The Bonds of Interest

By The Mogambo Guru

09/26/05 Retirement. What comes to mind when that word is uttered? Traveling the world in a Winnebago. Spending the days reading on the beach. Well, The Mogambo tells us that to get there, we'll have to save 100% of our income just to offset roaring inflation…

It was very interesting to me to read the letters to the editor in Barron's this week. Five of the eight letters were in reference to the Barron's article by Alex J. Pollock, dated September 5, 2005 entitled, "Can You Afford To Retire?" It uses these long-term averages to calculate how much money you will need if you want to retire for 20 years after working 40 years. In short, you somehow amass enough money that two days of working will be able to finance one day of retirement.

The basis of his astonishing investment return calculation is that you will get, on average, a real, inflation-adjusted, yield in Treasury bonds of three percent. Hahahaha! Now you are starting to see why I initially dismissed the article! Inflation is now running, according to the just-released CPI report, at 3.6 percent! Ten-year T-bonds are yielding 4.27 percent! This is a real, inflation-adjusted, yield of 0.67 percent! And this has been going on for years already! So, the idea of bonds yielding, after inflation, an average 3 percent, Makes The Mogambo Laugh With Scorn And Contempt (MTMLWSAC).

But suppose that the long-term average yield on bonds really is a lofty three percent. Then that means that T-bonds, right now, should be yielding 6.6 percent. But, but, but, they are not yielding that! They are yielding a lot less than that. That means, to get back to the three percent real, inflation-adjusted, yield, bonds have to start not only yielding 6.6 percent, but also more than that! They have to yield more to make up for the last few years where you were making a lot less than three percent. Currently it's about 0.67 percent, and it has often been a lot less than that. If they don't, then the long-term, real yield would be less than three percent, which violates the constants we all stipulated to at the beginning. So, now we are talking about a nominal yield of eight to nine percent! Hahahaha! And not only that, but the guy makes no adjustment for the taxes you are going to pay on those capital gains when you sell the bond, the taxes on the interest, or as is the case in the real world, both.

I know that you are happy that you are suddenly making eight to nine percent, and you are doubly happy that we are ignoring taxes. Already I can see your mind working on how you are going to defraud the taxman. As an aside, let me advise you to never, ever cheat on your taxes, as the penalties they can levy on you will break your back, break your heart, and consume your whole life; as you think about it, fret about it, and have nightmares about it. You will worry about it every waking moment, and the few lousy dollars that you are ahead cannot possibly be worth it, especially after paying the lawyer, to try to keep you out of the slammer. The way to pay fewer taxes is at the ballot box; when you get rid of the big-spending morons you accidentally elected last time, because you showed up at the polls either stupid or drunk, or as in the case of The Mogambo, both. And if you are from Massachusetts…yes, I am especially talking about you.

But this is not about taxes, or why the halfwits we elected to Congress have made inflation so high with their socialist spending programs and entitlement programs that are now supporting a full third of all Americans. This is not even bringing up the horrid Federal Reserve, a secretive cartel of private banks who cleverly put the name "federal" in the name they chose to make people think that it is a government agency, but it ain't, even though their incredible stupidity makes them seem like a real government agency.

Alex J. Pollock: Where Are You in the Business Cycle?

No, this is about what we professionals in the economics business call The Mogambo Big Freaking Point (MBFP): It all depends on where you are in the business cycle. Write this down in your notes. You will find it very instructive in the years to come. Here is my iron clad, unassailable reasoning. Today you are getting a real yield of about a half of a percent, right? So, to get back to a real yield, interest rates have to go to – and let's be conservative – eight percent.

But what happens if you buy a bond today, one that yields that real 0.67 percent that we were laughing about earlier? When interest rates rise to that long-term average of eight percent (which is, as we know, about double – double! – what today's ridiculously over-priced bonds are nominally yielding today), the market price of the bond that you are now so proudly holding will plummet to less than half what you paid for it! You will realize a loss…a big loss…a huge capital loss if you sell! Huge!

And if you don't sell the bond before maturity, you will be stuck with that damned silly, embarrassingly puny 4.27 percent yield, when everybody else is making eight percent, until the damn thing matures! I will leave it up to you to imagine how your career will fare, when every day at work people will laugh at you and say "Hahahaha! Mogambo is a big fat idiot who locked us into getting half-a-percent interest on our money for the next twenty years!"

The Mighty Extra-Sensory Mental Powers Of The Mogambo (MESMPOTM) are abuzz, meaning that I know what you are thinking. You are wondering, "Does any of this impress pretty girls or boards of directors?" Unless you are a woman, then you are thinking, "Does any of this impress hot hunks with tight buns or boards of directors?"

Let me tell you, from a guy that knows first-hand that boards of directors are not happy when you report that, through your own ignorance, stupidity and poor judgment, the firm's money is locked in for twenty long years, generating almost nothing in return. In fact, boards of directors are usually far beyond merely "unhappy." They are more toward the end of the spectrum where they summon security guards to clean out my desk, and they steal my stuff while they do it…important stuff…personal stuff, like that autographed photo of President Bush I had on my desk, where he has written, "I hate your guts, too! Now stop insulting me, you stupid little jerk."

I will not even comment on the stupidity of thinking that everybody can make money in the stock market. They can't. If everyone puts 10 dollars into a bucket, then it is impossible for everybody to take twenty dollars out of the bucket. Jeez! You would think it would be obvious!

Remember that part where I said that it all depends on where you are in the business cycle? Well, we are only talking about today. Stocks and bonds are a bad, bad idea today. There was a time when buying bonds was a really, really, good idea, and they were paying above their long-term, real, inflation-adjusted average! Then, when interest rates fell, as they inevitably do, the bonds went up in value! This ain't, in the vernacular, nowhere near that time no how.

And there was a time when buying stocks was a very, very good idea, too; back when the P/E ratio was below its long-term, real, inflation-adjusted, average, too. As with bonds, this ain't that time, either. This ain't, again, nowhere near that time, no how.

Alex J. Pollock: One Day's Pay for One Day's Retirement

The sad truth is that inflation will destroy whatever little bit of money that you set aside, as it is currently destroying the little bit of money that you have been setting aside, especially for the last five years. The sad, sad truth is that you will need to save at least one day's pay for one day's retirement. In other words, you must save 100 percent of your income if you want to have enough money to offset the roaring inflation that we are going to have over the next decades!

So, how bad is inflation? Alert reader Mike S. sent me the table of inflation calculated by Freebuck.com, using the same components of the official consumer price index, but calculated by merely looking at the price of something in 1968, and then looking at what the item costs now. Both of the statistics have housing at 40 percent of the total market basket.

So, what is the bad news? Well, first off, the official government number is that annual inflation has averaged – and I hope you have a safety helmet on when you hear this – 4.71 percent since 1968! This is, in historical context, so horrifically bad that is ranks as one of the longest and worst episodes of inflationary misery in our history. After the paramedics have restarted your heart, tell them to stand by, because next you are going to learn that the Freebuck.com people show, and quite easily, too, that inflation is really running at 5.96 percent

That six percent inflation is, coincidentally, less than the real, wallet-busting, prices-you-pay type of inflation that is roaring right freaking now! Actually, true inflation is somewhere between seven percent and 11 percent, as far as I can tell, and I get that from looking at the checks I have to write every damned month. It is the worst in decades, judging by the number of tears that I shed while paying those bills.

Notice I said "decades," although you were probably distracted by watching the way little drops of spittle fly out of my mouth when I say it with such vehemence and how sparks of outrage are shooting out of my ears. So, I will repeat: You must save 100 percent of your income to stay ahead of inflation if you think you are going to work for 40 years and retire for 20.

Regards,

The Mogambo Guru
for The Daily Reckoning

September 26, 3005

The Mogambo Sez: Gold is, if you have been reading the newspapers, on a tear, as more people than just you and I recognize that only precious metals can save us now.

And in response to all of you who want to know if the government will again confiscate gold, the answer is “yes,” but not now, nor anytime soon. One day, when consumer buying has completely dried up because nobody has any money, and the few people who do have any money cannot afford to buy anything because inflation is off the charts, the government will get the bright idea to confiscate your gold; or your house; or your car; or your retirement accounts; or anything that you have that is worth something; and put dollars in your hand, hoping that you will run out and buy something.

That this day is coming is foreordained, as there is no way – no freaking way, no freaking way in hell – to stop the collapse of the despicable economic system that has evolved in this country. If there was a way – any way at all – then one other country in the whole history of countries that have gotten themselves into this kind of mess, would have thought of it by now. None have, although they have tried everything, even the stuff that they already knew would not work. Then they went to war. Which merely finished them off.

Welcome to fiat currency, fractional-reserve, deficit-spending hell. They call it “hell” for a reason.