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THE PETE ANDRESEN INVESTMENT NEWS ANDRESEN & ASSOCIATES

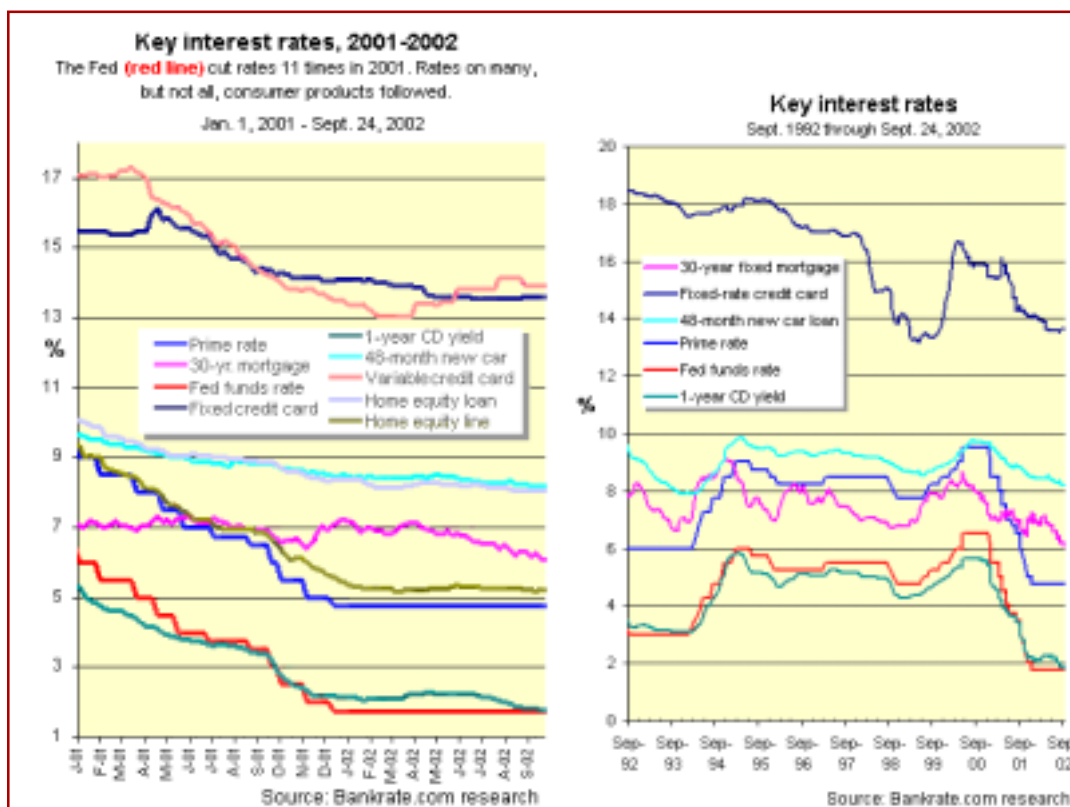
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WATCH OUT FOR THE BOND BUST

We may be about to experience yet another market breakdown. This new investment implosion could reshape the way we face retirement, alter the fabric of our financial institutions, and even threaten our homes.

I'm talking about a collapsing long-term bond market caused by rising interest rates. When interest rates go up, bond values go down, and mortgages become more expensive. Also, the issuers of mortgages have to work for their net income much more aggressively than they do in low interest rate environments.

What evidence do I have for such an assumption? First, interest rates are profoundly low right now, as low as they've been in decades. Unless we experience a Japan-style deflation, which I don't see happening right now, interest rates are due to rise gradually in our recovering economy as simple demand for capital creates more competition for loans. At the moment, we've got lots of supply and relatively little demand, which is keeping interest rates flat.



When the economy recovers, the Federal Reserve will slightly tighten the money supply to keep inflation from booming. That will also exert a slightly upward effect on interest rates.

Inevitably, with the Iraqi War looming and repeated terrorist strikes in the cards, we will grow a federal deficit, which means that the Treasury will belly up to the bond market bar. That means greater demand for money, which in turn means higher interest rates.

Should the Terror War continue and become a chronic condition of life, as we may expect, increased defense spending and the resulting employment will boost wage-driven inflation. This may not be much, but it will be enough by itself to cause at least a moderate pullback in the bond markets. And if oil prices go up as well, we may expect the bond market to contract even more profoundly.

Investors who hold longer-term bonds and never-maturing preferred stocks, which act like long-term bonds, might be profoundly damaged by simple bond price declines. Investors in junk bonds won't see the same rate of principal loss due to interest rate increases. However, they may see bond devaluations as the underlying companies experience problems making debt payments. In a nutshell: keep bond maturities short, and credit quality high. If you've got long-term bonds, consider selling them.

Avoiding an adjustable rate mortgage is a conservative choice right now. Yes, I know this kind of mortgage is cheap, but it may become very expensive if rates go up. The last time we had this experience, in the late '70's and early '80's, home owners in some cases simply couldn't make the higher payments on their ARM's, and lost their homes. Especially risky are those 5 years or shorter adjustable rate mortgage offers on the Internet. They exist to trap you and make you renegotiate when the rates may be higher in a few years.

If interest rates rise gradually, as is most likely, then owners of short-term bonds should not be unduly impacted. Likewise, fixed rate mortgage holders should do well. The stock market should provide attractive gains if earnings recover to offset the increased cost of financing. Bank stocks will reel from the increases, and we'll find out, as we always do after a market decline, that some of them have let their business techniques get sloppy. Expect yet another round of financial restructuring, a housing market that retracts at least a little, and a troubled Ginnie Mae market.

How can we take advantage of this? Gold and energy stocks will rise only if inflation comes roaring back, which seems unlikely right now. More attractive are the inflation-resistant, economy-positive basic industry, medical, and commodities stocks, all of which may be found in bulk in any value mutual fund. Later, if interest rates get high enough, we'll also move from short-term bond mutual funds to actual mid-duration Treasuries, to lock in the rates.

I might be wrong, but it doesn't take much to be safe: just stay away from long-term bonds, preferred stocks, and ARM's. Oh, and invest in basic value funds. But you knew that already, didn't you?

Office Notes: Our office manager, Terry Iverson, has decided to explore the exciting world of agricultural produce brokerage. This is not a new adventure for her: before children she worked extensively in the field. We wish her all the best! After living with the

NASDAQ, she's ready for anything!

The office of Andresen and Associates will be closed November 28th and 29th for Thanksgiving. Enjoy your holiday!



Relationship between Bond Prices and Yields

It is important for investors to understand the inverse relationship between bond prices and their respective yields.

