Verus

Sound Thinking

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Normal normally isn't normal - it's just the result of what we've seen recently.

For many years there was one piece of market knowledge that everyone knew about valuation: equities yielded more than bonds, and they did so because equities were riskier than bonds. Because they had a higher risk of total loss, investors demanded more of the return came in the form of cash payments directly back to the investor, rather than simple speculative capital return. That's a completely reasonable and logical thought process, and it held true for a long time. It was "normal".

Then suddenly it wasn't. In the mid-1950s the relationship narrowed and then reversed towards the end of 1958. Equity yields dropped relative to bond yields and stayed "the wrong way around". At first investors found it hard to explain what was happening – many invested assuming that the relationship would revert to "normal", and lost money. Over time, as the old relationship receded into the past, and the new relationship continued to hold sway, the new relationship was what investors defined as "normal" and a new explanation was created – investors now didn't demand payment by means of dividend income because they were indifferent as to the source of their total return, wanted to avoid tax consequences, were happy to keep money invested in the enterprise with a higher rate of return, and they expected capital growth to make them richer[1].

Did this new explanation make any more sense than the previous one? Not particularly – both are coherent and rational ways of thinking about markets, and it's not inherently obvious that one is more correct than the other. It did, however, provide a better explanation of what had been seen recently, and it became the new normal.

The important thing, though, is that in a very real sense there wasn't a normal for this relationship. For a long time, the relationship between these assets was best viewed as one way – and then it wasn't, and a different approach was more explanatory.

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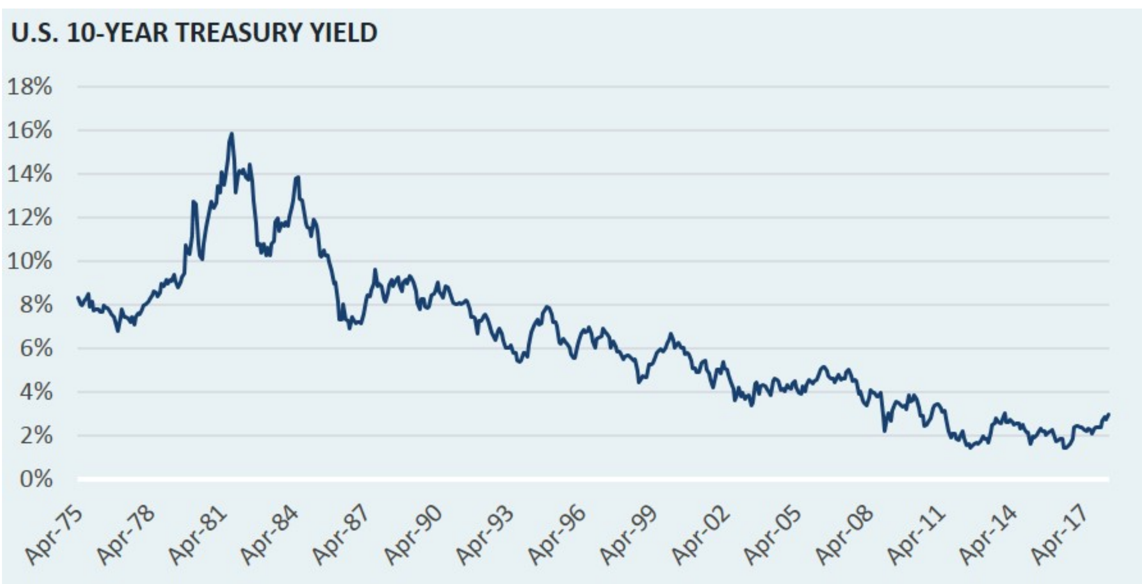
1. *When I started in the industry in the very early 1990's I had colleagues who remembered the old relationship and the old explanation, and who muttered into their lunchtime beer that things would eventually revert to the way they should be. These assumptions of what's "normal" are sticky ideas.*

Focusing on the mental image of what was "normal" in that relationship was helpful for a long time, but then it suddenly became actively damaging as the facts in the markets changed. What actually mattered wasn't what was "normal" – instead, what mattered was the facts. And those facts now said that equities yielded less, not more, than bonds.

That mental corrective has been on my mind a lot recently when we've been discussing the likely path of interest rates. The term that the talking heads have loved to use in this discussion has been "normalization" – and the question that's been asked has been, "when will interest rates return to normal"? By normal, of course, they mean higher, and maybe significantly higher. While we think the direction of that thought process is correct (rates are indeed likely to go higher), the magnitude and timing of that move is probably better thought of from first principles, rather than by anchoring too closely on what has happened in the past. The past is important to some extent though, and understanding what has happened over the last thirty years is a good way to begin thinking about what might happen in the next three.

Lower and lower

Not many trends are as solid and consistent as the drop in interest rates since the early 1980s as shown in the chart below.



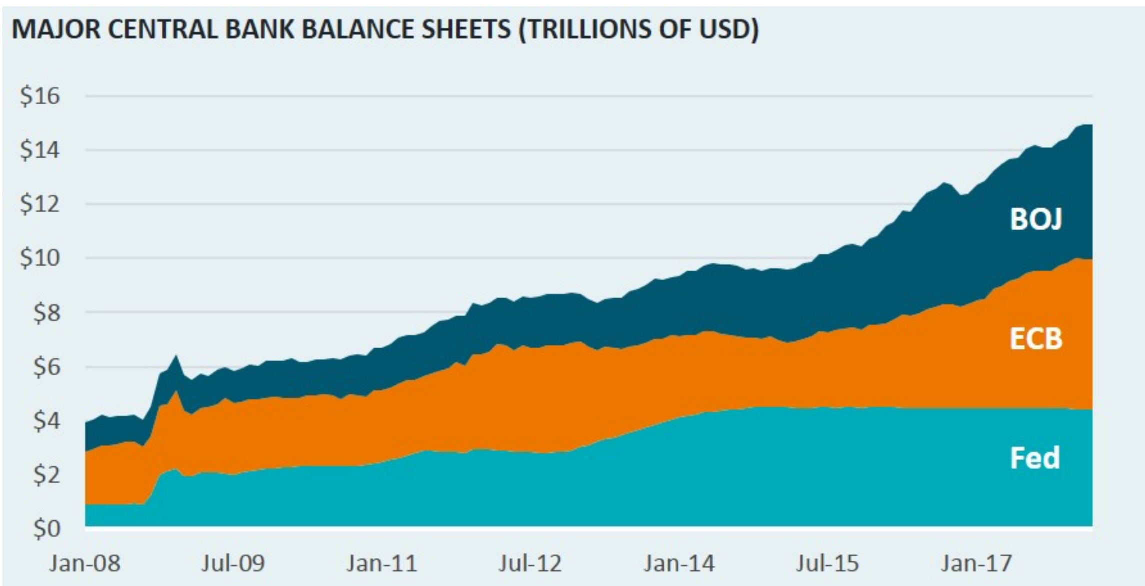
Source: Bloomber, as of 4/30/18

The disastrous monetary and economic policy during the previous inflationary period led to massive economic destruction across many parts of the world. Previously safe and prudent strategies became financial death traps, and what had seemed indulgent but possibly harmless economic management created misery for many. If this sounds personal that's because it is – I remember the impact of this inflation on my own grandmother, widowed at an early age with young children, and who followed her advisor's prudent advice to invest her comfortable nest egg significantly in government bonds throughout that period. High interest rates and a new focus on monetary policy, deregulation and tax reform brought economic policy back under control, and the steady move downwards in yields began from a high of 15.8% on the 10-year U.S. Treasury in August 1981. Inflationary expectations dropped precipitously, from 10% in 1980 to 3% in 1983 according to the University of Michigan survey, and the economy began moving towards a healthier balance.

Source: University of Michigan Consumer Sentiment Survey, as of 4/30/18

What drove this consistent move downward in rates from 1981 to 2012? First, the demise of chronic inflation. The removal of hyperinflationary pressure from the system eliminated the need for excessive interest rates to compensate investors for that inflationary risk and to bring inflation under control. As important, though, were the broader facts of the global economy. The 1980s was a period of resurgence of free markets and freer trade, and the beginning of the democratization of the computing revolution. Then, the 1990s saw the rapid broadening in the power of technology, as well as the sudden removal of communist and central planning constraints from a huge part of the world. Both of these effects were broadly disinflationary – new capacity and human potential were released to flourish in a more efficient way, which was expanded by the continued drive towards free trade. The drumbeat continued in the 2000s. The voices who had been warning in the mid-1990s about excessively easy money were beaten away by the implementation of the Greenspan put after the tech crash and 9/11. The further expansion of the global economy and the rise of emerging markets continued to provide beneficial disinflation: not only through the massive expansion of capacity and the benefits of comparative advantage, but also due to the rise of millions of new middle-class families that provided a demand boost. Neither central bankers nor markets felt the need for higher rates – "normal" kept drifting down.

Of course, during this time plenty of bad decisions were made, plenty of capital was misallocated, and far too much leverage was applied to parts of the system where leverage was more dangerous than was understood. By 2008 the consequences became unavoidable, and markets crashed – but ironically the cure (easy money, access to credit, the certainty of liquidity and availability of finance) looked an awful lot like the underlying cause of the disease (which was in large part a combination of easy money, the access to credit, and the certainty of liquidity and availability of finance!). Central banks threw open the doors of their vaults, took interest rates to all-time lows, and expanded their balance sheets, and around the world a hundred thousand inflation hawks winced, prepared for the sudden and uncontrollable return of inflation.



Source: Federal Reserve, ECB, BOJ, as of 3/31/18

It's quiet. Too quiet...

There are few sadder sights than a disappointed inflation hawk in a deflationary environment. Month after month rates and inflation have stayed low. Financial asset price inflation has of course been significant, but from the standpoint of an asset owner that looks less like a problem than a gift. The broader inflationary disaster that many had expected has simply failed to materialize, and the longer it has taken to materialize the louder the predictions of disaster have been. Combined with forecasts of inflationary disaster has often been a parallel (but oddly contradictory) complaint – that none of the extraordinary measures used in the last 10 years has been effective. Monetary expansion has, on this argument, both failed to work on the economy (see the relatively low growth rates that developed economies have produced in the last few years) and has also set the economy up for an inflationary disaster.

While the low rates that we have seen are unprecedented, the economic catastrophe of the last 10 years is also a rare event. Maybe the inflation hawks have been listening to the silence of the hospital room with the slowly recovering patient and confusing it for the quiet of the zombie apocalypse, likely to end poorly for anyone with a pulse but no shotgun.

So what has really been going on?

I think the inflation and monetary hawks have been looking at the last 10 years in the wrong way. The multiple generations of Quantitative Easing, and the variety of abnormal approaches to monetary policy that we've seen have been focused less on the creation of rapid economic growth, and more on ensuring that the basic pipes and capital flows in the economy continue to exist and to function. The scale of the problems that caused the financial crisis were greater than could have been imagined, but even though large financial institutions were lost, and huge capital value destruction happened in the economy, by and large the engine of the economy continued to turn over. Capital was available to enterprises, companies could make payroll, consumers didn't discover themselves unable to withdraw cash, and the lights stayed on. Monetary policy was more survival policy than anyone involved in it would ever be able to admit, at least at the time. The reason that the inflationary pressure didn't appear as expected wasn't because it didn't happen – it was because the environment was markedly more deflationary and sensitive than it may have looked at the time.

Back towards normal

The whole conversation in the marketplace, then, about when rates will get back to normal and the pace of rate rises, is a little distorted.

The Federal Reserve certainly wants to make sure that interest rates move up to higher levels than they are today, if only because those higher levels will allow them to have dry powder to use during the next downturn. They are, however, well aware that central banks are one of the most likely reasons for an expansion to come to an end, and so the rate of change of interest rates will be dependent on the ongoing reactions from the market to the Fed's signaled expectations of future changes.

Normal rate levels, though, may be materially lower now than they were before. This isn't an argument for the economic hypothesis often called "the new normal" – the idea that a low growth, mediocre economic environment is all we can expect from the future – instead it's more of an argument for a higher rate of growth, but with less inflationary pressure than that rate of growth might have generated in the past. Technological change continues rapidly, and continues to exert downward pressure on inflation. Emerging markets continue to grow their middle class, and although there is more attention to the details of some trade deals from the standpoint of the U.S., there is little evidence that the world is moving towards a real new trade war. Unemployment statistics show little labor force slack, but underemployment remains a major factor, and it's difficult to be sure how much of the true labor capacity is really being counted accurately. This is not to say, however, that inflation is no longer a risk for investors concerned with real returns. Inflation protecting assets still have a role to play in portfolios – even in a low inflationary regime, an inflation shock driven by an external factor, such as conflict in the Middle East that causes a spike in oil prices, is still an important potential risk to mitigate.

More than that, the capital markets are global. The US government bond market remains one of the highest carry markets in the developed world. The 10-year yield has hit 3%, but the likely upside from here is limited by the insatiable demand from investors for yield. Even if the Fed wanted to raise rates at a much faster pace they would likely find that task challenging.

The way ahead

So where does this leave us when thinking about interest rates and their impact on portfolios in the coming months?

First, we don't expect the Fed to get ahead of the market in the near future, and we don't expect a sudden rise in expectations in the near future either. While the economy is growing nicely, there is still plenty of room to run, and the Fed is aware of the sensitivity that recoveries have to over-excitable central bank behavior.

Second, I don't think that we can be sure what "normal" interest rates look like in the new economy. It's unlikely we will find ourselves back in the 1970s, and it's certain that we can't see rate drops of the type we saw in the 1980s – there's nowhere much for them to drop. While it's possible that the right interest rate is between 4% and 5%, it's also possible that it's either higher or lower. The economy has changed markedly, and with that change we have to recognize our expectations of normal have to change too.

Third, I think that portfolios should be taking a sanguine view about rate moves. While overloading to hyper-long duration bonds may be an unadvisable bet, investors should be worried more about their broader risk positioning than trying to manage their duration in too much detail. A neutral to mild underweight stance seems appropriate – not overweight to be sure, but also not using too much of the active risk budget to try to time and manage the duration of the portfolio too closely. The Fed is likely to listen to the market, and while rates are likely to rise they are less likely to surprise to the upside.

Or, to put it another way, maybe there is no normal, at least in interest rate terms, and at least in the current environment. And if there's no "normal", maybe we have to work out our preferred positioning the hard way, by looking at what the economy needs and how it will react, rather than simply substituting judgement for a rule of thumb. Rates will rise, for sure, but how quickly and how much remain to be seen, and will be decided by how the economy reacts to those rises, rather than some simple historical line on a chart.

ABOUT THE AUTHOR

Mr. Toner has a degree in Law from the University of Oxford in the United Kingdom and is a CFA charter holder (Chartered Financial Analyst). He is a regular author and speaker on a range of investment topics. He is a member of the Audit / Finance Committee of The Medina Foundation in Seattle. He is also a member of the CFA Institute and the CFA Society of Seattle. Mr. Toner is a trustee of Charles Wright Academy, an independent co-educational school based in University Place, WA, where he also sits on the finance and endowment committees. He is also a board member at the Seattle Metropolitan Chamber of Commerce, where he co-chairs the finance & audit committee. He has been happily married to his wife, Heather, for nearly 25 years, and is the proud father of two children.

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