INCOME AND THE FUTURE
WEB BUZZ 2011.12.12

Just a little history before looking at the future. Early in the new millennium we mentioned that one of the things we expected was income being in short supply before long. At that time the 30-year government bond was around 6%. What we emphasized was that one of the risks that is rarely mentioned is reinvestment risk. Yes, one could have gotten a better yield in corporate bonds then, but when interest rates go down corporate treasurers refund the bonds (i.e. take them away from you) and force you to reinvest at lower rates. Not so with governments. They are non-refundable. Even more importantly, we expected interest rates to decline due to consumer debt putting a cramp on real GDP growth. Fed action to attempt to keep the U.S. out of recession would use lower rates to stimulate growth (which they have done in spades). If one had purchased 30-year governments at 6% in, say, 2001, one would still be receiving 6% income as opposed to 3% now. Also, those that were afraid to go long term back then are receiving close to 0%. Short term bond holders face reinvestment risk much more often than long term bond holders.

Under today's conditions there are hardly any sources of income from one's investment unless one is interested in European sovereign debt – for example, short term Greek debt yields 300% - but, of course, they can't pay either income or principal. Again, due to worldwide over-indebtedness those who have been conservative and saved for the future in short term bonds have to sell assets to pay day to day expenses. This, of course, is another form of the common man subsidizing the too big to fail government and Wall Street sectors, which are linked at the hip.

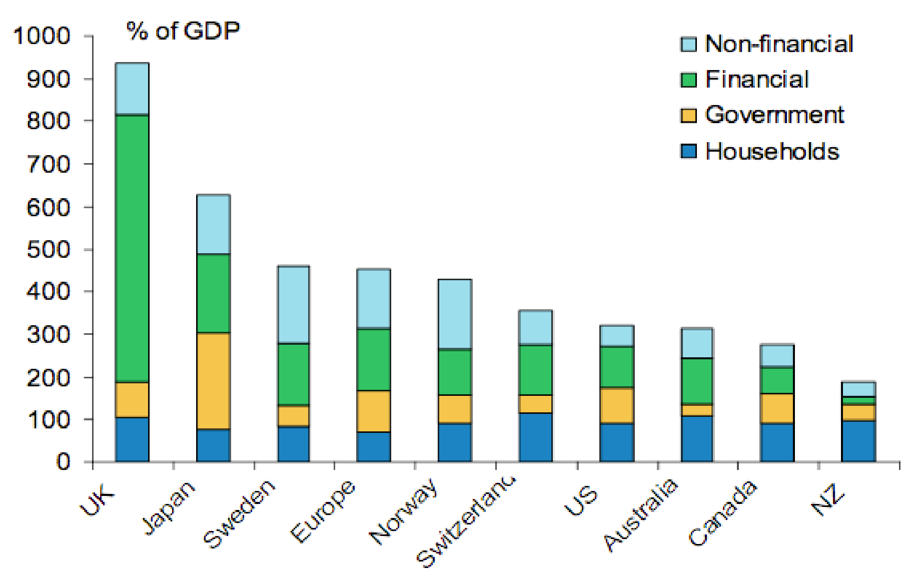
It appears to us that there is no good way out of the financial crisis we face. Europe is in recession and has no way to pay off their debt other than restructuring through default. Then, dare we say, mayhem comes to the streets. Those of us in the U.S. have our own debt problems. If we come to their rescue, then we become like them. We are almost there now. The operative word is almost. We do have time, but Washington has to come to its senses.

It seems fairly clear that very little will be done over the next year. The politicians are like children – spoiled children at that. Recession still remains in our future. Although the economy has acted better than we expected, it still is extremely slow.

Please note the following chart concerning worldwide debt. Each day it becomes worse. The can is becoming less kickable every minute. Slow to no growth remains operative.

Exhibit 1

G10 Debt Distribution



Source: Haver Analytics, Morgan Stanley Research

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