BLUE WATER'S Market Perspective

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We welcome back all of our long-term readers, and in addition we extend a warm welcome to those who are new readers. We will present our usual review of the economy (authored by Wilson), market trends (authored by Sivalingam), and a segment on financial planning (authored by Pfahl), followed once again by a brief discussion of a special topic (authored by Wilson). **This time the special topic for discussion will be "A Primer on the Bond Market."** We hope that this issue's offering will prove useful to a wide range of investors and will help explain more completely our opinions on what should be done under current market and economic conditions. For new readers, please note that each issue going forward will feature a special topic for more detailed examination, plus a bi-monthly economic and market review. There will only be room for a brief discussion of each topic, so even the busiest reader ought to be able to glean something from this report with a minor time commitment. Please feel free to send us an e-mail or call with questions, comments or suggestions.

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Economic Summary:
The Fed's Big Decision

By Kevin M. Wilson

In just two months, the Federal Reserve will probably end its quantitative easing (QE2) program, as scheduled. Under this program the Fed greatly expanded its balance sheet by purchasing $600 billion in new Treasuries. Another $300 billion in maturing Treasuries and Agencies already on the books have been replaced to keep the balance sheet aimed at its enormous target size of around $2.6 trillion. It is likely that the Fed will keep buying about $17 billion per month to offset maturing securities and maintain the size of its balance sheet after QE2 ends. This massive intervention in the bond markets by the Fed has essentially monetized the Federal deficit since November 2010, because securities equal to nearly 90% of new Treasury issues were bought by the Fed in that period. However, so far the monetization represents only about 13% of the cumulative deficit piled up since the crisis began, which is a kind of comfort. In contrast, the UK monetized 100% of their crisis deficit, and they are already facing sharply rising inflation.[1]

The massive Fed intervention under QE2 has had several effects, the primary one being a huge rally in risk assets such as stocks and commodities. In fact, there appears to be a close correlation between Fed bond purchases and the rise of the CRB commodity index.[2] That rally may falter once QE2 is perceived to be ending. Another effect has been the 10% decline in the dollar, which has helped and should

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The Fed's Big Decision (Continued)

continue to help American manufacturers stay competitive and increase their exports. A third effect has been to raise bond yields substantially, such that the 10-yr. US Treasury is now yielding 3.395%, some 0.892% above the 2.503% level where it stood in late September.[3] A similar increase in yields was observed during the course of QE1, but it bled off in the months after QE1 ended. The most likely explanation for the rise in bond yields under quantitative easing is that the markets have naturally expected some inflationary pressure to appear, since that is the goal of QE, and have demanded higher yields as compensation. Some observers believe that this yield premium, which crept up over the last few months, will now likely disappear again when QE2 ends and markets no longer expect such huge demand from the Fed.

If this scenario happens, it may lead to quite a surprise, since the consensus is now of the opinion that interest rates will rise, not fall, driving yields higher after the Fed intervention ends. Some mighty big bond market players[4] are actually shorting Treasury bonds in the belief that they will fall in price (rise in yield) in the near term. Others though, counsel that deflationary pressures remain high, with the housing market in trouble again, unemployment still quite high, and economic activity apparently slowing down, with capacity utilization still depressed.[5] As you might imagine, it is pretty important to get this call right, although in our opinion it is not prudent to try to be really early in making the call, since there will be a transition period as market participants wait to see what happens. The set-up is actually technically very similar to what it was last May, when QE1 ended and longer-term bonds rose as yields fell in response to the end of the Fed's monetary easing. Whether we observe the same thing this time depends on the relative importance of several factors: 1) changes in the expected inflation outlook as expressed in the spread between 5-yr. Treasuries and 5-yr. TIPS (inflation-protected bonds); 2) active trading volumes on long vs. short positions in Treasuries; 3) relative cash flows into or out of bond mutual funds and ETFs; and last but not least, 4) perceptions about the interaction of monetary policy and various economic trends.

Taking the last factor first, author and economist Gary Shilling has argued that the deflationary pressures of the declining housing market, falling wages, high unemployment and depressed capacity utilization will trump any inflationary pressures arising from higher food and energy costs associated with the Fed's QE2 program. Author and fund manager John Mauldin has argued on the contrary that the capacity utilization problem is actually overstated because the decline is probably structural, and thus permanent. If there is no actual slack in the system, then downward pressures on prices may be neutralized. Meanwhile Federal deficit spending may apply huge inflationary pressure as new debt has been serially monetized by the central bank, as in QE1 and QE2. Historically this has generally led to hyper-inflation episodes following financial crises.[6] Initial signs of this possibility have already arisen in the UK, as mentioned above, and we may be seeing other examples soon.

Counterbalancing all the talk about inflation is the fact that bonds are holding up much better than expected, suggesting that a change in attitudes about inflation risk and market risk may be underway.

Another factor, the inflation outlook, can be captured by observing the 5-yr. TIPS spread to Treasuries. It has been climbing since before QE2 started, rising from 1.27% in late September to 2.32% in late April.[7] This indicates inflation expectations are increasing rapidly but are still quite moderate. However, the March CPI increased at an annualized rate of 6.0%, indicating inflation rates may be accelerating. Yet another factor involves the effect of cash flows into taxable bonds via mutual funds and ETFs. These cash flows are still quite strong, reaching an average of $4.6 billion/week over the last four weeks, about the same as flows into equity funds.[8] Finally, it is unknown what kinds of volumes are involved in shorting the Treasury market, but it is known that the manager of the largest bond fund on earth, Bill Gross of PIMCO, is actively shorting. Still, it may be important to note that the 10-yr. Treasury bond yield has fallen by 38 basis points (0.38%) since February 8, driving prices up a bit in spite of all the inflation talk and recent shorting activity.

A number of observers have noted that the prospects for inflation after QE2 ends may be greatly enhanced. Fund manager John Hussman has presented a series of articles describing the tightly constrained way that T-bill yields vary with the monetary base (cash plus bank reserves) and nominal GDP.[9] His point is that now that the Fed has allowed T-bill rates to fall nearly to zero, it will be very difficult for them to exit from their easing strategy without causing a massive increase in inflation. Any external (market-related) pressures on interest rates would have the same effect. Based on mathematical relationships involving the above three variables, the only way the Fed can head off inflation is to reduce the entire $600 billion addition to their balance sheet under QE2 to zero in just a few months. This might be done, but it seems extremely unlikely that the Fed could move so quickly, or would want to do so. Philadelphia Fed president Charles Plosser has independently calculated that normalizing interest rates to 2.5% would require the Fed to dump over $1.25 trillion from its balance sheet onto the markets to limit inflation risk. This scale of action is hard to imagine, but the alternative of a quickly rising inflation rate is not so difficult to imagine. The Fed's balance sheet is also positioned with leverage of about 50:1, far more leverage than Lehman Brothers had when they imploded. This means that even a 1% increase in long-term interest rates would effectively wipe out the Fed's capital.

No one can predict what will happen now, so the inflation situation remains highly uncertain.

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The Fed's Big Decision (Continued)

Counterbalancing all the talk about inflation is the fact that bonds are holding up much better than expected, suggesting that a change in attitudes about inflation risk and/or market risk may be underway. It may be that we need to wait for more evidence. In fact, we could very well get a stock market correction first, and then inflation later. If that's the case, look for both bond market and stock market whiplash in the months ahead.

But Will the Recovery Continue?

Several economic factors are putting downward pressure on the global economy right now, and their combined effects may tend to weaken the recovery a bit. Rising oil prices, which we discussed at length in the previous issue of this newsletter, continue to subtract from global growth. The risk of a recession caused by higher oil prices seems to be receding for the time being, however, based on diminished violence in Bahrain and Saudi Arabia. This could change overnight, with perhaps the most dangerous likely scenario involving a revolution in Algeria, the source of about 2 MMBO/day of oil production. Meanwhile, the Libyan intervention by NATO is bogging down, increasing pressure on oil markets as it dawns on many that Libya's oil production may not be coming back anytime soon. Perhaps the good news is that oil speculators have played a dominant role in the price move so far, and therefore demand alone does not justify current prices. This could cause a sharp market correction at some point if the general stock market declines, the dollar rallies, or oil demand falters.

The Eurozone crisis continues, with an ever-increasing risk of at least one sovereign default. The most likely culprits right now would be Greece or Portugal, with Ireland perhaps at risk in future years, based on the astronomical rises in government bond yields these countries are experiencing right now. Greece has seen such high yields on its bonds (e.g., 21% for 3-yr. debt) that the rates are really prima facie evidence that a default is inevitable, since no government could be expected to service their debt under such onerous terms. It is interesting to note that longer term Greek bonds actually have lower yields, suggesting that markets think the risk is quite high in the near term. Additionally, Greece's debt/GDP ratio of over 150% suggests a default must occur because no other country in history has experienced such a high ratio without defaulting.[10] Although this appears to leave the Japanese debt/GDP ratio of over 225% unexplained, that story isn't over yet, and default by the Japanese government is not out of the question if current trends continue. The pressure on Greece and Portugal is increasing as some Eurozone countries such as Germany, Ireland, Iceland and Finland deal with voter revolts over footing the bill for bank incompetence.[11] It is likely that the extremely unrealistic policies of the Eurozone and ECB in dealing with the sovereign debt crisis will soon take center stage again as they fail to win support from the bond markets. Remember, Eurozone policy is centered on dealing with liquidity, which is ironically just fine right now. However, the actual problem is insolvency, and there is no easy solution for that, nor has one been proposed.

Actions by central banks to combat inflation, especially in Asia, are also slowing down economic activity as these regulators tighten commercial bank credit policies. In spite of the many steps already taken in India and China, inflation has risen to around 9% in the former, while the latter's actual inflation rate is probably close to 14%, although they report only 5.4%. This means more tightening steps will need to be taken in the coming months. The present global problem with inflation has arisen from the extraordinarily easy monetary policies that many countries adopted in the wake of the financial crisis. As Milton Friedman once said, inflation is always and everywhere a monetary problem. Since 2005, money supply in the Eurozone has risen by 52%, Japan's money supply has risen by 39%, and China's money supply has risen by a whopping 250%. This puts the modest 15% increase in global money supply that is due to U.S. actions in perspective. China, on the other hand, is responsible for fully 50% of the total increase since 2005.[12] In any case, all of this money has put tremendous upward pressure on prices as too much money chases too few goods. Negative real interest rates still prevail in many Asian countries, and that will continue to drive commodities speculation and inflation. Unlike the situation in the U.S., the Chinese are experiencing a true wage-price spiral of the type the western world experienced back in the 1970s. It will be difficult to stop, and will require much more effort on the part of the Chinese government.

Market Summary:
Markets Re-grouping

By Dheenu V. Sivalingam and Kevin M. Wilson

The Eurozone debt crisis is far from over, as discussed above, and the risk of contagion in the financial system remains very real. If Greece defaults, many European banks would take substantial losses, and their interconnectedness would amplify the effect. The euro and the dollar are vulnerable to sharp declines against gold in the coming months. Gold reached $1,518.10 per troy ounce, a nominal record in late April, while silver climbed to $49.31 per ounce, its highest level since 1980. Euro-area debt reached a record in 2010 according to Eurostat's report on 04/25/11, making it harder for Germany, France and the Eurozone's other better-off countries to bear the costs of the fiscal crisis triggered by Greece, Portugal, Spain and Ireland. Debt rose in all 16 euro-region countries, lifting the region's average to 85.1 percent of GDP from 79.3 percent in 2009. The strange notion that the solution to a debt crisis is more debt will eventually have consequences. This uncertainty has helped blunt the Euro/Dollar pair trade's overnight trajectory, which has led us to believe that there is a higher probability of a bounce in the U.S. dollar in the short term. However, we still believe that long term structural U.S. dollar weakness is here to stay.

News that regulators in Beijing have quietly increased capital ratios for the five dominant Chinese commercial banks should come as no surprise. The flow of "gray market" credit that has allowed fixed investment to continue largely unchecked despite government tightening measures underscores the fact that inflation is no longer the only concern facing the credit markets. Systemic risk is increasing, but any move to hedge against it now will face difficulties. We note that the one-week, two-week and one-month SHIBOR rates (overnight rates between Chinese banks), which are very volatile in nature, have all shot above 4 percent in recent days, indicating serious risk of systemic problems. We have no clear conviction on the direction of Chinese equities but we continue to monitor them closely to see how the markets are reacting to the tightening measures. Recent moves by Beijing have disproven the consensus that the tightening cycle was nearing completion in the wake of still strong inflation data. We continue to anticipate further tightening in the near-term and the prospect of a loosening currency band seems very possible in the near to intermediate-term. Beijing's recent comments hint that a possible policy shift to supporting Yuan flexibility, even revaluation, may be under consideration.

Momentum on short to intermediate term timeframes in major domestic and foreign stock indexes has clearly aligned in favor of continued upside. Here at home, we are watching the S&P 500 come into a highly visible potential resistance area on the daily chart.

With QE2 nearing its scheduled termination date, the FOMC meeting followed by Chairman Bernanke's debut press conference on 04/27/11 will dominate market narratives. In general we do not anticipate any major signals from this event; thus, monetary easing will end as scheduled, but with no tightening measures in place as yet. This would imply that Bernanke's complacency regarding inflation carried the day, with good support from the Fed's other inflation doves. Since U.S. real wages are in fact falling, and housing is still imploding, perhaps Chairman Bernanke has good theoretical reasons to doubt the impact of inflation. But consumers most decidedly do not agree, and they will play the decisive role in our service-based economy. So far consumer confidence is still at acceptable levels, and sales revenues are still increasing at a slow pace. But higher energy and food costs are starting to have an impact, and it makes sense to remain wary of a decline in sentiment. Speaking of sentiment, the latest S&P Case-Shiller Home Price Index report tells us that "prices for the 10- and 20-city composites are lower than a year ago but still slightly above their April 2009 bottoms. The 10-City Composite fell 2.6% and the 20-City Composite was down 3.3% from February 2010 levels. With an index level of 139.27, the 20-City Composite is virtually back to its April 2009 trough value (139.26), while the 10-City Composite is just 1.5% above its low." The housing sector's continuing problems do put some downward pressure on the recovery, but it is not clear whether it is enough to really mess things up. Time will tell, but so far the weak recovery continues.

Momentum on short to intermediate term timeframes in major domestic and foreign stock indexes has clearly aligned in favor of continued upside. Here at home, we are watching the S&P 500 come into a highly visible potential resistance area on the daily chart. We are closely monitoring the 1344 area and we will not be surprised to see some volatility and two-way trading around this level. In terms of sector flows, Healthcare has emerged as a clear leader. Our Balanced portfolio strategies are benefiting from this move since they have the most exposure to this sector. We have identified some securities to pick up for our Select portfolios on any relative weakness, but we are paying close attention to our security selection here since sector correlations are in the process of changing right now. In addition, Basic Materials and Energy are making efforts to resume leadership, with mixed success. We continue to look to these sectors for further leadership, based on our opinion that we are in a mid-cycle business environment. Tech may have bottomed on a relative basis and we have added it to our shopping list to start considering buys in attractive individual Tech issues. ■

Wealth Management Planning Note: Demand Destruction May Permanently Change Energy Economics

By Patrick J. Pfahl and Kevin M. Wilson

As of mid-March this year Americans have shifted $14 billion more into their gas tanks than they did this time last year. This minor shock to the driving public will no doubt send a ripple through our economy resulting in what economists call "demand destruction." This is simply the decline in oil demand caused by changes in people's consumption behavior in response to high prices. If oil and gasoline prices continue to rise, perhaps something like a permanent form of demand destruction will occur, just as it did in the 1980s. It has been said that the permanent version of demand destruction will eventually change world energy economics, as consumers permanently shift away from oil use and towards a reliance on electricity (e.g., hybrid and electric cars, high-speed rail).[13] This is not news to the largest publicly-traded oil players or to OPEC, both of whom were severely impacted by the wave of demand destruction in the 1980s. Ironically, OPEC was formed in 1960 as a "global organization dedicated to stability in and shared control of the petroleum markets." OPEC's supposed control will be lost forever if permanent demand destruction sets in, as it most certainly will when prices exceed the threshold for the switchover. That threshold level has been estimated by Deutsche Bank at about $180/bbl. of oil. There are a number of changes in consumer behavior that are already visible:

LIGHT RAIL: It is estimated that by the time gasoline reaches $4.00 per gallon, 670 million more public transportation trips will be taken nationwide than a year ago, and this would theoretically climb to over 1.5 billion trips if gas reaches $5 per gallon. This behavior is similar to that seen in 2008, when people reduced their total driving mileage by 34 billion miles. Analysis of this driving cutback indicates that 49% of the miles were saved by people canceling or consolidating shopping trips, 26% by people cancelling or modifying vacation plans, and 25% by people using different transportation such as mass transit/car pools/walking. Ironically, this change in consumer behavior comes just as our very own Northern Lights Rail project, designed to provide high speed rail traffic between Duluth and Minneapolis, has fallen out of favor and the Duluth City Council voted to ask for a return of all research funds. One might suspect that the $2 billion price tag for the project may actually sound appealing in future if gas prices hold at current levels or creep up higher over the coming months. It's probably not an accident that we have seen more advertisements on how cheap rail transport is, lately.

"SHUNPIKING:" This is slang for "finding another route for the specific purpose of avoiding payment of tolls." Another problem with higher gas prices and fewer miles being driven is the simple fact that our highway infrastructure continues to need maintenance but the primary funding source, our gas tax, is declining. Coupled with the fact that according to the Federal Highway Administration we are on schedule to double the average mpg per light vehicle on the road by 2030 from 24 to 48 mpg - one should expect changes. Toll roads (user fees) have been utilized in America since 1799 and despite the lack of them in our region most new Federal highway projects in the planning process today are either outright toll roads or the plans include the option of adding toll plazas later. Thirteen states have built or are planning toll roads under a system called the Build-Operate-Transfer (BOT) system (a European import). Private companies build the roads and are given a limited franchise. Ownership is transferred to the government when the franchise expires. Charles Kuralt once said the best way to miss America is by taking the highway – in the future it may be the cheapest way too.

HYBRID/ELECTRIC CARS: The biggest changes of all are likely to come as a result of the increased efficiency of light vehicles, as alluded to above. Much of that progress will come from the results of a massive R & D effort by the automobile companies over the last few years. For example, according to Deutsche Bank, Toyota spent over $8.8 billion on R & D in 2009 alone, equivalent to all of the R & D spending of the world's major oil companies combined. By 2020 about 20% of global vehicle sales will be high efficiency hybrid or electric cars. This is estimated to be capable of reducing oil demand starting in 2015 or sooner, reaching a total reduction in demand of about 2 MMBO/D by 2025.[14]

DOLLAR MENU: Our entire retail infrastructure has been built around and is dependent upon people driving alone in their vehicles to work and shopping each day. The driver is the retail value proposition – location and convenience are the targets. The problem is that with consumers driving less because of high gasoline prices, restaurants and other retailers are directly impacted. Wendy's was the first to try a "dollar menu" in 1989 and it worked – it took a slumping sector and revived it. By 2004 McDonald's had permanently established the dollar menu, which now accounts for the majority of sales volume in fast food restaurants. By engineering speed and convenience into our dining life, restaurants have adapted to changes in people's consumption behaviors – so that we continue to eat out. Restaurants and other retailers are starting to build new stores only on main roads and highways, and in proximity to other stops like gas stations, in order to cash in on the new reluctance to drive.

BUDGET WOES: Gas prices of $4/gal. also have hurt our cities, schools and states. Locally the Superior Schools have 225/sq miles to cover with bus routes up to 50 miles long, with over 50% of the students riding a bus (Duluth's District 709 covers 335 square miles). With fuel prices up nearly 50% since school began last fall, budgets are suffering. Demand destruction may occur when the districts upgrade their buses over time to improve mileage to 9 miles per gallon instead of 6 – and they are being

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Demand Destruction (Continued)

pushed to continue searching for even more efficient means. Minnesota's budget for snow removal is $100 million per year and has varied up to $250 million based on fuel and weather differences from year to year. A large portion of the higher expenditures in that budget went to fuel cost increases this year.

SODA POP: Soft drink manufacturers are being hit with a trifecta of problems – transportation costs have increased, raw materials have increased (bottles are made from petroleum and cans from metal), and corn prices have reached nearly historic levels (only year higher was 2008). The main ingredient in sweetened soft drinks is corn syrup. Most beverage manufacturers do not maintain price control of their products and consequently are taking big hits in profitability. Other industries are also being impacted due to higher transportation and raw material costs.

Energy demand destruction, the bane of OPEC in the 1980s, returned in 2008-09 and appears to have just arrived for another round in 2011. Eventually prices will go high enough to trigger a permanent round of demand destruction, in which new technologies will be adopted that cut energy demand in a big way. The World has stepped up with engineering solutions to combat high fuel costs, and over time these new products will replace our less efficient or more energy intensive current technologies. Even things we now do for convenience will have a big impact over time, such as Internet shopping (with free delivery). We expect that solutions will continue to sprout exponentially – in line with the rising costs at the gas station.

Special Topic:

A Primer on the Bond Market

By Kevin M. Wilson

James Carville, President Clinton's political advisor, famously said that when he died, he'd like to be reincarnated as the bond market – because they are the ones with the real power. In this discussion I will try to explain why even presidents need to pay close attention to the dictates of the bond market. In the previous edition of this newsletter I wrote that the huge Federal deficit and the Fed's quantitative easing program (QE2) have roiled the bond markets for months, and bond traders are watching closely for portents. What they are watching for specifically is which of two potential scenarios plays out when the Fed ends QE2, presuming it does what the consensus now expects. In the first scenario the Fed might maintain its balance sheet at current levels by continuing to buy Treasuries to replace maturing securities, estimated at about $17 billion per month. This could possibly result in a mild, orderly transition to a more normal market. Bond yields might even fall in this scenario, driving bond prices up. In the second scenario the Fed might maintain the size of its balance sheet, or it might alternatively end QE2 abruptly, but either way, the markets might perceive a very high inflation risk and sell off dramatically as yields rise to much higher levels.

The Fed's exit strategy from its quantitative easing and loose money policies may well reassure the bond market, but then again it may not. Bond traders and big institutional investors will want to see whether the withdrawal from the markets of the world's biggest purchaser of Treasuries (the Federal Reserve) has an impact on the aggregate demand for the U.S. Treasury's never-ending new supply (estimated at $2.4 trillion this year). There is a firm belief on the part of some of the biggest players that the 30-yr. bull market in bonds is ending, to be replaced by a long, dangerous bear market as interest rates rise from their very low current levels back to more normal rates, or even elevated rates if inflation kicks into high gear, as many fear.[15] But why should the average investor be concerned about these issues, and what should investors do to protect their portfolios? And why, as I have repeatedly stated over the years, is the bond market so important to the functioning of the economy?

Let's start by talking about some basic definitions. A government bond is a debt investment in which investors loan money to the government (to fund its operations) for a certain amount of time at a specified rate of interest. In the simplest case the government pays investors in the bond a periodic interest payment (say, 3.5% per year) until the bond reaches its maturity date (say, 10 years from now), at which time the entire principal of the loan is paid back. Government bonds, especially those of the U.S. government, are commonly referred to as "risk-free," meaning that there is no credit risk associated with holding the bond to maturity. However, there are other types of risk that could arise, such as currency risk or inflation risk. Currency risk could exist for foreign investors such as the Chinese and Japanese governments if the value of the dollar declines, as it has for many months now. Inflation risk would affect all investors in circumstances where the purchasing power of bond assets is reduced by inflation during the holding period, causing the investors to in effect lose money as time passes. Bond markets have very strong reactions to perceived risks because most investors buy bonds to get a safe and predictable stream of cash flows, and these risks can damage the actual safety and predictability of those cash flows (interest and principal payments).

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A Primer on the Bond Market (Continued)

It is important to understand that the price of a bond at any point before its maturity is a function of the time remaining before maturity, the prevailing interest rates on offer for new issues of similar bonds, the prevailing credit quality of the bond, and the liquidity of the markets (i.e., how easy it is to trade the bond). When a bond is sold before its maturity, prevailing conditions can cause the bond's price to be higher (i.e., it sells at a premium) or lower (i.e., it sells at a discount) than when issued. For example, if you wanted to sell a 4.0% 10-yr. Treasury bond in the 4th year, and the prevailing 10-yr. interest rate has fallen to 3.0%, you could expect a sizable premium to be paid (bond price has gone up) because buyers can no longer get the higher interest rate locked in to your existing bond, and they would be willing to pay more to get that rate. Thus, when interest rates fall, bond prices go up. The opposite case would be selling the same bond, but with prevailing 10-yr. interest rates at 5.0%. Now you could expect a sizable discount to be applied (i.e., you would lose money) because the prevailing interest rate is much higher than that of your existing bond, and it would require a discount for a buyer to take your bond instead of a new issue at the higher rate. Similarly, if the credit quality of the bond falls after you purchase it, the risk will be perceived to be higher, and therefore the price will be discounted to offset that risk if you need to sell the bond before its maturity. Finally, if the market for the type of bond you own is over-supplied relative to demand, prices may fall due to the law of supply and demand, as with any other business transaction.

Applying these bond rules and definitions to the current situation illustrates the extreme importance of what the Federal Reserve and the U.S. Treasury have done and will be doing in the months ahead. In late April Standard and Poor's, the bond rating agency, affirmed the AAA (highest quality) status of U.S. Treasury debt, but listed the outlook as negative rather than stable. This implies that U.S. credit could actually be downgraded within the next several years if nothing is done about the huge and ongoing Federal deficits. This credit risk, if it actually occurs, would cause a downward re-pricing of all U.S. debt. This is a very serious issue and has caused a certain amount of consternation in big holders of U.S. debt like China's government, although so far the Japanese government, another big holder, is a bit more sanguine about it. Large institutional investors such as mutual funds and pension funds, and large individual investors are also concerned. In any case, bond markets have taken a measured view of this possibility so far, but political events around issues like Congress raising the debt ceiling and ongoing negotiations over the Federal budget could drastically alter the equanimity of the bond market.

No one knows what will happen, but bond markets are calm so far in the faith that those smart folks at the Fed will somehow pull it off. Let us hope they do, but we'll keep our powder dry in case they don't.

Fear of a downgrade by ratings agencies could actually help politicians to focus on solutions, but failure to do so would scare bond market players into taking action. What they might do in that circumstance is to demand a risk premium to buy government debt that might, from their point of view, later be downgraded. That premium would take effect in the form of higher bond yields and lower prices. Higher yields would cause the debt service costs of the Federal government to soar, potentially causing even higher Federal deficits over time. If the fabled "bond vigilantes" showed up, the situation would be even worse. When people on Wall Street refer to the advent of the "bond vigilantes," they usually mean that the bond markets control the availability of credit, even to governments, and if they are not happy they can demand higher yields to offset perceived risks. There is no appeal to the "bond vigilantes," only submission, once they decide to demand higher compensation for risk. That is what has happened to Greece, Ireland and Portugal as their credit ratings have fallen in the last year or so. The eventual default of Greece and Ireland is now seen as a real possibility, given their debt service requirements at bond yields that are now as high as 20%. The impact on our economy if a downgrade to U.S. credit quality occurs might not be as severe as that in the 'Club Med' countries, but it would still hurt the economy and cause uncertainty and volatility in the stock and bond markets.

Returning to the prospect of inflation after the end of the QE2 program, if the Fed's exit strategy fails to control fears about inflation, again the bond markets could react negatively, demanding higher yields to offset the perceived inflation risk to bond investors. If inflation actually took hold, this would represent a true paradigm shift for most investors, as it has been more than a generation since bond investors have faced a secular upward trend in interest rates caused by higher inflation. Most investors have little or no experience dealing with this kind of investment environment. Standard stock, bond and cash portfolio allocations used in the last 30 years by investors and their advisors would not only fail, but would cost investors huge sums as the markets rebalanced to reflect the new risks. The sensitivity of the bond market to political uncertainty would be raised even higher, making volatility more pronounced. Virtually all risk assets could sell off during periods of high volatility, and a bear market for both equities and bonds could result. There has been a great deal of debate about whether an increase in inflation will actually occur when QE2 ends.[16] It would appear that nearly miraculous levels of skill will be required at the Federal Reserve in order for it to tighten monetary policy without causing higher inflation, given the massive interventions and high risk tools used by the Fed to combat the weak economy over the last three years. No one knows what will happen, but bond markets are calm so far in the faith that those smart folks at the Fed will somehow pull it off. Let us hope they do, but we'll keep our powder dry in case they don't.

Please Share Our Newsletter or Refer Others to Blue Water to Help Them Preserve and Grow Their Wealth

We encourage you to share our newsletter with business associates, friends and family. Let them know what we have done for you to preserve and grow your wealth. We would be glad to help your contacts benefit as well. We are not a "stay the course" or a "do nothing" type of firm. We are actively researching, analyzing, and managing risk every day. We do not take our fiduciary responsibilities lightly. We work hard on your behalf to anticipate economic trends and take action accordingly based on our assessment of risk and potential returns. We have made significant investments in our business to make sure we have the best information and people that are capable and intellectually equipped to make important and timely decisions managing your wealth.

Please attend our next "Monthly Market Forum" if you can; we'd love to see you, your relatives and your friends there. Scheduled meetings will be held at 5 pm - 6:30 pm on May 19, 2011 at The Kitchi Gammi Club, Duluth; and June 16, 2011 at a Location TBD. The meetings are suspended for July and August to accommodate summer vacations. If you can attend in May or June, please RSVP to Blue Water. Business casual attire suggested.

References Cited
(Endnotes)

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6 Carmen Reinhart and Kenneth Rogoff, 2009, This Time Is Different: Eight Centuries of Financial Folly, Princeton University Press, 496p.

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