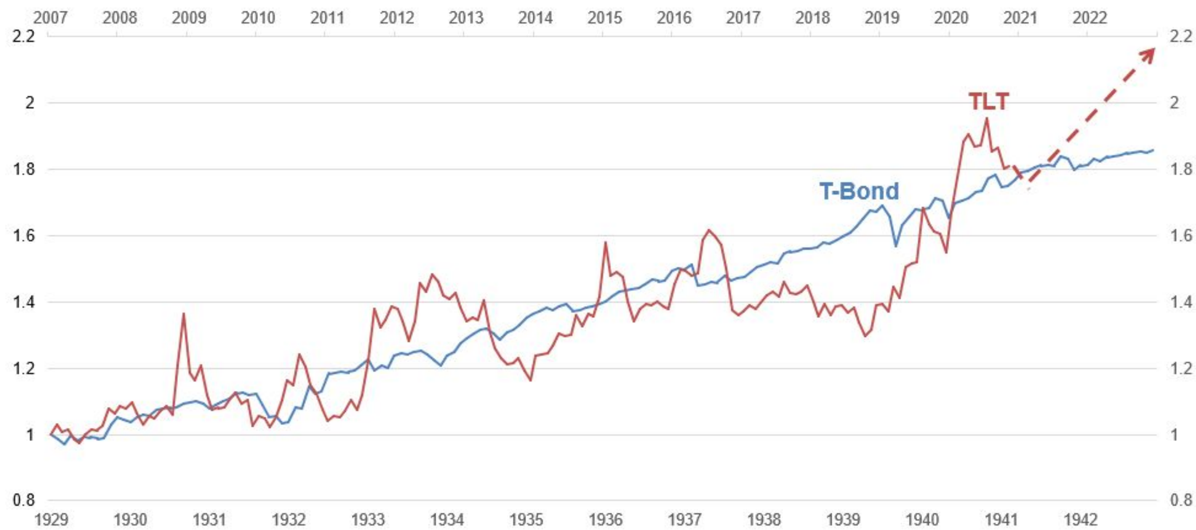
The Secret to the Deflationary Play: 30-Year Treasury Bonds

The problem with the winter economic season is that almost all financial assets deflate after the fall bubble boom season ends. Only the highest-quality longer-term bonds appreciate substantially and become the safe haven, especially globally and in the best currencies, like the U.S. dollar today.

In the last winter season, from 1929 to 1942, long-term U.S. Treasuries returned 85% cumulatively. Investment-grade corporates returned more, at 118%. The problem was, all but the AAA corporates lost money in the worst crash, from 1929 to 1932, due to rising default risk—and that's what we'll have ahead in 2021 and 2022. In the COVID-instigated first crash, investment-grade bonds traded closer to junk bonds, as some industries got hit with 50% to 80% revenue drips, not the more-normal 20%+ ones that happen in a deep downturn.

So, until the downturn becomes clearer and especially until we find out whether COVID-19 is staying or retreating, I like sticking with the long-term Treasuries.

Comparing Winter Seasons: U.S. T-Bond 1929-1942 vs. TLT 2007-2022



Source: Global Financial Data, Yahoo! Finance.

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This chart shows that despite a stronger economy now than in the 1929–1932 winter season, T-Bonds have performed just as well, and they should do better ahead once we have a deeper downturn and major deflation in prices. The present winter season will be two years longer than the 1929–1932 one if it lasts into late 2022, as I project. Because of endless QE, long-term rates are even lower this time, heading very likely to zero or lower on the 10-year Treasury.

I am projecting that, from a near-term low around 1.75 on this cumulative growth of a dollar chart, the T-Bond Index will rise to between 2.10 and 2.20 by the end of 2022. At 2.15, that would give a return ahead of 23%. That’s about what you would expect on the TLT (iShares 20+ Year Treasury Bond) ETF, which has 10- and 30-year bonds with an average duration of around 20 years.

Big Difference in Returns on 30-Year vs. 10-Year Treasuries Ahead

Returns in Deflationary Scenario Wherein 10-Year T-Bond Rates Fall From 0.96% to 0% and 30-Year from 1.75% to 0.4%*

	Gains
10-Year T-Bond	9.5%
30-year T-Bond	38.1%
Zero Coupon 30-Year**	49.6%
TLT ETF (Avg. 20-Year)	23.0%

*This is roughly proportional to the sudden fall in yields during the February to March Covid-19 stock crash, except this scenario would be a bit deeper.

** Zero coupon means you buy the bond stripped of the interest payments at a discount for that and that creates more leverage. You can also buy "strips" to do this, which is more common.

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Here's where the secret sauce comes in. Assuming a relative fall in rates similar to those of the sharp February-to-March crash, wherein the 10-year went down to 0.32% and the 30-year fell to 0.71%, I calculated appreciation on the 10-year vs. 30-year if each fell to 0% and 0.40%, respectively….

The difference was more than I expected: 38.1% on the 30-year vs. 9.5% on the 10-year. The 30-year zero-coupon bond with interest stripped out and selling for a discount (which you can buy easier through what are called "strips") would see a return of 49.6%. The TLT again comes in at 23%.

We're getting very close to the optimum buy point on TLT, around $153–$155. TLT hit $153 in June and $154.80 just last week. With stocks looking like they are at or very near a peak, this is a great time to stock up on 30-year Treasury bonds or 30-year zero-coupon bonds or strips. Talk to your broker about that.

The ETF called the PIMCO 25-Year U.S. Treasury Zero Coupon (NYSE: ZROZ) is a 25+ year zero-coupon bond fund you can purchase. It has a total value of only $431 million and average daily volume of 60,000 shares, or about $10 million. This is a 2-year hold, so the lower volume would not be a barrier, as it would be for trading. And even Treasury bonds tend to be bought in $5,000+ increments, which can be a bit cumbersome. Year-to-date returns on the ZROZ have been 24%, vs. 17.8% on TLT. Over the past two years, it has outperformed TLT by about 50%.

So, it's time to look at 30-year Treasury bonds and their closest equivalents… especially if TLT gets back near $153.

Harry

Got a question or comment? You can reach us at info@hsdent.com.