



# The Investment Coach™ Weekly Commentary

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## Watching The Moneymen

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The word *vigilante* comes from the Latin, *vigilare*, “to be watchful.” The bond traders and bond buyers are watching the president and his moneymen and their spending spree. They don’t like what they see!



In 1984 analyst Edward Yardeni coined the term *bond-market vigilantes* to describe traders and investors who enforced discipline in financial markets based on what they bought and sold. For a while as the sub-prime meltdown continued, safety was the dominant concern. As demand for Treasury paper soared, prices rose and interest rates sank to new lows. Now, a growing fear is for the safety of future buying power and the vigilantes are demanding an inflation premium. In recent weeks interest rates on longer term Treasury paper have jumped, and bond prices which move inversely to interest rates have slumped.

On March 18, Ben Bernanke announced that the Federal Reserve Bank would in effect start printing money to buy financial assets. The Law of Supply and Demand never has been repealed. Print more money, increase the supply of dollars in circulation, and the value of existing dollars drops. At May’s end, the euro hit a 2009 high against the dollar as the greenback weakened. As ten-year Treasury yields moved up, thirty-year fixed rate mortgages rose above five percent.

Currently inflation is not a major problem. Over the last twelve months consumer prices fell at a rate not seen since 1955. Excluding food and energy, the source of the biggest declines, core inflation jumped 1.9 percent from April 2008, to April 2009. It’s the deficit that has the vigilantes spooked.

In the political campaigns of 2008 the deficit spending of the previous administration was blasted. The Congressional Budget Office says the deficit this

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year will eclipse the previous record four-fold. Uncle Sam will need to raise \$3.25 trillion this year alone, up from \$1 trillion in 2008. Long-term projections are grim!

Who are the vigilantes? This go-round, primarily foreign creditors. Treasury Secretary Timothy Geithner journeyed to Beijing to sweet talk the Chinese who are nervous about the value of the massive pile of American paper that they hold. “It’s a fortune, Cookie!”

For now, the traders are headed for the exits, and money is moving from Treasuries into corporate and inflation-protected bonds and equities. Main Street investors are beginning to consider an inflation premium as they formulate an investment policy. A real yield of three percent over an inflation rate of three percent, adjusted for taxes at a twenty-five percent average federal and state tax rate, requires a gross annualized return of eight percent.

If you have been procrastinating about converting an adjustable-rate mortgage to a 15 or 30 year fixed loan, do it now. If you have a home equity line that will jump as interest rates rise, concentrate on paying it down. Interest rates, inflation rates, and tax rates are headed up.

A few months ago, the conversation with investors was purely about safety. Now the conversation is turning to defensive strategies to hedge inflation and taxation. The vigilantes are sending strong signals to Washington. Will they listen? The long-term purchasing power of your dollars is riding on who prevails—the vigilantes or free-spending politicians. **It’s a contest that you should keep an eye on!**



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