Harry's Take

November 1, 2022

Reader Mailbag: Questions and Harry's Answers on Bonds, Stocks, and Global Recession

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 bought ZROZ at $105 US. I have noticed that the few times the 10-year has decreases, ZROZ has gone up in value. Most of the time, the 10-year has been going up and ZROZ has been going down. Is this a coincidence?

A: In bonds, interest rates or yields and the value of bonds go in opposite directions. A Treasury bond goes up in value if Treasury bond interest rates fall or go down, because your bond now has a higher relative rate. So, if you buy ZROZ, you are betting on 10-and 30-year T-bond rates going down. That's what will make ZROZ or TLT go up. For that to happen, the economy typically will be slowing and/or inflation rates will be coming down.

Inflation is still near its highs and is very slow to fall, despite the Fed starting to tighten. The more aggressive the Fed gets in raising rates to slow the economy and/or the more the economy shows signs of finally slowing, the more ZROZ is likely to go up in value. There will come a point soon at which investors will start worrying more about the slowing economy than the stubbornly high inflation. At that point, T-bond rates will fall and TLT

and ZROZ will go back up in value. In past recessionary cycles, this happened much earlier.

Q: Please, can you tell me how the SQQQ works? If you buy this to short the Nasdaq and the Nasdaq drops, say, 1000 points, what will the price of SQQQ be? I saw in 2020 it went up from 500 to 700 per share. Now it has gone up from a low of 28 to 56. What is the target if Nasdaq drops to 7000?

A: It is simple. SQQQ is a three-times-leveraged short of QQQ. It is designed to be short or to move the opposite of the Nasdaq 100 (QQQ) at a weight of three times. If QQQ goes down 1%, you will be up 3%. If QQQ goes up 1%, you will be down 3%.

Q: I wanted to buy some put options against HSBC involved with Chinese real estate. This has really been dropping *quickly*. It currently is around 27. Do you have a feeling as to when and how fast Chinese real estate will fall? I missed the big, recent drop but want to get into the action. Your call on SQQQ was great, by the way!

A: The fall in Chinese real estate will take years to work out, but it is leading and should lead the fall in real estate globally. Real estate always takes longer than stocks to bottom, and China is coming out of the greatest real estate bubble ever. A put on HSBC would be more about the near term and the Chinese real estate bubble burst is leading the global one, so I would expect HSBC to keep falling. But it's trickier this late in the game, when you can get strong bear-market rallies against the bigger downward trend. I would rather play a trend that is likely just starting, like the safe-haven rally in TLT or ZROZ for U.S. Treasury bonds.

Q: Your position as I understand it is to invest in TLT and ZROZ for the continued market downturn. My understanding is as follows:

1. As interest rates increase, TLT and ZROZ will decrease in value. Also, by all indications, interest rates will continue to rise for now.

2. It is my understanding that your position is that there will be a "point of panic," at which time TLT and ZROS will escalate significantly as people exit equities and flee to bonds. Is this accurate?

3. Here are some indicators I have observed:

    a. VIX really hasn't escalated with any significance during this entire downturn, and
    b. VXX (or equivalent) has been pummeled. Between 3a and 3b, Trump had a far bigger impact on markets than what is going on now, and what is happening now seems to be extreme.
    c. So, the panic indicators are sound asleep! VIX, QLD, and VXX (or equivalent) are all down.

4. As I understand it, stocks and bonds are not responding with an inverse relationship as they have in the past. If that is true, is this quantitative tightening going to materially change the outcome of your forecast?

So, here is my question: Is it a “point of panic” that you are forecasting?

A: Long-term interest rates continue up in the early stages of a stock crash as inflation continues on a lag, but then start to fall when investors see that the slowdown will bring inflation down. We are locking in yields on the safest, longest-term bonds, as only they will fall when the economy slows. The higher-risk corporate bonds fall in value, even though inflation and risk-free rates fall, because the risk of default will rise to more than offset that. No default risk is assumed on U.S. Treasury bonds; that's why they are the only play here, and it's their yields that come down in a downturn. There is a point (around now) at which corporate bonds will keep falling due to rising default risk, but the safe-haven Treasury bonds will start to rally as a result of a shift toward economic slowing and deflation, as they don't have the default risk.

Q: What are your thoughts on re-entering the stock market in selected areas over the next 12 months?

A: I do not expect this downturn to be over until at least late 2023, November or later. It could be as late as mid-2024 or so. It's way too early to re-enter stocks.

Q: Could you explain why you think the greatest Treasury bond rally is about to happen? What are the economic environment fundamentals that cause them to rally? Could you reference other times in financial history when Treasury bonds have rallied in large amounts and the factors that led to those rallies?

A: Longer-term Treasury bonds are locking in yields for 10 to 30 years. You will get that yield regardless of whether future such yields go up or down. If future yields go down, then your bond will appreciate, because it has locked in higher yields. The 30-year will appreciate more, because it has locked in those higher yields for longer. If yields rise in the future, then your bonds will fall, because people can now get higher yields into the future. At present the yields are low, but if you take the opportunity, you could see much more appreciation if I am right, as a deep downturn causes future yields to fall further and approach zero.

Q: Just a thought: If the Fed delivers another global financial crisis, do you think that puts central banks at institutional risk? Politicians will look for someone to blame, and I think the cat is out of the bag about what money printing does. If the free market set the rates, things would get super-fair, super-fast.

A: If the central banks could just keep turning on the printers, then the economy would boom forever and we'd finally be in heaven on earth. Here are two simple answers: (1) you won't get something for nothing in the end, and (2) the law of diminishing returns still applies. It will take more to get less (in a repeating cycle) with artificial stimulation.

It's more a question of what will happen when we hit that tipping point and the momentum reverses… But it will always reverse when the progress is not real, and printing money out of thin air is the textbook definition of not real. I think we are very near that point.

Q: I am curious how we can expect zero-coupon bonds (ZROZ, TLT) to increase in value as interest rates continue to climb and the Fed is trimming their holdings. At what point do you expect them to turn around?

A: Zero-coupon bonds should turn around right about now or in the next month or so, as investors start looking more at the inevitable slowdown and falling inflation instead of late-stage inflationary trends. There's no way to time that perfectly, but that turning point should be soon; then, T-bonds will go up, while stocks will continue to go down.

Q: Gold-mining stocks are at ridiculously low levels. Will they go lower or go out of business? These stocks seem like a good hedge.

A: Gold-mining stocks are only a good hedge if gold goes up. Gold did rise early in the 2008 crisis, but it went down in the end, while TLT surged the most. While gold could be a decent hedge in the beginning, T-bonds and TLT should start winning out, eventually. So, if you add gold, get out early once it starts to underperform T-bonds, and then stick with T-bonds. They will do the best in the worst of the crisis, likely from the second half of 2023 forward. I would be out of any gold hedge by then. As soon as deflation looks more likely, then gold should fade fast and T-bonds should accelerate.

Q: I have current investments in Treasury Inflation-Protected Securities (TIPS), in addition to your recommended bonds. The interest (and thus dividends) has been rising all this year, but the principal has dropped off a cliff. As the yields rise with inflation, I expected the principal to be more stable. What gives? How should TIPS be reacting to rising interest rates? Will they skyrocket when rates come down, or is this a lose-lose situation?

A: The value of your bonds will go down when long-term rates go up, as you have locked in yields lower. And, conversely, T-bonds will go up in value when rates fall, as your rates will be higher, relatively. Keep those bonds, as rates are very close to reversing. Investors will be moving on from worrying about late-stage inflation and instead will be reacting to the recession and falling inflation and rates.

I would recommend TLT or more-leveraged ZROZ to play this downturn rather than TIPS. You don't need inflationary protection when the economy has seen inflation peak, albeit slowly thus far, and the economy likely will slow and inflation will fall faster ahead as the Fed is forced to fight inflation—and even harder than they have thus far, as the bond market is telling the central bankers that they aren't tightening fast enough!

Q: It seems like there are governments (like Japan) that are selling U.S. Treasuries in order to save their own currency. What does this mean for TLT? And here is another question: How do U.S. Treasuries (and, more specifically, TLT) fare in times of war? What if we are faced with a third World War?

A: We're quickly moving into a global recession, and that will bring down growth and inflation. That is when TLT and Treasury bonds do best—as falling inflation and recession make these the ultimate safe haven, rather than gold.

Downturns can stimulate wars as political conflicts grow and leaders want to stimulate their economies in a shrinking global pie. Hence, the odds of global war and subsequent increased inflation will grow as the downturn magnifies. I don't see a major war on the horizon at this time, and Ukraine has not impacted the world or inflation that much. The Ukrainians have surprised everyone, most especially the Russians.

So, I don't see war as the big issue now; the bigger problem is tightening policies, which will lead to falling economies and political tensions and thus grow the potential for conflict down the road. Wars tend to follow rather than to come during recessions and depressions. My 35-year Geopolitical cycle turned upward in 2021, and such upward trends also disfavor conflicts like Ukraine turning into major wars.

Q: You often talk about TLT and not ZROZ. Is it a buy or wait?

A: I use TLT as the buy and sell signals for ZROZ as well. They always react the same way, and they move approximately the same way in the markets. After breaking support at 107, it's been harder to time, but I recently projected that a number near 93 would be a good time to buy. TLT just hit near 91.85 and bounced back to near 98. That likely was a bottom. I would buy on any minor setbacks near term.

Q: One thing I am having trouble with is why you think ZROZ or TLT will go up in the face of potentially rising interest rates. I think a lot of your followers would love to hear you speak directly about how TLT would go up even with rate hikes. Let's say I bought a 30-year Treasury today; how would I make any money? Am I basically just preserving the money while everything else drops? Maybe on your next Harry's Rant you could speak a little more as to the mechanics of how a TLT owner could win.

A: ZROZ and TLT are NOT meant to be income plays, according to my strategy. I expect the U.S. economy to crack, the financial markets to crater, and the international markets to fall. If these things occur, then domestic and foreign investors will pile into U.S. Treasury bonds as a safe haven, which will push down long-term yields, benefiting TLT and ZROZ. But this is a limited-time opportunity. The 30-year Treasury yield might fall back to near 1% (and the 10-year to 0.5% or so), but it won't stay there.

After the U.S. and other economies stabilize and rally again sometime in 2024, yields will walk higher again, but only modestly, as fundamental inflationary trends driven by workforce growth will be very low for decades to come. These long-bond investments are projected to do well in the continued crash ahead, after which investors should be able to pick up stocks and risk assets at very low prices. This likely will be late 2023 at the very earliest and more likely mid- to late 2024 or so.

At that point, you WILL NOT want to be in these low-interest, long-term bonds, as the interest will continue to be low and they will fall in value, as they will no longer be needed as a safe haven after the crash has done its work and the economy starts growing again with the Millennial Spending Wave from around 2025 to 2037.

Q: What are your predictions for the Australian housing market?

A: I see Australian house prices going down 40% to 50% over the next two to three years plus. You might be able to find good enough bargains by early 2024, but it's best to wait until the world economy looks like it's bottoming more clearly. For the first time in a long time, renters will look like the winners!

Q: What are your thoughts on interest rates for the next 10 years?

A: Workforce growth will be 0% to 1% for the next decade plus. So, inflation should be in the 0% to 2% range and likely will be closer to 1% on the high end for a long time, and that means long-term bond rates and borrowing costs will stay low and not continue to appreciate after the crisis and deflationary stage are over.

NOTE: To be clear, I am recommending these 10- and 30-year Treasury bonds only for this crisis into 2024 or so… NOT for long-term holdings! Stocks, especially in technology in the U.S., Southeast Asia, India, Australia, and New Zealand are recommended for the next global boom from around late 2024 or so into 2037.

Look for more updates soon.

Harry

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