April 2006

Cash versus Bonds
US Dollar Devaluation: Plan B

Investors with a modest tolerance for risk should hold a combination of stocks and fixed-income securities. In this market commentary, I will focus on the latter – the fixed-income portion of one's portfolio.

In 1990, I recommended long-term government bonds. Later; in 1994, I began recommending Real Return Bonds. (At one point my client base held 1% of all the Real Return Bonds in Canada.) As interest rates continued to drop, clients enjoyed annual rates of 8%, 10%, and even 12%, on these investments.

In the summer of 2005, however, I recommended converting all of one's long bonds to cash. Why? Well, remember that there are two components of bond returns: one is the yield; the other is continuing change in the price of the bond.

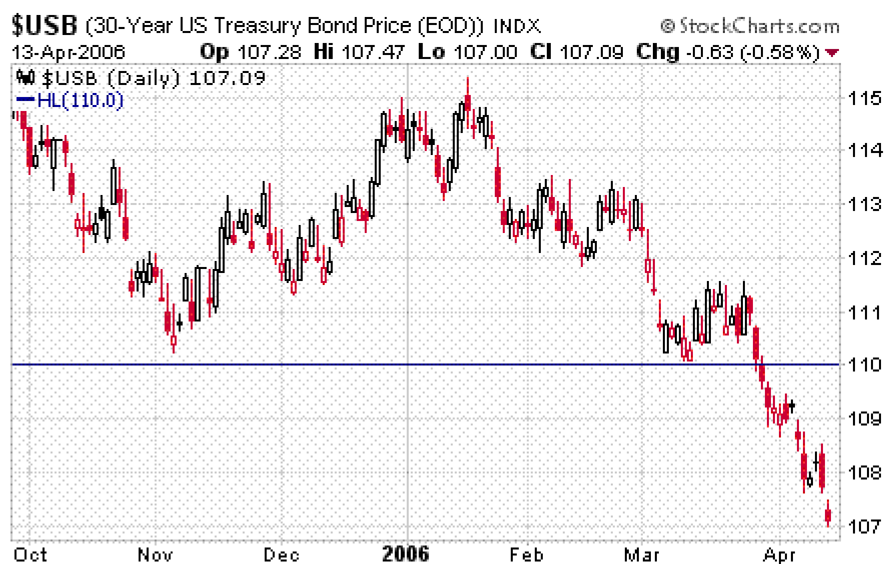
As an example, in December of 2001, investors could have purchased a Government of Canada 5.75% bond, due December 2023 at a price of $100 per $100 bond. By December 2005, that bond had a market value of $129. Therefore, in four years investors received the 5.75% as well as an additional 29% gain on the value of that investment in their portfolios. Not bad at all for a boring old government bond – in fact it's better than 12% per annum.

But obviously, investors can't keep earning 12% from a 5.75% bond. At some point bonds trading at a premium are bound to drop in price; and in fact that is just what has started to happen. The 10 year Government Bonds peaked in price in September, 2005, and the 30-year Canadian Bond peaked in December.

This brings me back to my point about cash. I have included below a table of the returns on various government bonds in the first quarter of 2006:

Bond	Yield Dec. 30 2005	Yield March 31/2006	Change in Price	Total Return for 1st Quarter	Annualized Return
5-Year Cda	3.93%	4.13%	-0.93%	0.05%	0.20%
10-Year Cda	3.98%	4.26%	-2.17%	-1.18%	-4.72%
25-Year Cda	4.05%	4.26%	-3.30%	-2.29%	-9.15%
Long Real Return Bond	1.45%	1.60%	-3.00%	-2.34%	-9.35%
CASH	**3.15%**	**3.25%**	**0%**	**0.8%**	**3.2%**

Although it may seem painful to be in cash, clearly a positive return is better than a negative one. And the yield on cash is likely to increase. Moreover, with commodity prices continuing to push higher, and with wage inflation rising, bonds will likely continue to decline in price as long-term interest rates rise.



For those who like to follow the charts, the long-term bonds are currently in a head-and-shoulders pattern, which would suggest a 21% decline in price over the next 18 months. Sound far-fetched? That would put 20-year yields at 5.6% - which is still quite low based on historical averages. In such a scenario, the total return for a 20-year bond would be -22%.

Cash of course, is not a long-term strategy; but cash is the best place to be until the upward trend in interest rates reverses.

One of my primary concerns over the past two years has been the devaluation of the US dollar. I have urged clients to concentrate on Canadian dollar investments, and to hold gold and gold shares since gold tends to move in the opposite direction to the US dollar. The Canadian dollar has, in fact, risen; and gold has doubled in value relative to the US dollar over the past four years.

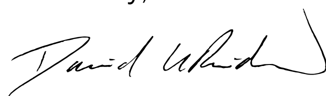
This brings me to another recommendation for a way to profit from the declining US dollar – the Yen. Currencies which have been allowed to float on world currency markets have mostly risen against the US dollar. The Canadian dollar, the Euro, the British Pound, and even the Mexican Peso, have all risen against the US dollar. However, Asia has been a major exception to this tendency. Countries such as China, Japan and Korea have all held their currencies down like a balloon under water. The central banks in Asia have been selling their own currencies and buying US dollars as a way of offsetting market forces of supply of demand. No where is this more the case than in Japan.

Japan has accumulated more than $850 billion US dollars – the greatest central bank intervention in the history of the world! There is evidence, however, that Japan is now reducing its US dollar purchases. Moreover, Japan has indicated that its 0% interest rate policy is about to end. The world is simply awash in US dollars, and as Japan moves from 0% interest rates, global investors will inevitably be more willing to hold Yen denominated assets. One way for individual investors to hold such assets is to buy short term Yen-denominated bonds.

Is the US dollar devaluation going to continue? It looks that way, since conditions which have sent the US dollar lower have not improved. These include a trade deficit of over $60 billion per month, rampant government spending (Bush has yet to veto one spending bill), low real interest rates. The growing protectionism evident in recent the United States policies and pronouncements is also troubling.

If you would like to discuss cash, bonds, Yen, or any other investments, please do not hesitate to give me a call.

Sincerely,



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