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**OBSERVATIONS ON THE MARKET** No. 227*By Greg Denemiler, CFA*

What does safe really mean? On Friday, the 10-year Treasury bond touched 3.11% as the equity market fell on fears that Europe was a terminal patient. Everything else was perceived as risky; stocks, corporate bonds, gold, oil, anything that could be bought or sold. But is earning 3.11% for the next 10-years really safe?

This seems to be a classic fear and greed scenario. It only takes a few days of calmer waters to make 3.11% look less appealing. In just one day, the yield has already moved back up to 3.21%. This means the bond has declined by almost 1% since Friday, or after taxes, about six months of interest. This may not sound like much, but the same 10-year Treasury bond was paying 4% just last month. If interest rates move back up to 4% sometime this year, the 10-year Treasury is worth about 5% less than it is now. We haven't even discussed the issue that our debt situation isn't any better than Europe's.

Europe's gross debt is currently about 85% of GDP, and their budget deficit is 7% of GDP. This compares with the US, however, our budget deficit is higher at over 10%. Why the rush to buy our debt? Because we have a common central bank that can initiate monetary policy across all 50 states without question, while the European Central Bank only has a common currency, not a common monetary policy across countries. This perception of stability makes our currency the only true reserve currency in the world today. That is good in the short-term, but doesn't address the problem of inflation.

It would appear that the world's determination to pump whatever money it takes into the global economy will eventually have some inflationary effect. For this reason alone, it does not seem very appealing to accept 3.11% for the next ten years. However, this run to safety is sowing the seeds to

help maintain our recovery.

Low Treasuries yields drive down mortgage rates. With 30-year mortgages back below 5%, this is a big stimulant to the housing market. The jumbo loan market (loans over \$417,000) is finally starting to show life. The jumbo market doesn't get much attention because it is hard to feel sorry for this group, but rates on jumbo loans are now below 6%. This is further evidence that the securitization market continues to improve, since few banks hold the loans they write. The recent flight to safety has also brought down oil prices. In a matter of only a few weeks, oil prices have declined from \$87 to \$70. Few factors help the economy more than lower gas prices for the summer. We still need a stable Europe even though our economy is not that dependant on it.

European banks do need to start lending to each other again. Every central banker knows this is a road we do not want to go down again, and they seem to show their concern. It would seem that the odds favor the massive global stimulus (now over \$2 trillion) buying the world some growth. Since the market now trades at only 13.5 times earnings estimated this year, it doesn't expect much. Headlines change the meaning of risk, so what do you do?

There are a lot of companies that pay dividends that are over 3%. Johnson & Johnson pays a 3.5% dividend and has raised it every year in the last ten. They have 20% of their assets in cash, and total debt is 20% of assets. Their interest expense is 5% of net income. If you had to pick between Johnson & Johnson and a ten-year treasury bond that pays 3.11% (with debt beyond what anybody really knows is there), which seems more secure? Tomorrow, J&J can surely decline more than a Treasury bond. But what if you had to wait ten years before liquidating either one, which one seems safer?