ISSUE 12 | VOLUME 3 | JUNE 2015

Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Stocks Over Bonds? Think Twice.

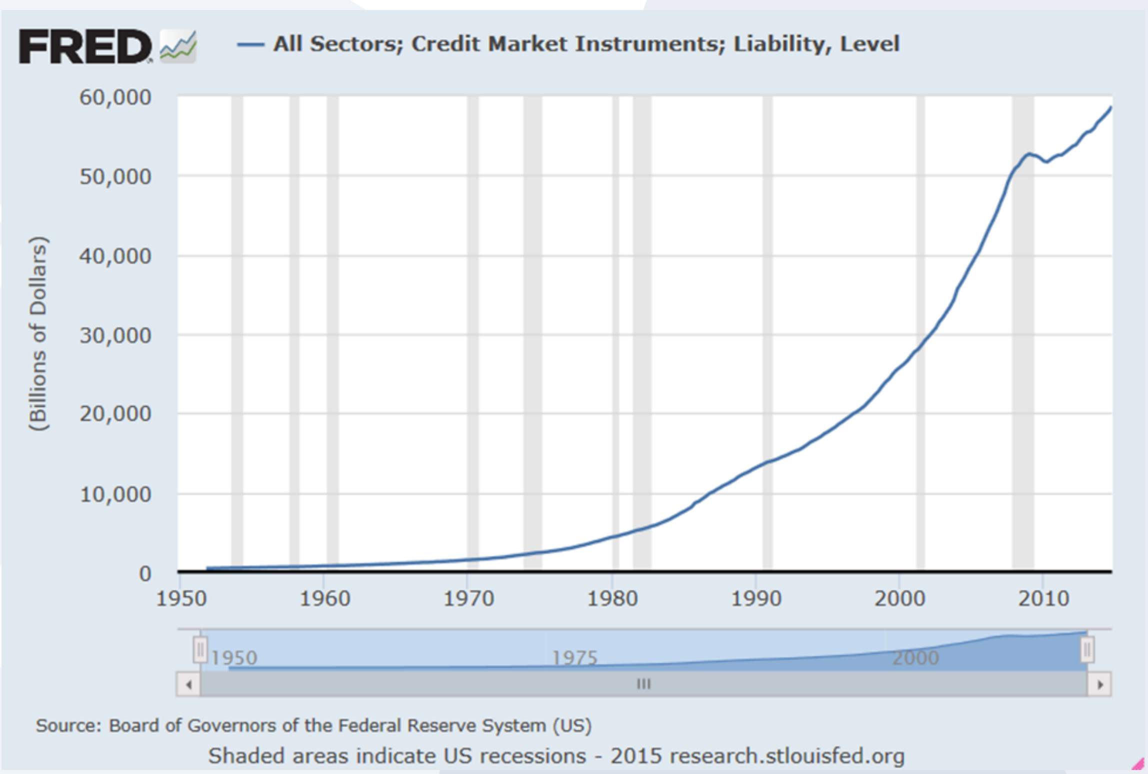
Over the last 2 months, there's been some pretty gloomy weather parked over bonds. Interest rates on 10-year U.S. Treasury Bonds have risen from 1.88% to 2.19% as of the time of this writing and for the longer duration 20-year U.S. Treasury Bond, that rise in rates has equated to an 8% drop in price as indicated by the Exchange Traded Fund (ETF) TLT. If you're an investor seeking safety in government bonds, you haven't found it. Bonds have experienced more volatility, and have lost more money, than stocks since late March. If you're ready to follow the guidance of the majority of talking heads on Wall Street and eschew bonds in favor of stocks, you may want to think twice.

For years interest rates have been low and for just about as many years we've been hearing that they're destined to rise. We could define low any number of ways depending on how far back we go to gain relative perspective, but the low we're talking about now is since short term rates were dropped essentially to zero in the wake of the financial crisis in 2008. It's from this rock bottom level that experts proclaim – and logically so – that rates have nowhere to go but up. True, when talking about short-term, central bank driven rates, but not necessarily true when looking at longer-term, market driven rates. That's an important distinction that most miss, but it's critically important when thinking about how to invest for the future.

We would agree with the majority of experts who feel short term rates will rise relatively soon. At zero, they really can't go much lower and at some point in order to preserve credibility, the Federal Reserve will probably raise them, even if only a little. Long-term rates however, aren't such a sure bet. The Federal Reserve, as much as it would like it to be the case, doesn't have direct control over long term interest rates. The market is the key driver here, and if it doesn't buy into the Fed's ability to stimulate the economy and create inflation, then rates could stay low for a while. The conditions that lead to higher rates are economic growth and inflation. Eventually overcapacity and overinvestment will push rates toward the top of their range in a business cycle, but that's not even a consideration now. We're all still trying to figure out if the economy is going to improve, 7 years after the last recession – which by the way is a point that shouldn't be dismissed. In most economic recoveries, things spring back to life fairly early with steady improvement over time, leaving no doubt as to what's actually going on. That's not the case here, and it hints toward a different story.

What we're most likely witnessing at the moment is what an economic recovery looks like when the planet is so burdened with debt that people simply can't afford to spend much more money on anything else. That's not to say they don't anyway, because after all, old habits die hard and spendthrifts can't be transformed into savers overnight, but rather the rate of spending that we've grown accustomed to over the last 30 years has to slow. This turning point, where spending begins to decelerate due to the high cost of servicing debt, is referred to as "peak debt", and there's a good chance we're very close to it if not experiencing it right now. Under these conditions, the economic acceleration and inflation that a good number of experts are calling for - and the basis for their rising rate predictions – seems unlikely, at least to any great extent. Rather, there could be an argument made, and we're making one, for historically low longer-term rates to remain in place for quite some time as this peak debt cycle unwinds. Central banks are pushing on a string trying to get broke people to buy things by making money cheap. A purchase made with borrowed money, even at a low interest rate, still creates a payment. Consumption fueled by debt rather than wage increases has limits, and we're bumping up against them now.

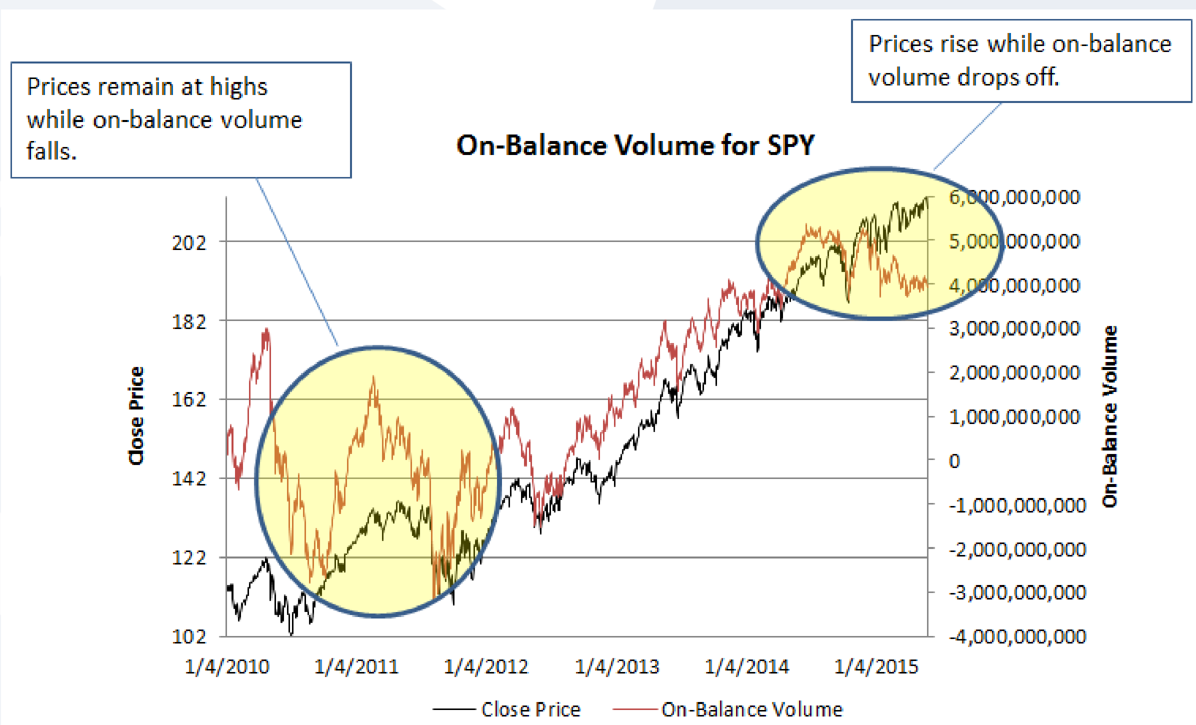
Instead, corporations are refinancing debt they already have, taking on new debt to buy back stock, and engaging in any other financial engineering scheme they can think of to manufacture more earnings for their shareholders. (We shouldn't forget that corporate executives are among the most interested shareholders, much more so than an investor whose shares represent a small portion of their overall diversified portfolio). So this central bank push isn't really trickling down to the consumers that truly drive economic growth. Instead it's only inflating asset prices beyond where they'd normally be if money weren't so cheap. That may bode well for markets, but it doesn't do much to help a flagging economy or to fix the biggest inhibitor of lasting and sustainable growth – huge levels of debt. In fact, according to a study by the McKinsey Global Institute earlier this year, it only serves to make the debt problem worse. Their study finds that as of Q2 2014, total global debt grew by $57 trillion from $142 trillion in Q2 2007 before the financial crisis. Here in the U.S., as you can see from the chart below, we've also thrown a few more purchases on the charge card, adding $11 trillion to the debt balance since Q2 2007 – a rather steep price for economic growth.



So the volatility that we're experiencing in the bond market will unfortunately be par for the course as conflicting data inputs, trading programs, and internal and external forces continue to yank markets around. A couple big, well-respected portfolio managers in late April made statements about how German bond (bunds) yields were so low that betting on them rising was one of the best opportunities out there. One of them went so far as to say it was an "opportunity of a lifetime". These statements likely caused the markets to react and German interest rates to rise almost immediately, and very dramatically. Add to this that some positive economic data came out of Germany shortly thereafter, and rates had further reason to rise causing quite a bit of chaos in global bond markets. This rise in German rates most likely affected our rates here at home, contributing to the sharp decline in bond prices recently. This is our new reality. We can expect price moves that result from very indirect causes such as issues in Germany or the European Central Bank making statements as to their policy actions. We can even see price volatility attributable to things that can't be pinpointed so easily. In a world filled with financial alchemy, central bank meddling, and high speed computers, volatility can spring up from nowhere. This is true for any asset class at any time. Bonds have been the unpopular investment recently, but the same type of volatility and negative sentiment can and will surround the other asset classes when the winds change. Diversification is more important today as it ever has been. Tomorrow may usher in different weather that is much more favorable to bonds and less so to the winners of the day.

A Storm Cloud on the Horizon?

The path of least resistance for the stock market continues to be up. Although prices have fluctuated within a fairly tight range since the beginning of the year, the S&P 500 is up just under 3%, which is enough to keep stocks in good standing with most. However, when we look at the volume of shares traded in the popular ETF SPY (SPDR S&P 500 ETF Trust), we can see that volume on the down days has been higher than that on the up days. When plotted, this is represented by the on-balance volume line, which we can see in red below. What's very clear is that although SPY is continuing to move higher, it's on-balance volume line is moving lower. This divergence could serve as a red flag and a clue as to what the "big money" may be doing. We saw a similar trend in early 2011, where on-balance volume trended lower even though the market wasn't. A 20% correction ultimately arrived in August of that year. No one technical indicator is perfect, and there can be various reasons why they indicate one thing versus another, but when potential losses start to outweigh the remaining potential for gains, their messages should be taken seriously. This is further reason for diversification and prudence.



Key Takeaways:

- Due to "Peak Debt" conditions, sluggish economic growth will keep interest rates low until meaningful deleveraging takes place.
- Expect volatility in the bond market as competing points of view and a plethora of variables drive prices—and on the flipside, rates—in either direction.
- Given macroeconomic conditions and valuations in both stocks and bonds, we view risks in stocks to be greater over the short to medium term than most high quality bonds.

The Student Loan Conundrum

In today's fast moving economy, having a college degree is becoming more essential than ever. According to finaid.org, a Bachelor's degree is worth $1.2 million more over a working lifetime than a high school diploma. Not only do holders of a college degree earn more, but unemployment rates in 2014 for bachelor's degree holders (3.4%) were also much lower than for high school graduates (6%).

But a dangerous trend has been taking effect. Student debt has risen as the cost of college continues to increase and more people are using loans to help pay for it. In addition, the students ability to pay off this increased debt burden appears to be waning. Consider the following:

- Only 29% of borrowers are current on their student loans and decreasing the balances while 17% are either delinquent or in outright default. (Source: New York Fed Consumer Credit Panel / Equifax)
- Between 2004 and 2014, there was an 89% increase in the number of borrowers and a 77% increase in the average balance size. (New York Fed)
- The mean outstanding balance has grown to $26k.
- Borrowers in their 30's and 40's have the highest mean balance at about $31k.

In fact, as of the end of 2014, total student loan balances were almost $1.2 trillion dollars making them the second largest outstanding debt, behind only mortgage debt.

So what are the greater macroeconomic effects of all this student debt? Let's explore a few examples.

As noted above, the average student loan balance is now $26k. So, in addition to trying to find gainful employment once they graduate, today's students have a sizable repayment note they need to begin making shortly after graduation. Many college graduates are choosing to move back home with their parents (hence the term "boomerang children") instead of incurring the cost of new housing. The Great Recession has also hit this group particularly hard as lending standards have tightened. Now, in order to buy a house, a much larger down payment is required than in the pre-2008 world. A down payment requirement of 20% or more is often mandated for those with little or no credit history (the position many recent college graduates find themselves in). So for those new graduates looking to buy a $200k house, a $40k down payment makes for quite a hurdle. Even with historically low interest rates, the percentage of home owners has continued to drop from pre-recession levels. No doubt, higher student loan debt has contributed to this home ownership decline. In addition, consider the collateral damage to all of the other jobs and businesses associated with the housing industry as home ownership has dropped.

Another impact of increasing student loan debt is household formation. The average age of couples getting married and starting families has continued to rise. With one or sometimes both parties having substantial loan payments, money that is normally saved for a new house, or just to build savings for all of life's other costs is not there. People find themselves delaying starting a family in order to advance in their careers and take that next step to higher income in order to save what prior generations were able to save right out of school.

Overall economic consumption is also effected by ever larger student loan balances. As noted above, home ownership is down and people are starting families at an older age. All of this delays purchases which help drive the economy. It is conservatively estimated that the average cost of raising a child is about $250,000. So as family formation is delayed, the portion of that $250,000 which goes to goods and services is not being spent. With student loan balances and defaults continuing to grow, this slowdown in consumption will not only continue but likely increase as well.

Finally, it's not just students and recent grads who are feeling the burden of student loans and college costs; parents are absorbing them as well. According to a survey by T.Rowe Price, 30% of parents plan on paying for college with 401(k) money. A further 31% plan on using funds saved in 529 plans. And finally, because money is being diverted from retirement savings toward the increasing cost of college by way of either saving for it directly or taking on increasing levels of debt, 49% of these survey respondents plan on putting off retirement and working longer. So, expect consumer spending to trend in the wrong direction as parents play catch-up with their own retirement rather than spend.

Proper planning for college costs is more important now than ever to make sure college graduates are not saddled with large student loans to begin their careers and parents are not putting off their retirement years in order to pay for it. It would also help if college costs stopped rising so rapidly. Based on the unfavorable trends we've discussed, basic principles of supply and demand may help us with that over time.

Key Takeaways:

- A college education is more essential now than ever.
- Due to the continued rise in college costs, student loan debt has grown to $1.2 trillion – now the second largest private debt, next to mortgage balances.
- Defaults are increasing as students are finding it harder to pay down increasingly larger loan balances.
- The impacts to the overall economy are far-reaching with the main theme being reduced consumer spending.

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