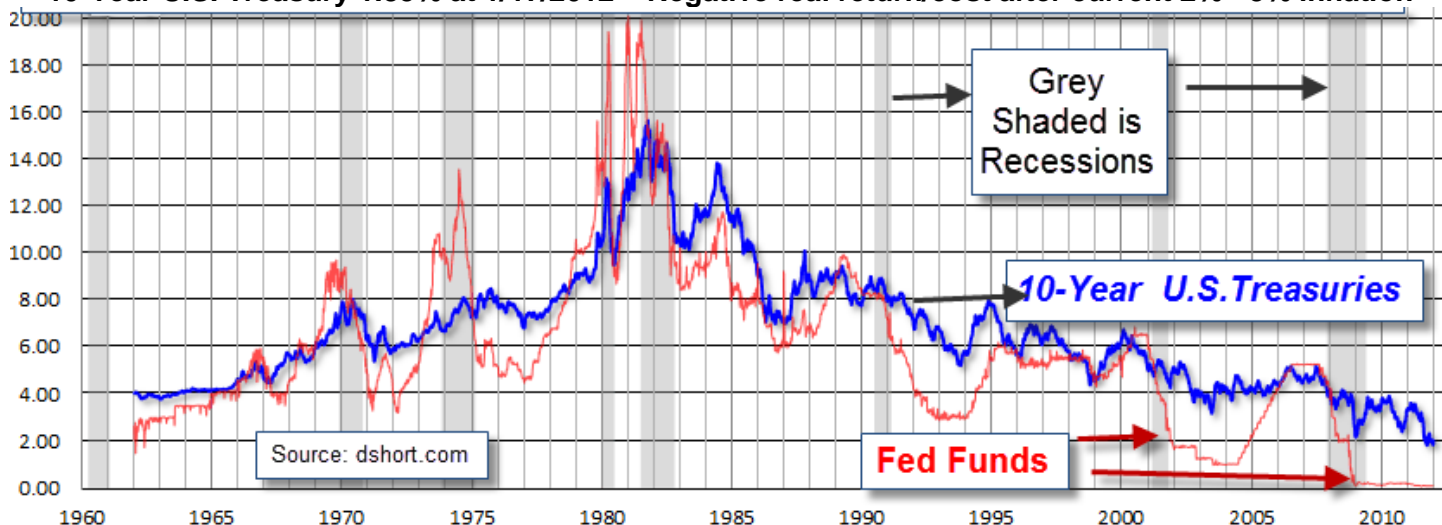


## Bond Outlook for 2012

Obviously there is no current “debt crisis” in the U.S. bond market

10-Year U.S. Treasury 1.85% at 1/17/2012 – Negative real return/cost after current 2% - 3% inflation



### Non Treasury bonds

Most bonds trade on a "spread" based on comparable risk over U.S. debt. Bonds if sold before maturity go up in value as rates decline and lose value when rates increase.

Bond investors have enjoyed overall declining rates for about the last 30 years, resulting in good total returns (Yield + Value) for many bonds.

### Interest Rate Risk

There is large potential downside risk if interest rates increase significantly, unless bonds are held to maturity. If held to maturity there is still the “opportunity cost” loss since you are getting a lower yield than if you had invested after rates have gone up.

If interest rates go up to 5% and you hold a 2% bond with, say, 9 years to maturity - your loss would be about 21%. The lower the current yield or the longer the maturity, the greater the interest rate risk. For more and to calculate any bond, you can use <http://www.free-online-calculator-use.com/bond-value-calculator.html>

MarketWatch 1/3/12 – “Interest rates are going to rise eventually. When that happens bond fund investors are going to get beat up substantially because historically rates move faster than small investors do.” This was from article “Your major risk in 2012 is missing the upside” which discusses the massive outflows by smaller retail investors from equities to bond funds vs. “smart money” like Warren Buffet –

i.e., Realizing the bond risks and instead buying equities.

### Excess U.S. Debt Long-term Risk

Interest rates could move up by action of the Fed to let rates normalize, to combat inflation, or if a “real” debt crisis develops in U.S. debt.

FitchRatings in late 2011 downgraded the U.S. debt outlook to negative, based on Congressional stalemates. Fitch warned that the U.S. debt could lose its AAA status in about 2020 if no action has been taken to slow the growth of U.S. debt. Relative to its global peers: “Fitch recognizes that the U.S. can support a higher debt burden for a given rating level. However, as debt rises, the fiscal space to absorb future economic and financial shocks diminishes and the risks of a fiscal crisis correspondingly increase.”

“Fitch believes that at least \$3.5 trillion of deficit reduction measures will be required to stabilize federal debt (held by the public) at around 90% of GDP in the latter half of the current decade.”

### Bonds with More Favorable Outlook

- 1) Carefully selected high yields, which historically do well in recoveries, with less interest rate risk.
- 2) Carefully selected foreign bonds with higher interest rates, but from strong countries without heavy debt burdens. For clients seeking such bonds I have extensive details on these options and specific recommendations. -- Continued next page --

## Bond Alternatives

For some investors, there are alternatives for those seeking higher income or longer term return potential, such as floating rate secured debt backed by assets of strong companies – the most secure asset class historically. Yield and value can increase if interest rates rise.

## Record Excess Demand for U.S. Debt

(Bloomberg News 12/28/11 Highlights) The U.S. government received record demand for its bonds in 2011. Congress may have little difficulty financing a fourth consecutive year of \$1 trillion budget deficits. The Treasury Department attracted \$3.04 for each dollar of the \$2.135 trillion in notes and bonds sold - the most since the government began releasing the data in 1992. The U.S. enjoyed an all-time high bid-to-cover ratio of 9.07 for \$30 billion of four-week bills it auctioned on Dec. 20 even though they paid zero percent (yes 0%) interest. (This means 3-9 times the demand by investors for U.S. debt over what was offered at Treasury auctions.)

The spreading sovereign debt crisis in Europe and slower global growth are driving investors to the safety of U.S. assets, helping to contain borrowing costs and making it cheaper as a percentage of GDP to finance deficits than when the nation last had budget surpluses under Clinton.

## Cheap Debt Financing Deficit

Low interest rates on U.S. debt meant that interest expense accounted for just 3 percent of the economy in fiscal 2011, down from 4 percent in 1999.

As of 12/31/11 the 10-year Treasury yield was 1.87% - with inflation between 2-3% the real return after inflation was negative. 5-year Treasuries ended 2011 at 0.83%, and 13 week Treasury bills at 0.010%

the 10-year Treasury yield was 6.57% in January 1993 at the end of the elder Bush's presidency, down from 9.54% in early 1989 when he took office. Yields have averaged 4.92% since Bill Clinton was sworn in as President in 1993 (as of 12/31/11).

## Money Market Fund Concerns

Many money funds are waiving part of their fees to keep their value at \$1. The largest money market fund, Fidelity Cash Reserves, pays one of the best yields at a mere 0.03% (7-day yield 1/5/12). It still has to waive part of its 0.37% management fee. Without the fee waiver the yield would be -0.02% (latest as of 11/30/11). Its total 2011 yield to investor was 0.01%. It appears its increased recent yield is from larger holdings in Bank of Tokyo-Mitsubishi (yielding 0.4%-0.5%), ING Bank and Rabobank in the Netherlands (yield 0.27%-0.50%); Credit Agricola, National Australia Bank and Bnp Paribas all listed in the top 9 holdings. On 12/15/11 Fitch downgraded Bnp Paribas due to its Italian exposure. Fidelity may have cut its Bnp holding after the latest Morningstar portfolio data.

1/1/12 MarketWatch - Another wave of money-market fund closings - With interest rates near zero and unlikely to go anywhere during an election year, more fund companies will simply give up on money funds. The problem is not really that the funds aren't making shareholders any money; it's that they're not making money for the fund sponsors.

**Bonds often are bought at a "premium"** because they were issued a few years ago and have higher coupon rates (yield) than similar bonds today. Therefore, you buy them at a premium from their "par" "face" or maturity value. However, if you hold until maturity in a few years you will lose the premium since you will only get the face value back. Taking this into account, "yield to maturity" is often less than the current yield.

**Bonds vs. Bond Funds?** - The spread on corporate bonds can be between 0.5% and a huge 5% as reported by CBS: "No this is not a typo. You will, unfortunately, have no idea that you are paying these hefty fees to the market maker. This is one of the financial industry's dirty little secrets." This is just one reason the article favors bond funds vs. individual bonds. This is also the case for municipal bonds, where the spreads can be as high as 2%-5% CBS Moneywatch.com

## My Approach

As there are always market risks, I recommend:

"Participate yet Protect" strategies especially for longer-term investments to help minimize the effects of future market crisis.

Alternative opportunities without stock or bond market exposure for more cautious investing in what we believe are various timely opportunities.

**Required Disclosures:** Past performance does not assure future results. Investors cannot directly invest in indices. There is no assurance that objectives will be met. Yields subject to change. High yield securities may be subject to greater fluctuations in value and risk of loss of income and principal than higher-rated securities. Fixed income investments entail interest rate risk, the risk of issuer default, issuer credit risk, and price volatility risk. Funds investing in bonds can lose their value as interest rates rise and an investor can lose principal. Additional risks are associated with international investing (especially in developing countries), such as currency fluctuations, political and economic stability, and differences in accounting standards. Loan investments are subject to interest-rate and credit risks. Floating rate loans tend to be rated below-investment grade and may be more vulnerable to economic or business changes than issuers with investment-grade credit.

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