

Fooled Again and We Love It!

December 27, 2004

The financial press at year-end is printing article after articles explaining why “everyone” has been fooled by the action of the bond market. A typical comment comes from Bloomberg as follows:

“If you had told a roomful of bond traders one year ago that the dollar would plummet, commodities would soar, and inflation would rise in 2004, not one of them would have predicted that the 10-year Treasury note would end within a hair’s breadth of where it began it, at 4.25%.”

Looking back at predictions of a year ago, the consensus of economists was that 10-year would close the year 2004 at 5.1%. Why are those that are recognized experts consistently wrong in their outlook when it comes to interest rates? Our answer is that they have been schooled in Keynesian economics and have yet to learn how the real world works. As you know, we remained fully invested in the long area of the government bond markets until September of this year. By so doing, we have obtained double digit returns in a year in which the bond market has been essentially flat and thus, has return the coupon (10-year note 4.25%) to those who were “foolish” enough to own bonds at all.

The Fed has remained permissive since early in 2001 – nearly 4 years and has now only begun to tighten. There is a reason for that. Could it be that they remain concerned about deflation? There will be a point when the bond market bears will reach almost 100% - that’s when we will buy back in and hopefully achieve double digit returns again. We love when they are wrong!