Harry’s Take

June 31, 2022

Reader Mailbag: Questions and Harry’s Answers on Treasury Bonds 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: I have questions with respect to the 20-year Treasuries Harry recommends in these times. If interest rates keep rising, won't these get killed in the short term? Pimco 25-year zero-coupon—a recommendation of Harry's—I saw drop to about 101 after this most recent interest rate hike, and then a few days later it had risen back to 108. What is contributing to this? I'm all cash and want to have something to diversify into, so I'm considering these recommendations but don't fully understand the risk in a rising interest rate environment.

A: These recommendations for 10- to 30-year Treasury bonds and funds like TLT (20-year average) and ZROZ (25-year) are based on the economy slowing and financial asset bubbles bursting around the world, this time all together and for the last time. The first stock bubble peaked in early 2000 and the first real estate bubble peaked in early 2006. It is a defensive play to actually make money rather than to preserve it by going to cash. It is not going to work until a more-obvious downturn, when deflationary forces set in. So, it requires some short-term patience. If this does not start to happen by the end of this year, then this scenario is questionable. If this scenario does occur, this will be the ONLY major investment strategy that makes you money when almost all financial assets come back down to reality after the greatest artificial, government-generated "bubble in everything" in history.

If you don't have the patience and are not willing to take some pain until this happens, then just be in cash. I say that this is worth waiting for, as it is inevitable. Central banks are finally being forced to tighten after off-the-charts stimulating since COVID. The biggest payoff will come when the markets are at their worst, as happened in mid- to late 2008 in the last crisis. But if you wait until it's obvious, the gains will be much less rewarding. Most of the gains in the 10- and 30-year T-bonds last time happened in just a few months.

Q: If the rates are going up, I think that the bond prices should go down. I don't understand Mr. Dent's recommendation to buy Treasury bonds. Won't the price for them keep on going down, too, until the end of the next year, since the rates are going up? Could you please clarify?

If this assumption is based upon the rates being lower in the future, pushing bond prices higher (time to sell), won't that mean that at that time, stock prices will be higher too? So, why not keep investing in stocks?

A: Rates go down after an inflationary surge drives them up at the end of an expansion. Then, central banks have to tighten by raising rates, but that slows the economy and rates fall. Falling rates make the longer-term safe-haven bonds like the Treasuries appreciate.

We're right near the inflection point at which longer-term Treasuries anticipate the slowdown, with falling inflation and rates, and appreciate.

Q: What are your thoughts on the Fed's plan to reduce the balance sheet? Do you think this will even happen, or might it be one of the possible triggers of the crash by stopping the bond purchasing and reducing the balance sheet?

A: I don't think the Fed's rate rises or balance sheet reduction will last very long without tipping us into a recession, which would cause a reversal from tightening policies to stimulus again.

Q: Inflation and TLT: one expert suggested that Treasury bonds will go down 70%, just like they did in 1978–1980 because of inflation and rising interest rates. My TLT position is already down 28% and ZROZ down 8%. His view is different from yours... He is saying this is not 2008. How is he wrong?

A: We are in the opposite, summer deflationary season from 2008 to 2023, only this time, central banks decided to print unlimited amounts of money to create inflation to offset a depression period like 1930–1942. Why? That's when we see the highest unemployment and business failures—a necessary shakeout after a very expansive growth boom.

Q: Grantham stated a while ago that the real danger in these markets is that bonds are also in a bubble. If the Fed actually becomes serious about raising rates, the stock market will continue to crash, but what about Treasuries? If the 10-year rises above 3.2% and continues to climb beyond 3.5%–4%, what happens then? At some point does the smart money begin buying high-quality bonds again, or are we all losers?

A: The truth is that most bonds will go down with rising default risks, as will gold. So that only leaves U.S. Treasury bonds as the safe-haven play, as in 2008 when they appreciated while most corporate bonds went down and stocks fell much more, along with gold.

Q: If a recession comes this year, does it have to mean that the markets will crash? Or is there a "permanent disconnect" now between the markets and the real economy, as Nomi Prins has suggested?

A: There's no way we go into a recession and the markets don't end up going down. Economists are not expecting the next recession until the first half of 2023. If it comes sooner, it will be a shock and will make investors wonder how $10T in combined monetary and fiscal stimulus since COVID fizzled out so quickly! That will show that the economy is as weak as I am saying it is, which has been masked by all of this endless and escalating stimulus. It will be hard for the Fed to change course so fast after finally committing to tightening policy. That would make it look like the Fed is panicking over the weakness of the economy.

The trillion-dollar question is, how do the Fed and central banks react if we do go into a recession so quickly after so much stimulus? And how do investors react if the Fed does panic and reverse policy back to stimulus so quickly? I think it will look like the central banks have finally lost control! It

will make it hard for them to come back and say $10T wasn't enough, we need another $10T plus.

I say that the central banks have finally backed themselves into a corner with their something-for-nothing policies.

Q: I am a new investor to your channel from Australia. Have you been recommending T-bonds globally, or only for the United States? I have been closely watching a 10-year T-bonds with 4.5% yield; they've come right off the boil.

A: I do recommend 10- and 30-year T-bonds (and the longer-duration bonds much more) for foreign investors even more, as the U.S. dollar will also tend to spike as a safe haven when things get to their worst, like in mid- to late 2008. That's also a reason to sell quickly once the crisis peaks and the bonds and the U.S. dollar reverse back down.

Harry

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