

## ARE YOU PREPARED FOR A SECULAR BEAR MARKET IN BONDS?

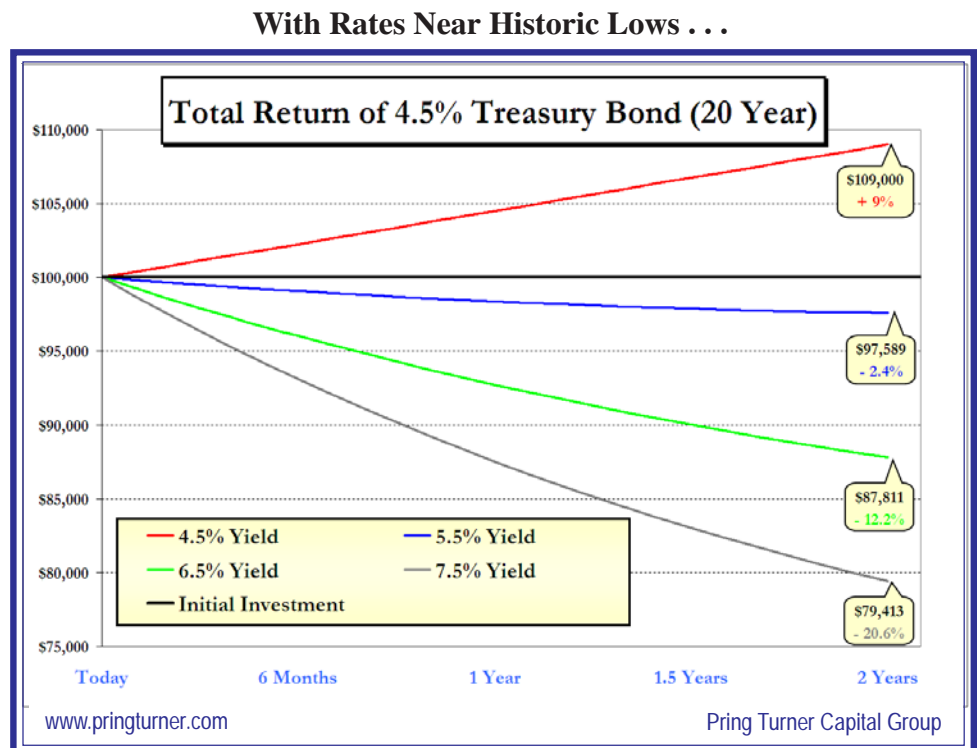
Our research indicates the strengthening U.S. economy has recovered to the point when interest rates will begin to move up (bond prices go down) for the duration of the current business cycle expansion. Even more important, we believe the secular (or very long-term) direction of bond prices is at a critically important turning point and a secular bear market may have already begun. Most investors do not fully understand, nor appreciate the potential *devastating* capital losses bonds will suffer in a secular bear market.

Bond investors have enjoyed a thirty-year trend of lower interest rates and are likely ill prepared to deal with a trend reversal to higher interest rates. Are you prepared for a secular bear market in bonds? Our goal with this report is twofold: 1) to provide evidence to support our cyclical and secular bond forecast and 2) introduce tactics to help protect and grow your wealth in a hostile environment for bonds.

In the summer of 1985 we wrote an article published in Barron's correctly calling for a secular reversal in interest rates from high to lower levels. At their peak, 20-year government bonds yielded 15% and after reaching a low of 3.1% have recently rebounded to 4.5%. History shows secular trends do not last forever and after almost 29-years it's time to see if there are signs of a major reversal.

Bond holders have benefited the past three decades as interest rates declined, and conversely bond prices advanced. Bonds have also been a safe place to hide especially in the last 10-years as the secular bear market in equities has unfolded. But if a secular advance in yields is underway, long-term bonds will decline in price and will no longer be the safe haven for investors. Just as it was difficult to believe that the 15% yields in 1981 would experience a historic decline, now it is equally challenging to accept that over the next few business cycles, rates could double or more and find themselves back up to the 8-10% range. Yet, if we look at previous cycles such numbers are not unreasonable. For example, between 1900 and 1920 corporate bond yields rose from 3.6% to 6.4% and between 1946 and 1981 they rallied from 2.5% to 15.4%.

An unexpected advance in yields will be quite damaging to bond investors. Figure 1 illustrates several interest rate scenarios. For example if the rate on a 20-year government



**. . . A Small Rise In Rates Can Lead To Big Losses!**

Figure 1

bond rose from its current level of roughly 4.5% to just 6.5% over the next two years an original \$100,000 investment *including interest* would fall to \$87,800. Today's paltry coupon income provides little protection to offset price losses with even a small increase in interest rates.

### Bonds: The Technical Position

In order to assess the current technical secular structure we need to look at what has happened in the past. Chart 1 for instance shows corporate bond yields on an annual basis back to 1857. The blue arrows indicate that there have been five secular trends since that time, three down and two up.

#### Bond Owners Beware . . .

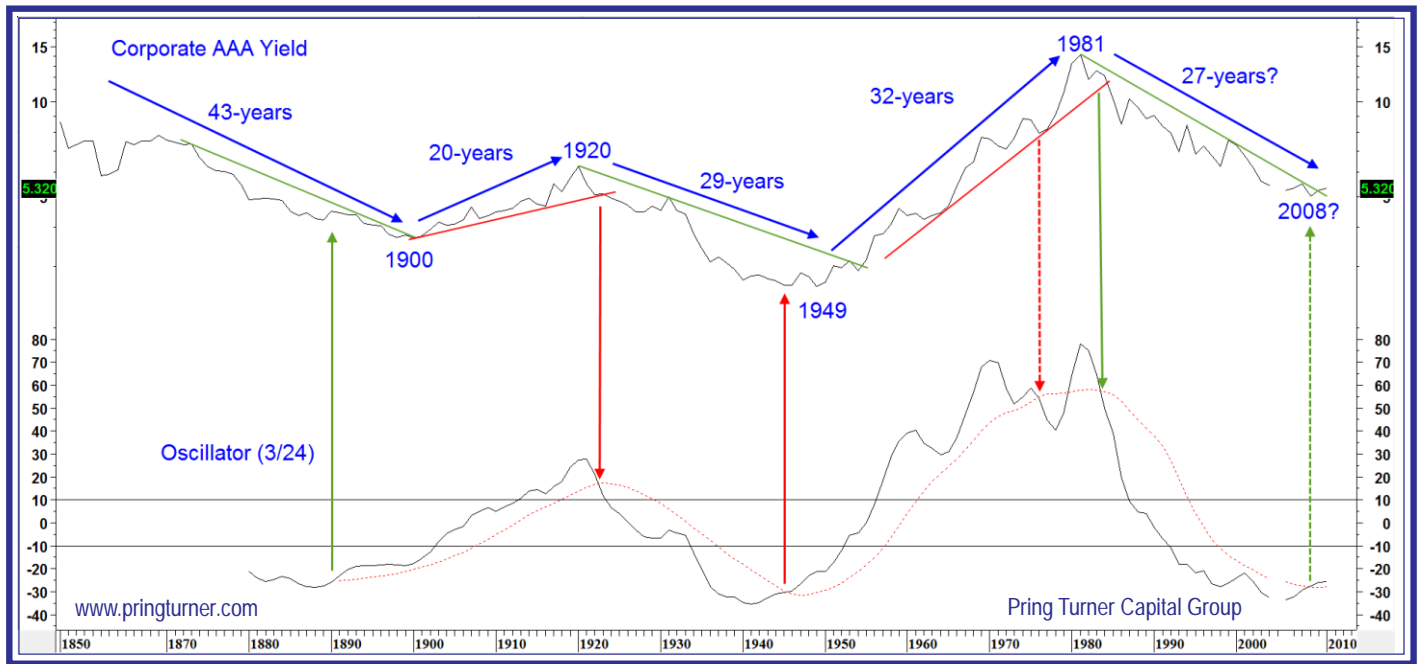


Chart 1

#### . . . Secular Trend at Critical Juncture

If we assume that 2008 represented the interest rate low, which has so far been the case, the average trend duration was 30-years, not far from the duration of the most recent decline. Useful trend reversal signals have been generated in the past when the 3-year oscillator has crossed above and below its 24 year moving average *and* been confirmed by a trend break in the yield itself. The time of the only false momentum signal in 1976 there was not confirmed by a trendline violation. This momentum indicator triggered a signal for higher yields recently and also violated its 27-year down trendline. This study has already signaled a reversal in the secular trend.

### Bond Yields and Commodity Trends

One of the most important fundamental influences on bond yields is the course of industrial commodity prices. The two are compared in Chart 2. Rising or declining commodity prices reflecting economic demand are inexplicably tied to inflation levels and trends. Rising inflation is the arch nemesis of bond owners as it robs those bond investors of purchasing power. When inflation begins moving higher, bond buyers will demand (and get) higher interest rates in order to get a 'real' return for lending their money. The arrows show at virtually every turning point commodities lead bonds. During the 1980's and 1990's commodities experienced a trading range as yields softened, but for the last 10-years commodities have been rising thereby fulfilling their leading characteristics once again.

The commodity index is featured on its own in Chart 3, along with a long-term price oscillator that captures secular trends. Swings in the oscillator fit nicely with the secular bull and bear markets. Reversal signals are generated when the oscillator crosses above and below its moving average and this is later confirmed by a trend break in the

## Commodities in Secular Uptrend . . .

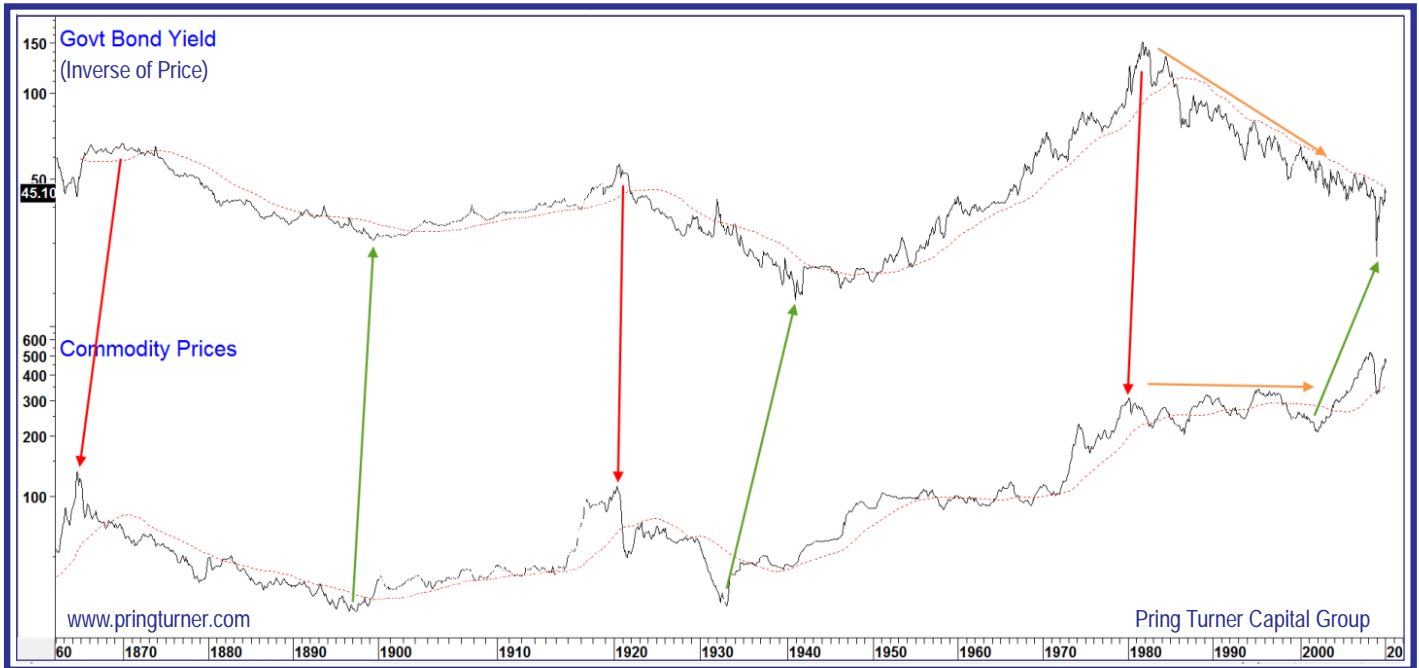


Chart 2

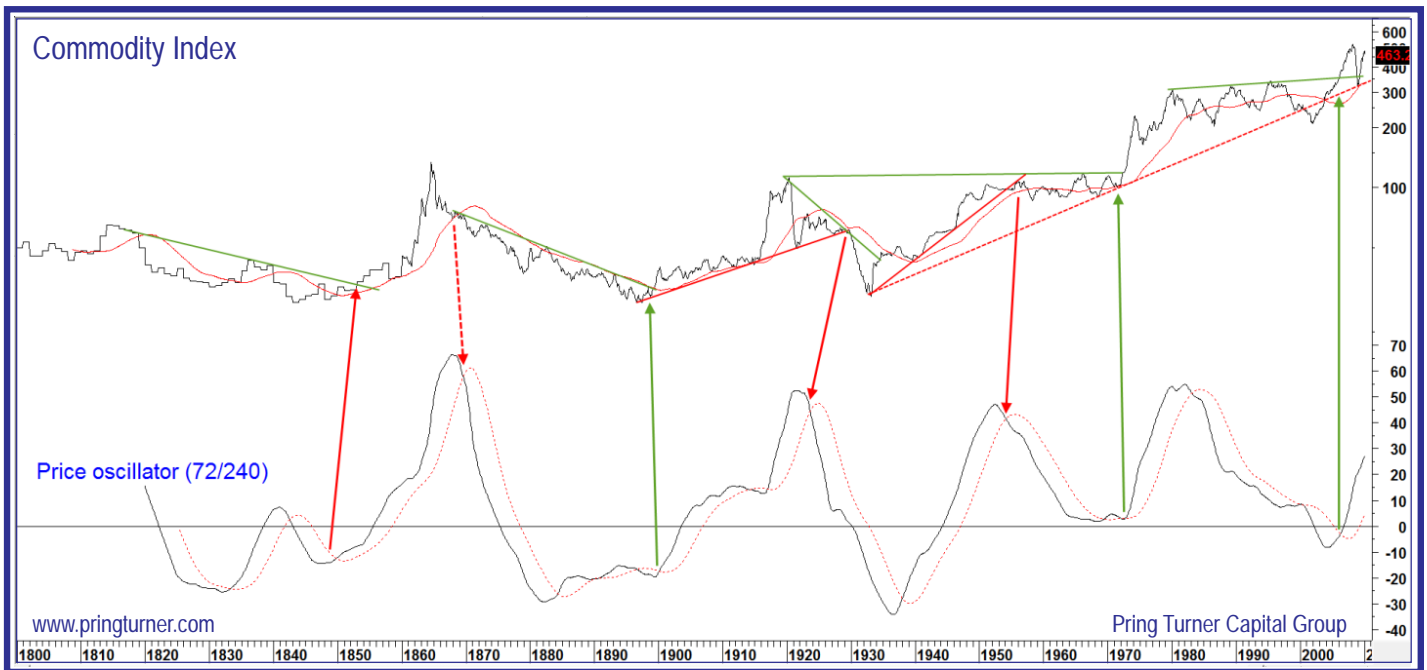


Chart 3

## . . . Adds To Risk In Bonds

Index itself. At the moment the secular trend for commodities is up because the oscillator is rising and the Index is above its green breakout trendline. In addition, the series of rising cyclical peaks and troughs is intact. These factors all suggest that commodities are headed higher over the next 5 to 10 years.

What about the current business cycle picture? For that we turn to our proprietary Inflation Barometer, a model consisting of 10 reliable technical and fundamental indicators designed to capture inflation changes caused in every new business cycle. When it moves above 50%, it triggers an “inflation” buy signal for this business cycle

**Our Inflation Barometer Recently Reached Maximum 100% Reading . . .**

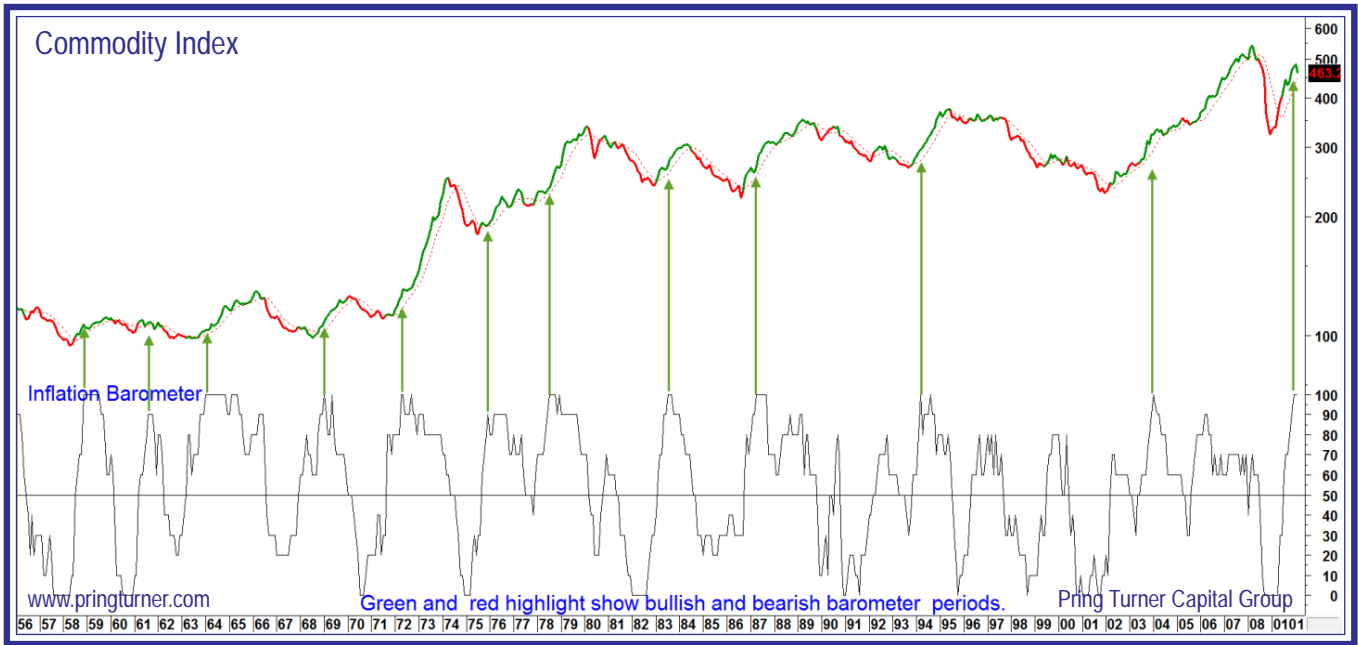


Chart 4

**. . . Often Leading to Sharp Commodity Price Gains!**

suggesting higher commodity prices. Readings above 50% are represented by the green highlights in Chart 4. The green arrows show that when the Barometer first reaches the 100% level in the cycle. This 100% level is often an early event and substantially higher inflation and commodity prices generally follow.

Our Inflation Barometer hit 100% January 2010 and is still at the maximum reading today (April). We expect sustainable higher commodity prices for as long as the current business cycle strength continues. Higher commodity prices *mean* higher inflation pressures which *means* higher interest rates, which *means lower bond prices!*

**Our Bond Barometer Just Gave A Sell Signal For This Cycle . . .**

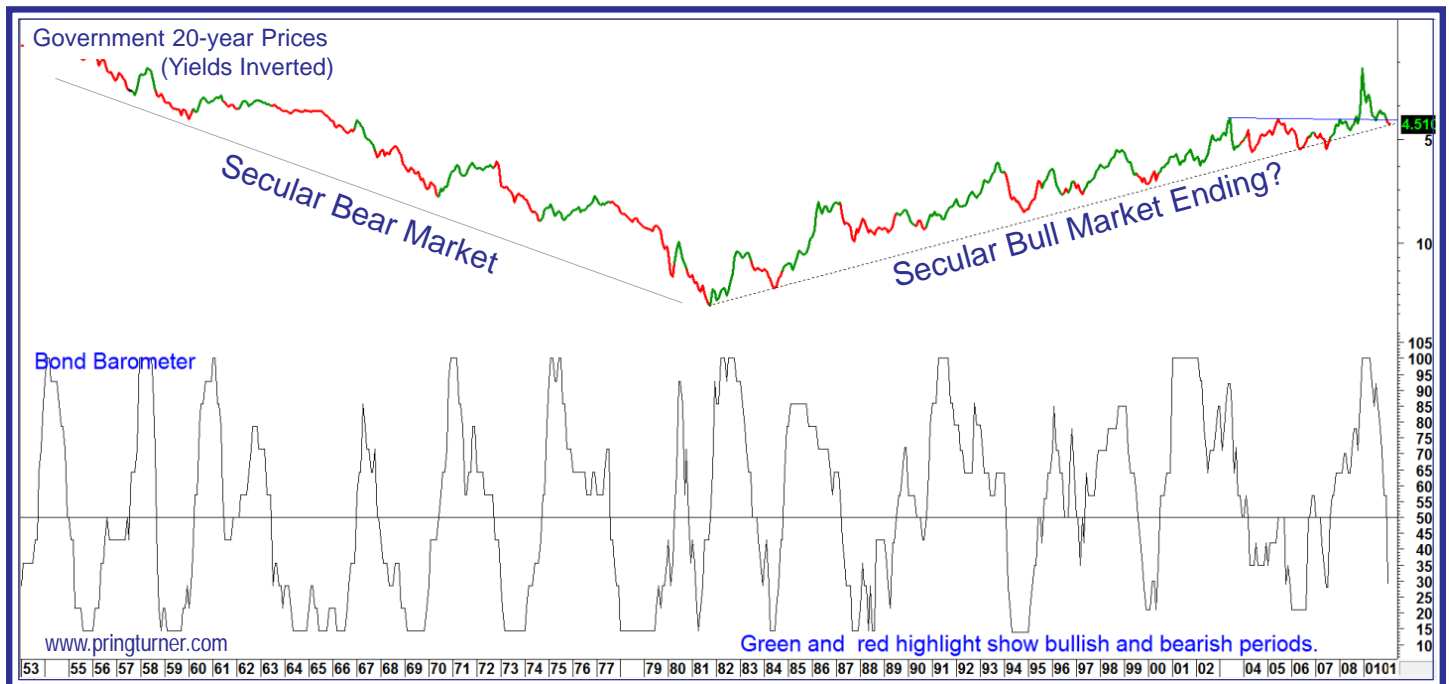


Chart 5

**. . . And the Secular Trend for Bonds Is at a Critical Juncture**

## **The Business Cycle Trend of Bond Yields and Prices**

Chart 5 features our Bond Barometer, a model that comprises monetary, economic, and technical indicators. Like its inflation counterpart, it goes bullish for bond prices with a reading in excess of 50% and bearish for prices with a reading below 50%. In March it fell from 56% down to 29% flashing the first warning sign for bonds since December 2006.

Note how much more time bonds prices rose (green) than fell (red) during the last 29 years' secular bond bull market. Compare this to the last secular bear market (1953-1981) when bond prices spent more time falling (red) than rising (green). If, as we expect the secular trends for interest rates are reversing, investors will have to struggle with longer adverse periods of falling bond prices than experienced in the last three decades.

### **What Does This Mean for Bond Investors?**

A secular reversal in long-term U.S. interest rates has likely been signaled. Investors should be alert to this monumental and critically important change.

1. A momentum indicator based on annualized data for corporate bond yields and a trendline for the yield itself have already signaled a secular reversal in bond yields (chart 1).
2. We expect higher commodity prices will lead to higher bond yields (lower bond prices). Commodities lead bond yields and have been rising for 10-years, whereas bonds have been in a trading range for the latter part of that period (chart 2).
3. Since the Bond Barometer is at a bearish 29% level and the Inflation Barometer is at 100% reading, the expected rise in yields for the current cycle will be sufficient to trigger a longer-term reversal.

In summary, if you want to wait for even further confirmation, the signals we would look to confirm a secular trend reversal would be a monthly average for 20-year government bond yields in excess of 5% (currently 4.5%) and for Moody's AAA Corporate Yield an average above 6% (currently 5.35%). If this secular trend reversal is confirmed, new tactics will be required to successfully manage and protect your portfolio.

### **Tactics For A Secular Bear Market in Bonds**

Our proprietary bond barometer has just given the first sell signal for bonds in three years, putting bond investors on high alert. In addition, we have evidence the secular or long-term trend for interest rates is at an early critical juncture. A trend change away from the favorable environment for bond prices that has existed from a business cycle time frame (past 3 years), and secular time frame (past 29 years) requires an investor to carefully re-evaluate their bond strategy. Faced with potential devastating capital losses from bond investments, tactical and strategic portfolio changes have to be acted upon.

Basic changes for a hostile bond environment include 1) reducing bond allocation percentage, 2) reducing the average bond portfolio maturity, 3) raising the overall quality of bond holdings, and 4) increase exposure to inflation-sensitive investments.

One example of reducing the average maturity can be executed with a short-term bond ladder that ensures full return of capital within a shortened time frame. This laddering strategy enables the investor to continuously roll over maturing bonds at higher and higher rates and protect principal values. Raising the quality of the bond portfolio makes certain your principal will be returned in full upon maturity. A tactic that increases exposure to inflation sensitive investments could include short-term international bonds emphasizing currencies denominated in strong natural resource based countries, such as Canada or Australia. The current 100% reading in our Inflation Barometer further argues for reducing the percentage of bonds and instead emphasizing inflation beneficiaries such as natural

resources like energy, metals, mining, agricultural and forest products. Combining these tactics will help insulate portfolios from higher inflation, rising interest rates and lower bond prices.

Even within this difficult secular bear market, there will be rewarding tactical opportunities. The key to successful exploitation of these opportunities will be the application of business cycle analysis. Bond investor success will depend upon these tactics and taking advantage of cyclic opportunity that occur every business cycle. The benefits of knowing cyclic and secular interest rate increases are coming will help you protect and even grow your capital in the coming hostile environment for bonds.

Martin Pring

Joe Turner

Thomas Kopas

#### About Pring Turner Capital Group

Pring Turner Capital Group is a registered investment advisor, providing highly personalized investment management services on a fee-only basis since 1977. The three managing partners, Martin Pring, Joe Turner, and Tom Kopas combine for over 100 years of professional investment experience. Martin Pring is the author of numerous highly acclaimed books regarding market analysis and business cycles, including *Technical Analysis Explained*, *The All-Season Investor*, and his most recent *The Investor's Guide to Active Asset Allocation*. Please visit our website at [www.pringturner.com](http://www.pringturner.com) for more information.

#### PERFORMANCE SUMMARY THROUGH EQUITY SECULAR BEAR MARKET 1/01/00 — 03/31/10

|  | Return  | Beta | Risk Measures*<br>Standard Deviation |
|--|---------|------|--------------------------------------|
| Pring Turner Performance (Net of Fees) | +81.85% | .49  | 9.71%                                |
| S&P 500 (Including Dividends)          | -4.2%   | 1.0  | 17.69%                               |

\* As measured over 10.25 years by two traditional risk benchmarks

See Performance Disclosure Below

Readers are welcome to visit our website [www.pringturner.com](http://www.pringturner.com) to view our recent special report on “Our Secular Outlook for Stocks”.

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