Harry's Take: Thursday Bonus Edition

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Reader Mailbag, Part II: Questions and Harry's Answers About Investing and Inflation

We receive many questions on various topics, including direction of the markets, demographics, and interest rates. From time to time, we gather a series of questions on a topic or two and send them to subscribers as part of our Reader Mailbag series. Reader questions may be edited for clarity.

Q: In Harry's Take for January 4, 2022, you say in the first paragraph that bonds are in a bubble. Near the end, you say that the only safe havens are the highest-quality long-term U.S. Treasury and AAA corporate bonds. Are 30-year U.S. Treasury bonds the lesser of many bad choices, or is the key phrase "highest-quality"? Am I missing something?

A: Yes, Treasury bonds are the highest quality and AAA corporates would be second. In a crash of the magnitude I am seeing, only the highest-quality bonds are seen as not having default risk, which rises for all other bonds in direct proportion to their higher risks. The risk-free or very nearly risk-free bonds go up in value as the risk-free rates fall in a deflationary crash. But the risk premiums that rise on other bonds more than offset that fall in rates from deflation. Deflation means prices and margins are falling and a lot of businesses experience falling profits and failures. That's why those bonds go down in value: you might not get paid back! Their overall rates go up to compensate for rising default risks. Rising rates mean falling values for existing bonds with lower rates.

The most important principle for those safe-haven bonds is then longer duration. A 30-year Treasury will appreciate a lot more than a 10-year if

risk-free rates fall. Ditto with a 20- vs. 10-year AAA corporate. I like the 30-year Treasuries the best, because they are both the safest and the longest duration. TLT is the closest simple ETF you can buy with long Treasury rates, but it averages 20 years vs. 30 years. So, 30-year Treasuries are best, followed by TLT and then by 20-year AAA corporates or a fund that focuses on very-highest-quality long-term corporates.

Q: Do you recommend staying in TLT when the stock market tanks? Or should one move out of TLT for now and move back in after the market has sunk 40%–50%?"

A: TLT is an ETF that holds 10- and 30-year Treasury bonds for an average 20-year duration. I expect yields to go down in the crash ahead, and that would make these bonds go up in value. TLT has already appreciated off and on since early 2021. Using the 2008 crash as the best example, TLT went up modestly in the early stages into mid-2008 and then spiked up dramatically into late 2008. So, it is still a good time to buy, but just do not expect strong returns until we hit a financial crisis, which is likely to come sooner than last time. It should be at least very late 2022 until I think we will have seen most or all of the gains, and then it may be best to move to cash and wait for stocks to bottom, which is expected to happen more like in late 2023.

Q: Your correlation between workforce growth and inflation was helpful and prompted some thoughts. Many predict inflation will be persistent because of wage increases which are sticky, which is true at a micro level, but what if, at a macro level, the negative workforce growth offsets the wage increases and business adapts to getting the economy moving with less labor? The aggregate expenditure on labor may come out the same because of offset between the wage paid and the number of workers; that is, productivity improves. This would support the notion that inflation may give way again to the deflation we had been seeing before the "helicopter money." So, is it workforce growth that correlates with inflation or aggregate wage growth that correlates with inflation?

A: The normal logic is that workforce growth requires a major upfront investment to incorporate and train workers, which causes inflation and then wages rise. The supply and demand of labor "decides" whether such wage gains keep up with inflation or exceed it. After the crash/depression, which will cause the workforce to crash, workforce growth will be very

slow for years to come, with inflation naturally being in the 0%–1.5% range. Currently, inflation is 7% (per the recent Consumer Price Index report) and edging up, due to the massive stimulus program creating rising consumer demand against lower supply from various COVID supply restraints. So, this inflation is temporary, but it is what is threatening this recovery and continued rises in stock prices. The odds are that the economy will slow into 2022, and that will bring inflation and long-term Treasury rates back down. So, *buy or keep those bonds* (I like the 30-year Treasury best, then TLT, then 10-year for returns). This will be only for about 1 year minimum and 2 years maximum until bonds bottom and start moving toward the recovery and higher rates again.

Q: What about moving stocks and mutual funds into annuities? I hear annuities aren't affected by the market, plus we could set up monthly payments for income.

A: Fixed-income annuities will not be affected much, but variable annuities that own stocks will go down in value. Putting money into a high-quality annuity with Treasuries and/or AAA corporates works just like my recommendation to buy those very bonds as a safe haven. Normal corporate bonds or funds will garner rising default risks and falling values. You may be able to shelter your income from taxes in such an annuity. Talk to a financial advisor about that.

Q: If labor force participation continues its downward slide, won't that put upward pressure on wages and also inflation?

A: That depends. It will put downward pressure on GDP growth, and a negative workforce growth rate would imply lower inflation on a lag, as that is the Inflation Indicator on a 2.5-year lag. But until that lag hits, it could create a minor, further bump in inflation from scarcer labor.

Q: You have not addressed inflation-protected bonds. Would that also be a good bond fund to purchase around now?

A: Inflation is only a very short-term factor; the markets will turn more toward deflation in the crash ahead, which I still see as most likely to hit this year and next. Inflation will turn to deflation fast and then return at even more modest levels in the boom to follow into around 2036–2037. So, you'd

buy the 30-year Treasury bond or TLT as a safe haven in the crash, for just a year or two likely, not for the long term. Who wants a 2% long-term bond? We will want stocks and risk assets again after the crash and not many or any long-term bonds, as modestly rising inflation will devalue them.

Q: If the Fed has more than doubled the money "in circulation," would this just devalue everyone's money so that seeming stock profits are merely just lack of loss, as in savings account value loss, due to inflation? Also, I know we are not at all on the gold standard, but with double the dollars printed, how does that just disappear when they raise rates to supposedly control the problem they created? Seems to me like they are suppressing gold prices, but after the crash they are engineering, they will make gold very dear. China has been hoarding gold and food, and it's not for nothing.

A: The central banks expand money supply by printing and injecting it into financial markets, which then go up. That has created an unsustainable bubble that will pop very sharply, twice as fast as a conventional market bubble. Then, that money and more will be destroyed, due to deflation of the $540 trillion global financial asset bubble. Much of this money will disappear—and it will happen more rapidly than almost anyone realizes... at least that's what history says!

Harry

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