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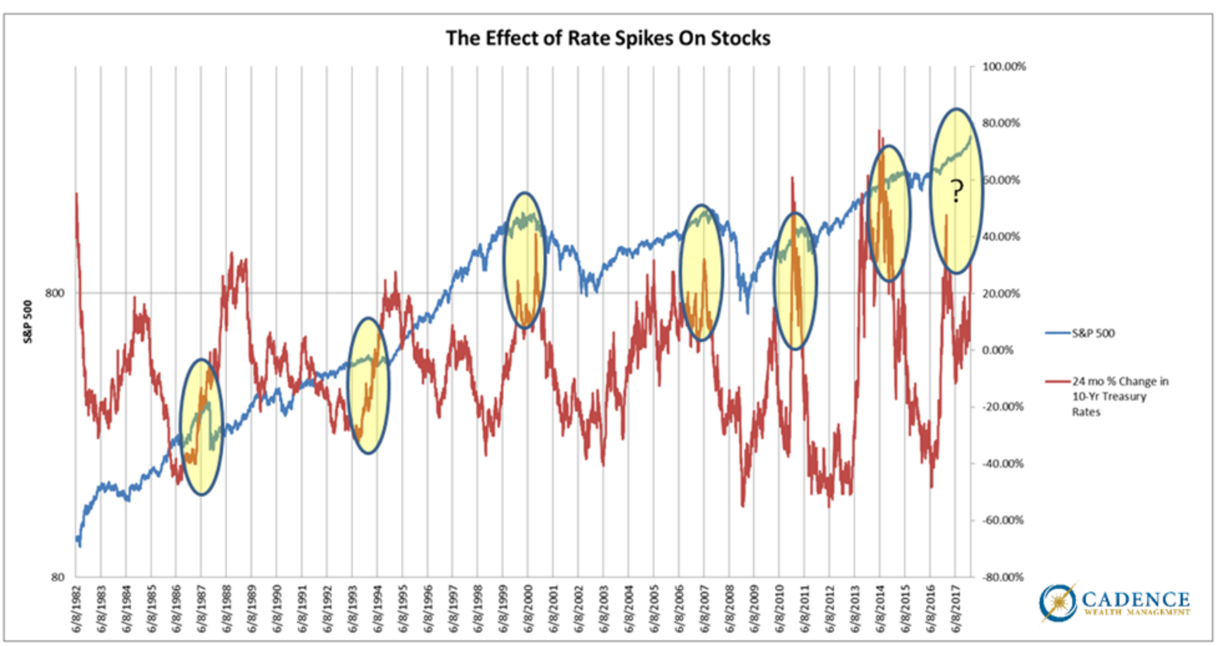
Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Bonds and Interest Rates Matter

As we've discussed, bubbles are dynamic and as a result, different each time. But one common theme among them has been the tendency for interest rates to play a role in their eventual demise. Rising rates are contractionary. When they rise, marginal borrowers get pinched as debt service costs go up and the rollover of existing debt becomes harder to carry out. As borrowers experience distress and eventual default, credit conditions tighten which essentially halts any economic expansion in its tracks. The more debt and leverage in the system when this happens, the more severe the effects.

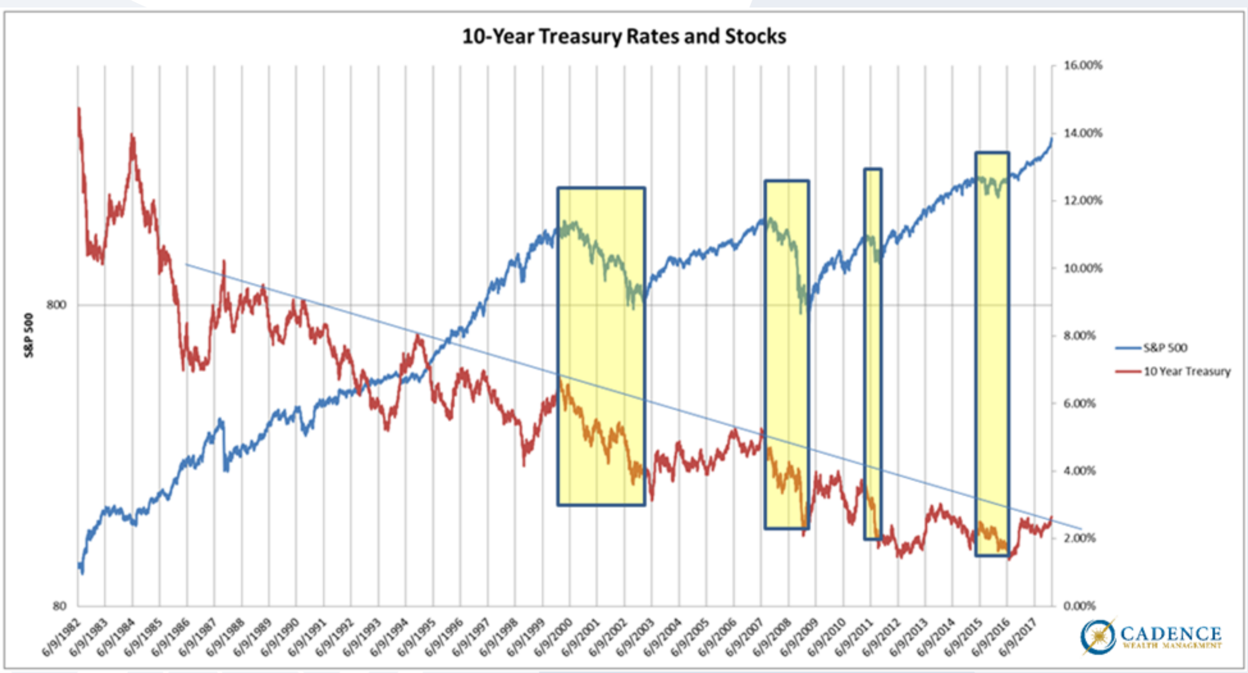
Regardless of what catalyzes this rise in interest rates, the consequences in a leveraged system are real. Looking back 30 years, there seems to be a causal relationship between rising rates and poor stock market performance. More times than not when the 24-month change in 10-year treasury rates spiked upward, stocks ran into trouble. Below, we've highlighted these spikes leading up to some of the biggest market declines in the last 30 years. Our interpretation of the data is that rising rates lead to tighter conditions regardless of the cause and tighter credit conditions choke off speculation and investment. This is certainly something to watch given how much rates have risen over the last two years.



Rising rates don't just signal possible trouble for stocks, they also mean there's a current problem with bonds. When rates go up, bond prices come down which means they are losing value within an investment portfolio. This creates a dilemma for investors since gains, of course, are preferable – especially when everyone's getting "filthy rich" investing in stocks. The irony of this is that after investors make that switch away from bonds to stocks, they tend to bring their bad luck with them. As we discussed, after a bit of a lag, these rising rates tend to spell trouble for stocks. What would have served investors better over the last 30 years would have been to stay put in bonds in order to protect against stock market risk and eventually recoup the losses incurred when rates rose as investors fleeing stocks bid up the price of those safer treasury bonds. The chart below highlights what happened to 10-year treasury rates during the last four largest stock market declines. This flight to safety led to lower rates and higher bond prices each time. Of course there's no assurance this will happen going forward, but there's certainly precedent here suggesting small losses in bonds over the short term could be a small price to pay in order to be in the right place when the tide turns.

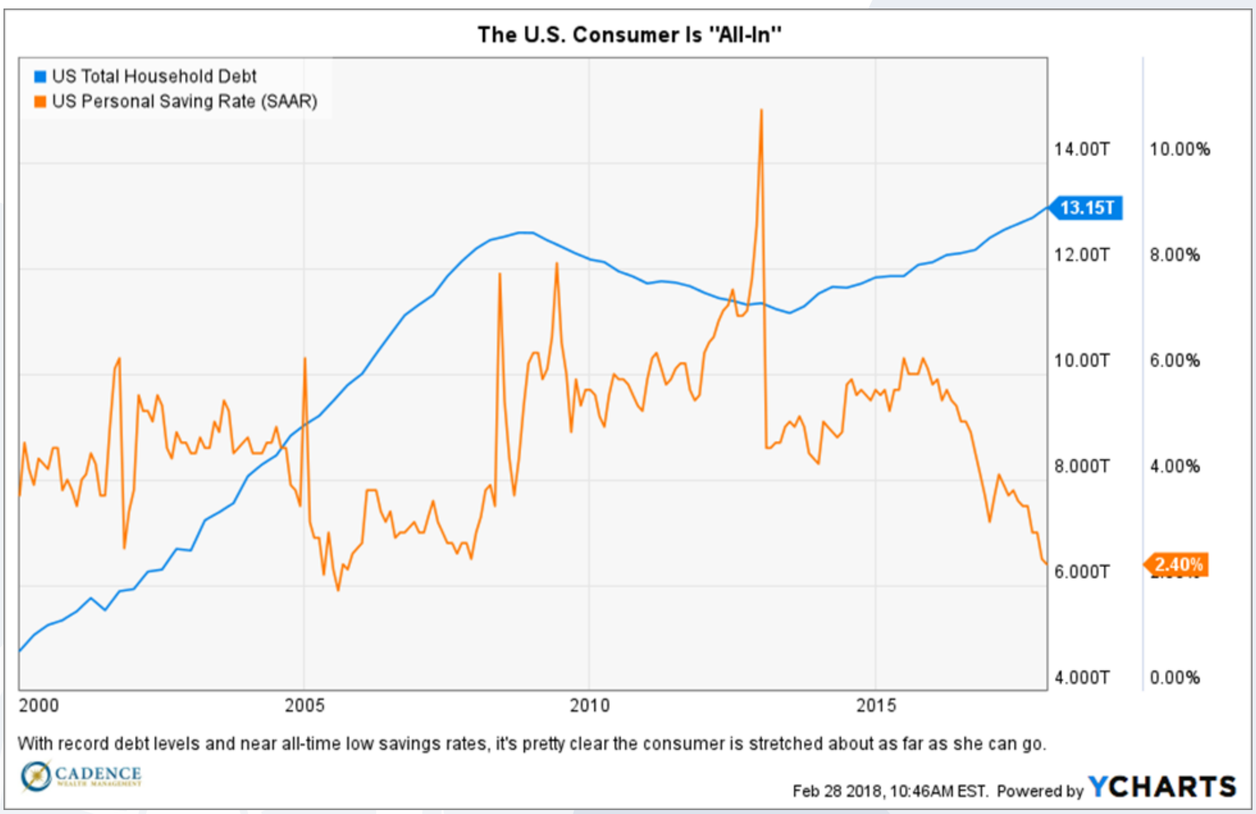
What's also interesting to note on the chart below is what's happened to stocks as the interest rate on the 10-year government bond rises up to its declining trend line (indicated by the thin blue line). As rates have risen up to hit this declining trend line over the last 30 years, turmoil has been a frequent consequence – Black Monday in 1987, the Tech Bubble in 2000, and the Financial Crisis in 2007 among them.

This tells a similar story to the rate of change chart we already discussed, but incorporates an upper boundary that could serve as a potential "trigger" point for market unrest. Whether this trend line remains orderly because it represents a certain magnitude of change in rates that ultimately leads to problems, or because traders and market participants all watch these levels, place importance, and ultimately make decisions around them is up for debate. Of course there's always a chance that it's completely random. Our thinking is that it's a combination of all three with the randomness coming into play at the margins. Since rising rates are contractionary, this trend line could serve as an area where traders and market players take notice and start to make some decisions pertaining to risks within the financial system.



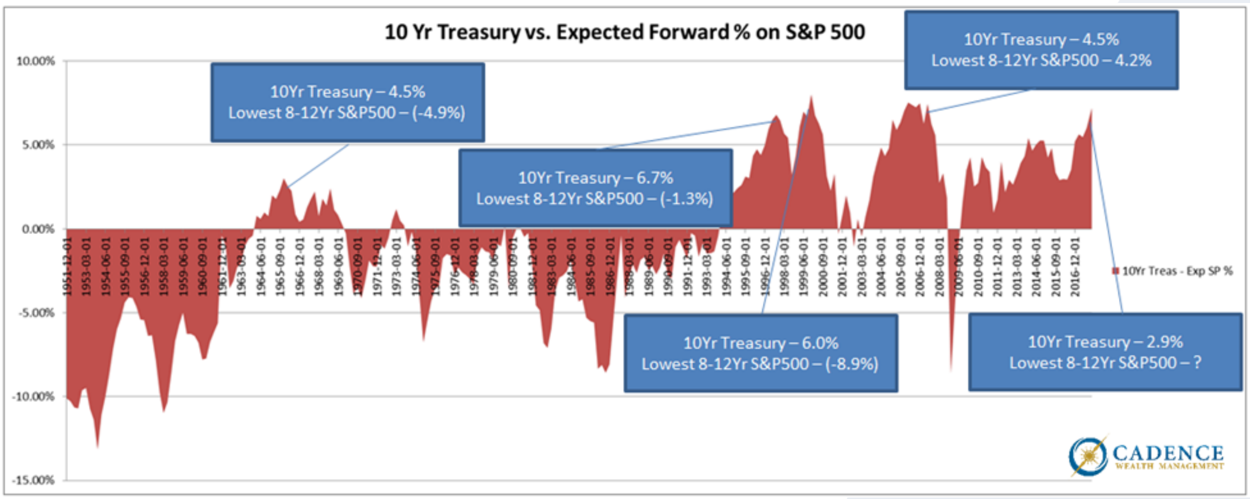
In addition to this flight to quality argument, there's also a more fundamental argument for holding treasury bonds in this market environment. Although there are many factors that can and probably will influence U.S. government interest rates over the coming months and years, not least of which being the accelerating deficits and debt levels we'll be experiencing here in the U.S. as a result of the very costly tax reform just passed as well as any infrastructure scheme that ultimately makes it through the legislative process, it's all relative. True, the more our government borrows, the higher rates should be. The less fiscally responsible we are and the more sobering the debt and deficit trends into the future, the higher the interest rates investors should demand in extending the U.S. government credit. All else however is not equal. On balance, the rest of the world is stuck in the same debt and growth problem that we here at home are, so they'll be borrowing and spending as well. This fact will likely mean that our fiscal issues will matter much less with respect to interest rates than if they were in isolation.

In the big picture, demographics are working against interest rates and have been for the last 10-15 years at least. In addition, the massive debt levels we have here at home and globally are deflationary. When borrowers struggle to pay their debts, there isn't much left for consuming or investing. When debts go bad, lenders don't have as much to consume or invest with either. This deflationary process keeps rates low. The fact that consumer debt has exceeded its previous peak of 2007 while the personal savings rate in the U.S. is near all-time lows at 2.4% suggests the consumer is "all-in" when it comes to allocating their cash flow. Between debt payments, rising costs of living related to healthcare, food, and shelter, and any discretionary spending on extras such as T.V.'s and iPhones, there isn't a whole lot left over. In fact, if consumer debt levels weren't rising, there probably wouldn't be anything left over for discretionary purchases at all. Where would Apple and Netflix be right now if consumers had held debt steady over the last 10-20 years?



The bottom line here is that without a healthy level of savings entering the banking system which ultimately translates into responsible loans for those with plans to invest the borrowed capital wisely, the system cannot sustain itself. Everybody cannot be a debt-driven consumer at the same time – yet that's precisely the type of system that today's markets depend on. When this fragile condition reaches its breaking point, our opinion is that it will be incredibly deflationary – at least initially. This would be good for fixed investments of high quality such as U.S. government bonds.

Past isn't always prologue, but what's also interesting to note is that over the last 70 years when market multiples are super high as they are now, bonds become a much better relative option. As we can see below, when the rate of interest we can earn on a 10-year treasury bond minus the total rate of return we're expected to earn in stocks over the coming 10 years (based on valuation and its historical relationship to future return) is positive, bonds become a pretty good investment option. In the mid to late 1960's when stock market multiples were high, investors would have done much better buying a 10-year government bond and holding it; same in 1997 and even in 2005.



What's important to keep in mind is that we're currently sitting on the highest stock valuations in history. After this bubble pops, our belief is that not only will bonds have been a far better option today than stocks, but an investment in bonds from 2005 through 2007 would also prove much better than a stock investment from the same starting point. Where stocks are currently higher than they were in 2007, they will be lower in due time. In short, that 2007 investment comparison isn't in the history books yet. Looking at an 8-12 year timeframe, we'll have to see where stocks end up in 2019 before making a final determination as to where investors would have been better off.

Given the weight of evidence and bubble dynamics, we think the smart and safe money should be on bonds winning out in this scenario again, just as they did by a fairly convincing margin in the previous two. This doesn't mean that investors should jettison all the other pieces of their portfolio to make room for high quality fixed income. It simply means that due consideration should be given to the relationship between stocks and bonds going forward and which might hold more relative appeal. It's never an all or nothing decision—there are of course other asset classes that investors should be considering as well in preparing for a changing investment tide. We'll elaborate more on some of those in upcoming letters. As boring as it may be, the bottom line is this; when history and math suggest that stocks stand to lose 60% of their value at some point, 2.9% on a U.S. Government bond doesn't look half bad. It's all relative.