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INTEREST RATE CYCLES AND BOND PRICES

As illustrated in accompanying Chart #1, it has been observed that, over the past 300 years, interest rates have behaved in a remarkably cyclical manner, with the duration of each cycle approximating 60 years. Because periods of rising and falling interest rates have each lasted about 30 years, the pattern is sometimes referred to as a "generational" cycle, one explanation proffered being that it takes a society about a generation to forget the lessons of their previous mistakes.

Furthermore, among the few near-certain relationships in the investment world are that, when interest rates go down, bond prices go up; when interest rates go up, bond prices go down; and, the longer the maturities of the bonds, the more pronounced or leveraged are these relationships.

Another characteristic of bond prices is that they tend to be cyclical, rather than secular. Unlike a common stock, which depends for its pricing largely upon the profits of its underlying company, and so, in theory, could rise for an indefinite period of time, the upper limit on the price of a bond is determined by the lower limits of interest rates, which is presumably zero. In short, because interest rates tend to be cyclical, rather than secular, bond prices tend to be cyclical as well.

The accompanying Chart #2 attempts to relate the behavior of bond prices and interest rates over the most recent of these long-term cycles. The total return on 30-day U. S. Treasury bills is used as a proxy for interest rates because it is short-term rates that are the tools most frequently used by the Federal Reserve to address its mandates of trying to keep the rates of both inflation and unemployment low. For this reason changes in short-term interest rate trends may precede changes in longer-term interest rate trends.

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From this second chart, it may be noted that the average annual return on T-bills declined throughout the Great Depression from 4¾% in 1929 to 0% in 1940, at which point the average annual rate began to climb again, ultimately peaking at over 14.71% in 1981. (The monthly rate actually reached 16.2% in June 1981.)

By 1945, at the end of World War II, bond prices had begun a downward trend that lasted until 1981 and caused long-term U. S. Government bonds to lose about two-thirds of their nominal value, over and above the loss in purchasing power inflicted on them by high inflation over much of that period.

Interest rates reversed in 1981 and have continued downward until, today, they are back to the 0% that prevailed in 1940. Over that same period, the prices of long-term bonds have soared to a level that has slightly eclipsed even their previous 1940 high.

In planning an investment strategy, it seems important to consider that, unless short-term interest rates go significantly into negative territory, which has never before happened, they can go little lower than where they are today. Furthermore, if they should rise again to the lofty levels experienced in 1981, long-term bonds could lose two-thirds of their value all over again. Ominous, too, is the fact that the most recent peak in the prices of long-term bonds occurred in July 2012, just 31 years after their 1981 lows.

With a further upside potential for bond prices appearing minimal and the downside risk appearing enormous, the case seems persuasive that bonds are in another one of their traditional cyclical bubbles, and that this bubble has already begun to burst.

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Chart #1

60-year Cycle in Interest Rates

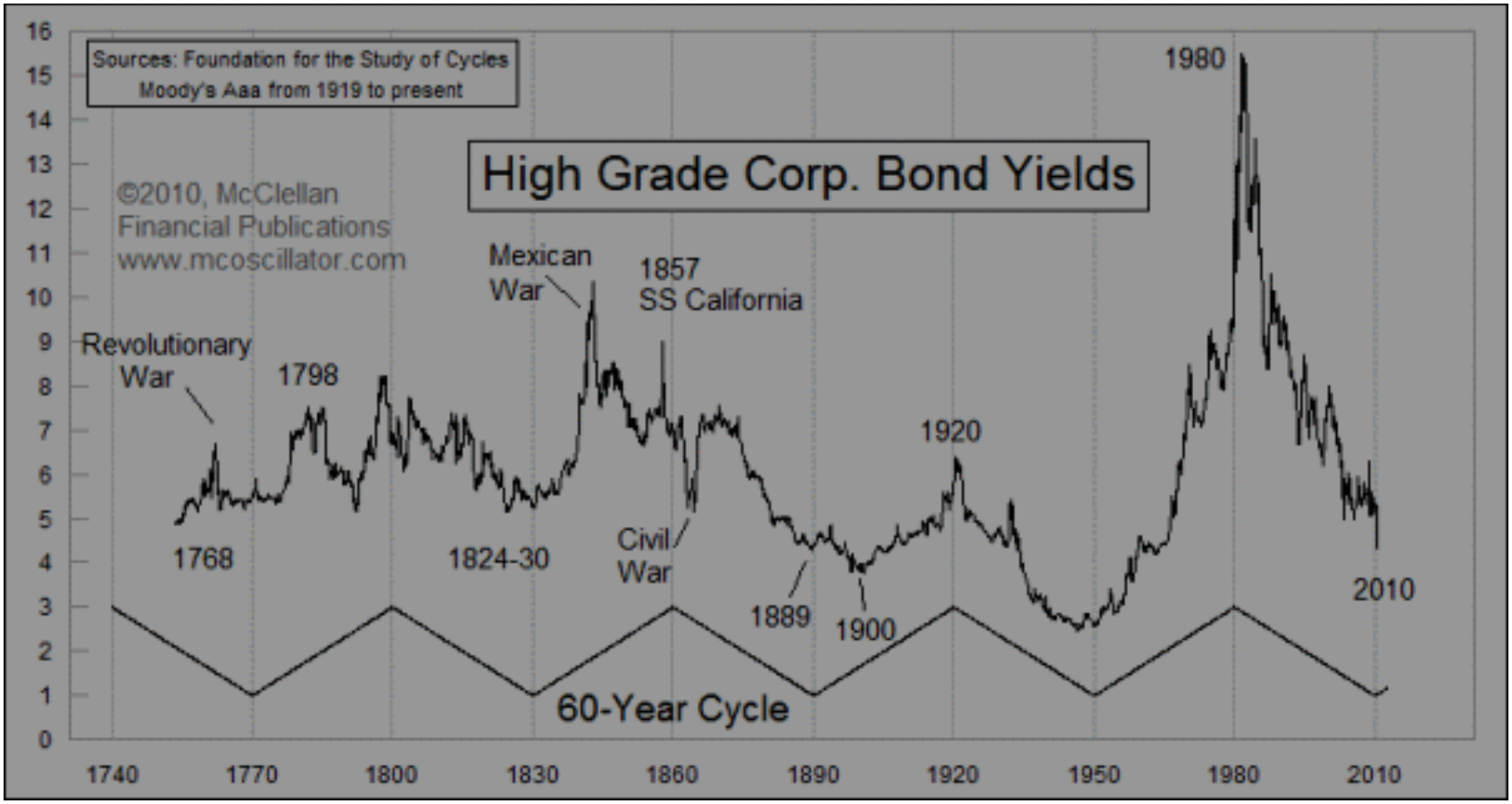

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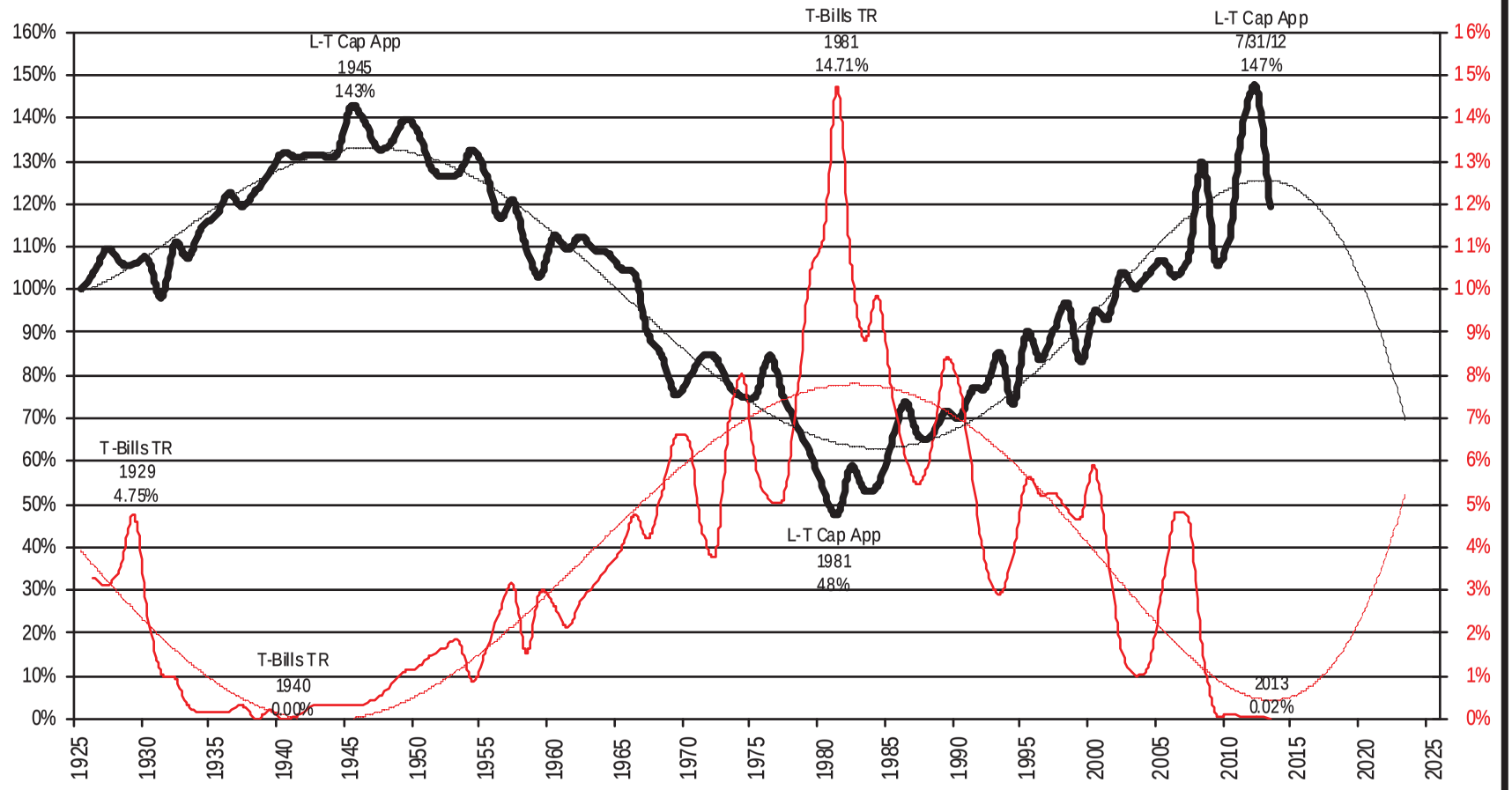
CHART #2

LONG-TERM US GOVERNMENT BONDS CAPITAL APPRECIATION INDEX & US TREASURY BILL TOTAL RETURNS



Sources: Ibbotson Associates, *Stocks, Bonds, Bills & Inflation 2013 Yearbook* & US Treasury 4-15-14

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