the advisor

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Lopsided

"The essence of risk management lies in maximizing the areas where we have some control over the outcome while minimizing the areas where we have absolutely no control over the outcome and the linkage between effect and cause is hidden from us."

Peter L. Bernstein
Against The Gods; The Remarkable Story of Risk

Lately investors have been wondering about the effects of the US Federal Reserve's "tapering", a slowing of its $120 billion per month bond buying programme (Quantitative Easing). QE has added more than $4 trillion to the Fed's balance sheet, which stands at $8.7 trillion. QE provided unprecedented support to financial markets but the Fed is now reducing its covid stimulus, making the fixed income market jittery. Ironically, tapering could actually be good news for the bond market.

What follows runs contrary to today's "persistent inflation" narrative.

First, some basics about bonds. Bonds are a form of debt issued by a government or a company that wants to raise cash. When you buy a bond, you're lending money to the bond issuer. Debt investors typically are realists (versus the dreamers that are stock investors). They care most about getting their principal back plus regular interest payments. Boring and predictable works for bond holders.

The price of a bond is determined by its yield – which is a function of interest rates, credit risk and inflation risk. If interest rates decline and the risks stay the same or decrease, then the price of a bond will rise. If interest rates climb and the risks increase, then the price of a bond will decline.

Credit risk is a catch-all phrase encompassing the risks likely to impact the ability of bond issuer to repay that debt. Those risks include: default, competition, managerial competence, and ability to service the debt. Many sovereign bonds, issued by national governments, are considered 'riskless' because they have the ability to tax their citizens to honour the debt. Their interest rate is considered the "risk-free rate". However, some countries are serial defaulters (e.g. Argentina, Zimbabwe, etc.) and not trusted.

The price of every financial asset is determined relative to the risk-free interest rate. If the risk-free rate is too high, then bonds will appear the better relative value. If it is too low, it favours stocks. The US risk-free rate is the single most important metric in finance.

At the moment, real US interest rates (the rate after taking into account inflation) have rarely been so negative. Real interest rates are about negative 6%, meaning bond holders are losing $4 per year in spending power on a $100 investment yielding a notional 2%. In comparison, it looks better to buy stocks that have a higher relative yield plus upside price appreciation potential.

The problem is that by supressing interest rates and by using QE, the Fed has distorted the whole financial asset structure. Bonds yield too little and stocks are very expensive. This will continue until interest rates are allowed to 'normalise', forcing the relative value of both stocks and bonds lower.

The Fed has been trying to normalise rates for years. In 2013, when the Fed began to taper its bond-buying programme, the markets threw a tantrum. The Fed reversed course, the markets calmed down and then marched higher. By 2017-18, the Fed felt confident enough the economy could stand on its own and began tapering while *simultaneously* raising interest rates - until the pandemic forced them to back peddle on both. Once reassured, the markets then resumed their advance upwards. In November, the Fed signaled it was concerned about inflation and started slowing its bond purchases. Investors have taken notice.

Clearly, there are problems with the belief that the Fed can reduce liquidity without consequences. To begin with, the Fed is not cutting liquidity in isolation. Other central banks and governments have started reversing liquidity too. All interest rates are relative. Higher yields in US bonds will attract flows of capital from other countries with lower yields and push rates lower in the US.

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Lopsided (cont'd)

Economic growth is also slowing. Over the next few quarters, the year over year comparisons will become narrower. In the third quarter, economic growth reduced sharply, registering a fraction of the growth in the first half.

This slowing in economic growth increases what is known as the 'deflationary gap', which means the level of real GDP falls further from the level of potential GDP. This deflationary gap in turn leads to demand destruction setting in motion a process that will eventually reverse the rise in inflation. Global supply chain bottlenecks appear to be easing, which will also dampen inflationary pressures. Treasury bond yields could temporarily be pushed higher in response to inflation, but the trend in longer yields remains downward.[1]

During each previous QE cycle, as soon as the liquidity flows were slowed or halted, adverse consequences occurred. Each reversal in Fed policy has repeatedly provided bond-buying opportunities. In the past, rates rose during QE programmes as money rotated out of the safety of bonds (risk-off) into stocks (risk-on). When those QE programmes ended, rates fell as investors altered their risk preferences and piled back into bonds. As the Fed tapers liquidity, investors' risk preferences will probably change once again.

With economic growth running below expectations, the Biden administration and the Treasury are pushing for more government deficit spending. Deficits will require more government bond issuance to fund future expenditures. The Fed will continue to be a buyer of bonds to maintain market stability, and will buy more aggressively during recessions. This will generate more demand for bonds in the future, which is potentially good news for bond investors (not so much for taxpayers).[2]

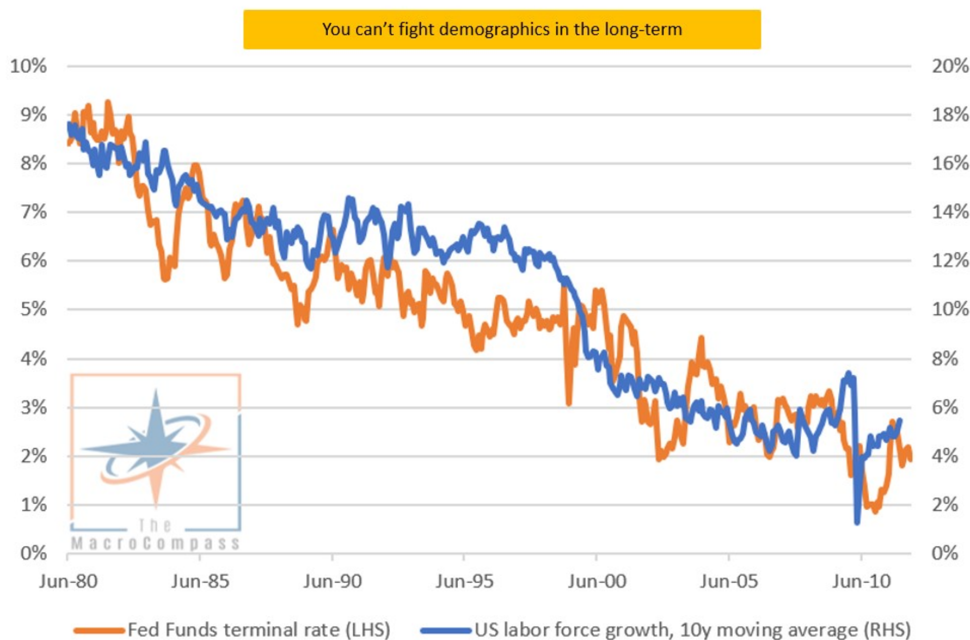
Demographics are also a factor to consider. There is a structural demographic lid on what's possible for bond yields. The chart on this page shows … "the 10-year moving average of the growth in the US labour force plotted against the market-implied pricing for the Fed Funds terminal rate (i.e. the final Fed Fund rate at the end of the projected hiking cycle). Basically, the chart points to one simple, but powerful concept: you can't fight demographics in the long-term."[3]

The US labour force grew at 15-20% on a ten-year moving average basis in the 1980s-90s, while in the last decade this pace has slowed to the low single-digits; it's projected to slow even further over the next decade. As the labour force shrinks, fewer people actively contribute to long-term economic growth and the number of inactive people increases. "Long-term equilibrium interest rates must head lower for the system to survive."[4]

Because it appears the Fed has broken the linkage between interest rates and inflation, stocks seem like the only game in town. Greed for further stock appreciation outweighs the perceived risk of lopsided equity exposure. However, when "risk-off" occurs, it will lead to a rapid fall in stock prices, pushing volatility higher and bond yields lower.

Prudent investors may not want to wait for a risk-off event to transpire. At present, market uncertainty is elevated and the range of possible economic outcomes is widening. If you want to lower your portfolio volatility and to make your capital more robust to shocks, you want some fixed income exposure.

Got bonds?



Sources:

1. Lacy Hunt, "Quarterly Review", Hoisington Investment Management Company, September 2021
2. Lance Roberts, "Fed Taper is Good News for the Bond Market", Real Investment Advice, 23 November 2021
3. Alfonso Peccatiello, "The macro framework you need to prepare your portfolio for 2022", The Macro Compass, 6 December 2021
4. Ibid
5. Chart this page, Alfonso Peccatiello, "The macro framework you need to prepare your portfolio for 2022", The Macro Compass, 6 December 2021

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