INTEREST RATES

THE FEVER CHART OF ANY ECONOMY

"The money markets are a very sensitive mechanism, causing interest rates to adjust quickly to small changes in economic growth and in the overall financial environment. Because of this sensitivity, they provide an objective view of the state of the investment environment. As Sydney Homer once said, "Interest rates are the fever chart of any economy".

"Since 1955, in the United States, the average level of short-term interest rates has been about 5-6%. The farther rates moved away from this range, the more the country was subjected to economic and financial disturbances in various degrees of intensity.

"In the 1970s short-term interest rates rose to 20%, well above the 5-6% average. As they moved toward this level, the economic cycle became more unstable, inflation increased to higher and higher levels, and the unemployment rate to an all-time high.

"When interest rates fall close to 2 or 1 percent, the country experiences not inflation, but deflation. "(From **Profiting in Bull or Bear Markets**, Chapter 6.)

Right now short-term interest rates (rate of 13-week Treasury bills) are close to 1.6%. They are at historically low levels, at the same levels they were during 1955-1965 (see chart below). Their level is a crisis level. This is not news. We are having problems, and they will stay with us for some time.

The reason their graphs are remarkable is because of their **investment implications**. The early 1980s were wonderful and most profitable times to buy and hold bonds. Yields were at historically high levels. The country had enough of higher inflation, recessions, and economic uncertainties. Something had to be done, and it was done. Inflation was brought under control. The economy strengthened and the country and financial markets boomed.

As it always happens in human affairs, however, **we were unable to stop at the right time**, which was in the mid 1990s. The Fed encouraged a bubble. As the bubble burst, a new set of problems emerged, and opposite of what we had in the early 1980s. We are now at the bottom of the historical range in interest rates where the economy typically flirts with deflation and soft economic conditions, as discussed in the book ***Profiting in Bull or Bear Markets*** by Dr. George Dagnino. Now, as in the 1970s, we are facing wartime conditions with difficult decisions to be made.

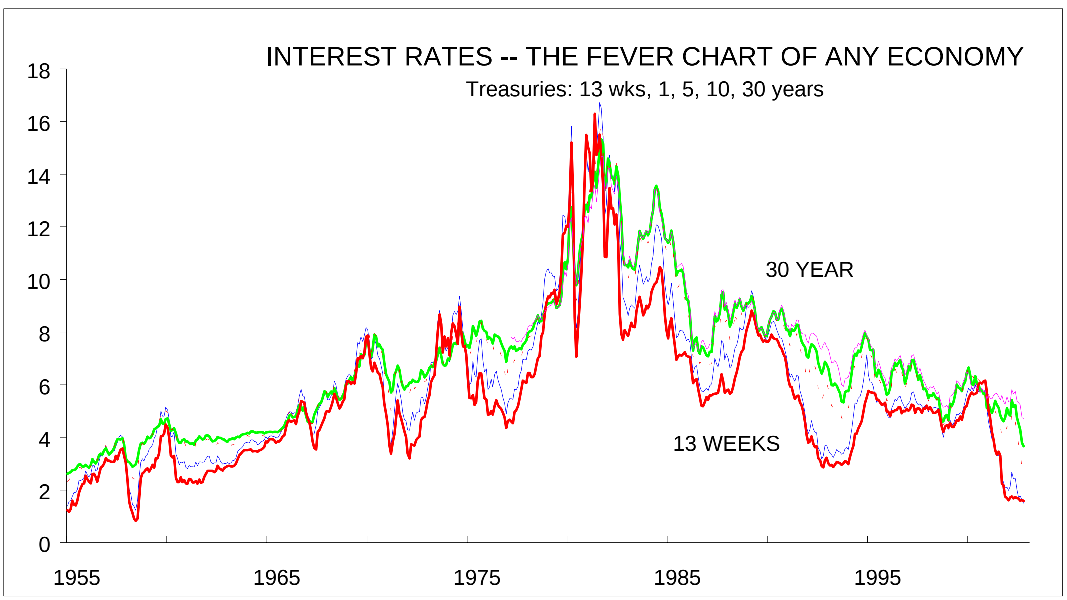
The country, however, will soon demand that something be done about the state of the economy. At any price. The country (consumers and businessmen) will ask Washington to reflate the economy, create growth, and generate jobs, even if this is going to cause a burst of inflation.

Conclusions and investment implications

Interest rates have reached historically low levels because of abnormally weak financial and economic conditions created by the deflating financial bubble of the late 1990s. As the country focuses on strengthening our economy, yields will gradually head higher.

As in the midst of the 1960s, interest rates will trade first in a narrow range for a while. Eventually they will start rising relentlessly as human emotions force their level to new extremes.

What we are suggesting is that we are entering a period similar to the early 1960s when **shorting bonds** is a safe long-term (at least 10 years) strategy. Profound historical odds are on our side.



These graphs strongly suggest that it is very difficult to find reasons to be bullish on bonds over the next several years. Soon we are going to set the stage (government spending, government deficits, and aggressive monetary policy) for the next wave of higher inflation and much higher bond yields.

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