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THE PER STIRLING CAPITAL OUTLOOK

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"If you want to eat well, buy stocks; if you want to sleep well, buy bonds."

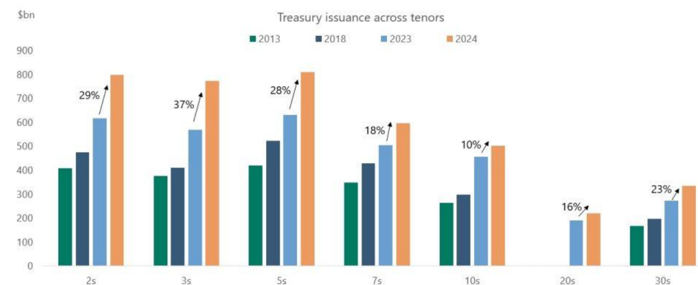
As is exemplified in this (now perhaps regrettable) quote by André Kostolany, who is renowned as an expert on the capital markets, bonds have traditionally enjoyed a (usually) well-deserved reputation for being steady, dull, boring, and generally quite safe.

However, in sharp contrast to this norm, the current confluence of economic and policy-related factors (both fiscal and monetary) has turned bonds, a traditional favorite investment of retirees, banks, and insurance companies, from slow and plodding to rapidly plunging.

In fairness to Mr. Kostolany, he probably could never have envisioned the global monetary environment that resulted from the massive government response to the pandemic and the temporary shutdown of the global economy, including a huge surge in money supply, interest rates in the U.S well below the rate of inflation, and a significant majority of debt securities around the world literally paying negative interest rates.

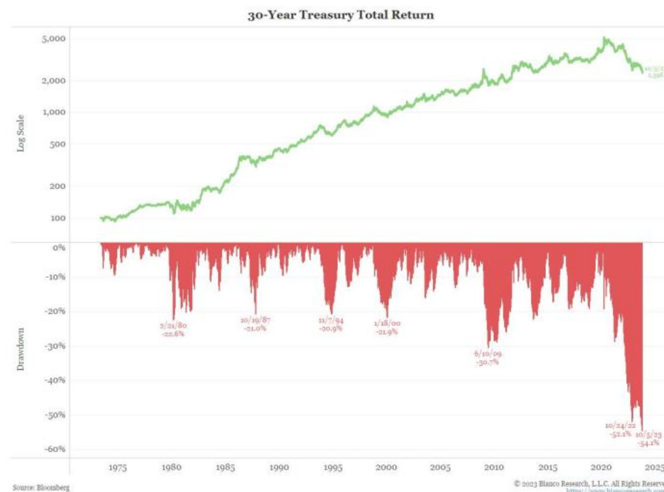
As we noted in our August commentary, "back in that bizarre window of time, when domestic interest rates were near 0% and most global debt actually paid negative interest rates, most market veterans knew that such an anomaly would have far-reaching implications but, because it was so unprecedented, nobody really knew what they would be."

However, over the subsequent three years, the implications of this unwinding of monetary excess have been laid bare for the world to see, including a historic surge in inflation and the massive accumulation of debt on the part of many of the world's governments, perhaps most dramatically in the United States and Japan.



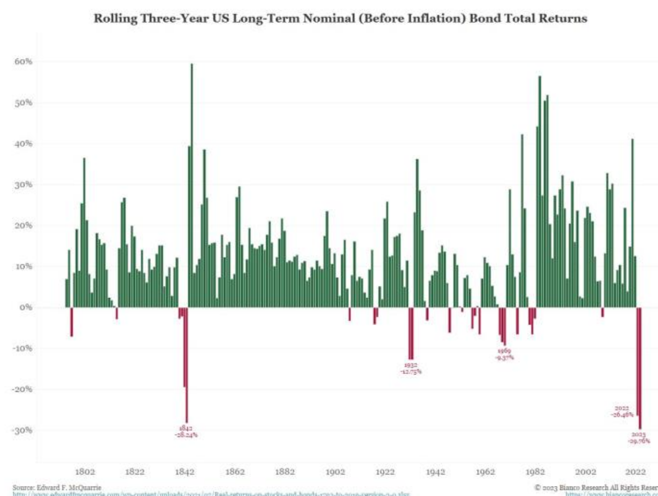
In response, most of the world's central banks have spent the past three years trying to unwind the excesses of this unprecedented era while, in the United States, Congress has been offsetting the Fed's efforts and spending money at such an extraordinary pace that Fed Chairman Powell defined it in an October 19th speech as "unsustainable". [1]

This spendthrift is causing a dramatic increase in the issuance in Treasuries [2] which, combined with the Fed's very aggressive rate hikes; quantitative tightening (which is further adding to the supply of Treasuries) and the surge in inflation, is creating losses in bond portfolios that are literally reminiscent of the bursting of the bubble in internet stocks almost a quarter century ago.



Since March of 2020, Treasury bonds with maturities of 10 years or more have plummeted by 46%, which is just below the 49% loss experienced in the equity markets when the dot-com bubble burst. [3] According to Bloomberg, "the rout in 30-year bonds has been even worse, tumbling 53%, nearing the 57% slump in equities during the depths of the financial crisis". [4]

Bloomberg further reported that "the current losses in long-maturity debt more than double the next biggest slump in 1981, when then Fed Chair Paul Volcker's campaign to break the back of inflation drove 10-year yields to almost 16%... It also surpassed the 39% average loss in seven US equity bear markets since 1970, including last year's 25% slump in the S&P 500 when the Fed started to lift rates from near zero." [5]

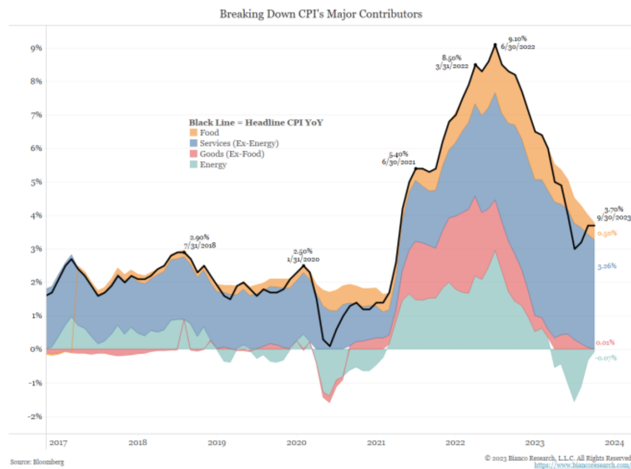


As noted, the thirty-year Treasury bond, which has traditionally been considered by many as one of the safest places on earth to invest one's money, has lost over half of its value due to surging interest rates, while the 10-year Treasury yield recently moved above 5% for the first time since 2007. (Importantly, the aforementioned interest rate risk does not apply if a Treasury or other bond is held to maturity.)

On a rather ominous note, the surge higher in yields has been the greatest since the increase in rates that preceded the 1987 stock market crash, although we do not expect history to repeat itself. Indeed, we would argue that most of the equity market reaction to the bear market in bonds probably already took place in 2022. Stocks tend to be forward-looking.

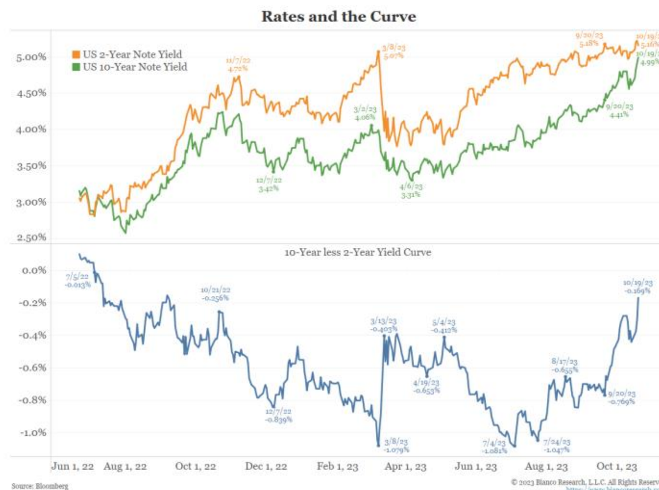
We are in the midst of the worst bear market in U.S. bond market history, which means that declines have now exceeded even the historic bond market losses of 1842, when "a series of events that began with the bursting of an asset bubble, followed by a banking collapse, followed next by a depression and defaults by eight of the country's twenty-six state governments" [6], just to put the current decline into perspective.

Remarkably, this surge higher in interest rates continues despite the facts that, over the past two years, the Federal Reserve has implemented the fastest monetary tightening cycle in history [7], and that the Consumer Price Inflation Index (black line) has collapsed from 9.1% in June of 2022 to 3.7% today.



After all, it has historically almost always been either an overly accommodative Federal Reserve or a sharp rise in inflation that has driven market-set and longer-term rates higher. We now have the opposite of both, and yet yields continue to climb.

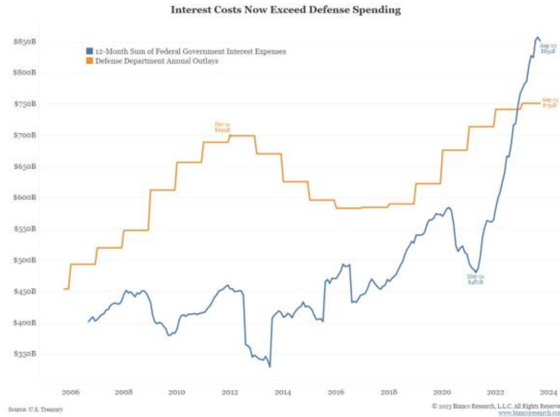
It is also difficult to attribute much of the current surge in market-set rates to expectations that the Federal Reserve will continue moving short-term rates higher, as almost all of the guidance from the Fed is that they are likely to increase the Fed Funds Rate by, at most, one 0.25% move higher.



To the contrary, the very fact that the markets reacted to the Fed's guidance (that they are either done or almost done hiking rates) by pushing long-term rates (like the 10-year Treasury) higher at a much faster pace than they have short term rates (like the 2-year Treasury) could be interpreted to mean that investors are concerned that the Fed is actually giving up their battle against inflation too soon, and that it will again get out of hand, much as it did when the Fed made that mistake several times in the 1970s.

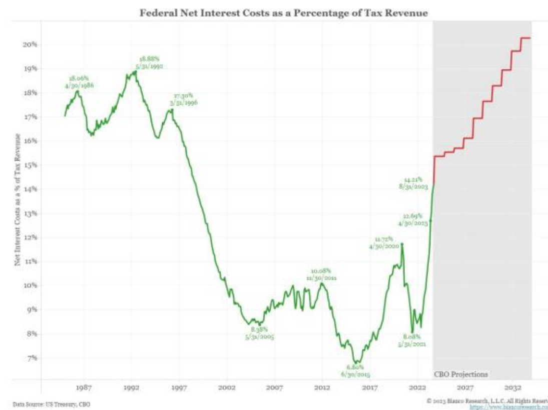
As you can see, during the tenure of Fed Chairmen Arthur Burns (2/1/70--1/31/78) and G. William Miller (3/8/78--8/6/79), they responded to every drop in inflation (red line) by lowering short-term rates (blue line), only to have inflation come roaring back each time. It was not until Paul Volcker became Chairman on August 6th of 1979, and not only raised rates to the highest levels in history but kept them there for a prolonged period, including two recessions, that the back of inflation was finally broken.

We believe that this perception that the Fed may be declaring victory too soon provides at least a partial explanation for why long-term rates continue their ascent, despite plummeting inflation and an anticipated end to rate hikes by the Federal Reserve.



So too is excess supply, which is growing dramatically, particularly in Treasuries, partially because of the Fed's recent shift from being the biggest buyer of Treasuries to one of the biggest sellers (as a result of quantitative tightening). Another driver of increasing supply is the government's need for cash to pay for its massive $2 trillion in new spending programs. [8]

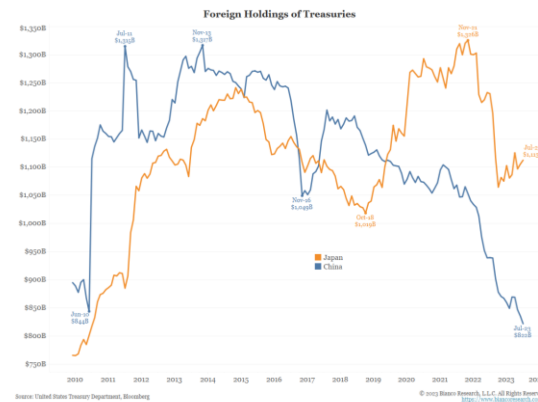
Almost unbelievably, the federal deficit has literally more than doubled from year-ago levels, to a massive $2.02 trillion. [9] Further complicating matters is the fact that the cost to the government of servicing its debt keeps going higher as maturing securities are being replaced by newly issued debt with notably higher yields.



The government is already spending more in interest on the federal debt than it is on defense, and projections from the bipartisan Congressional Budget Office warn that the number is expected to get much worse in the future.

Further exacerbating the excess supply of Treasury securities is the fact that Japan and China, which have since 2010 been the second and third largest buyers of Treasuries (the Fed has until recently been the biggest buyer), have become aggressive sellers.

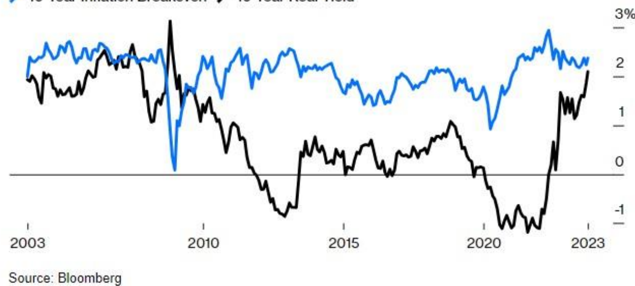
Remember that even the Federal Reserve is shrinking its balance sheet by a massive $95 billion per month as part of quantitative tightening, all of which is adding to supply.



With so much supply coming onto the market and this millennium's three biggest holders of Treasuries recently becoming aggressive net sellers, it is no wonder that rates are being pushed higher as investors demand higher yields in compensation for higher risk.

Putting even further upwards pressure on rates is the "good news is bad news" phenomenon, where a combination of a remarkably strong economy and a very tight labor market appears to be pushing higher what economists refer to as "r-star", which is the so-called neutral rate that is neither stimulative nor restrictive (in an environment when the economy is at full employment; is running at full capacity, and inflation is stable).

If that proves to be the case, it suggests that current interest rates are really not that high in the context of the current economic environment, and that the Fed could ultimately need to move rates even higher to generate the economic slowdown that they clearly (and we think appropriately) view as necessary to once again "break the back" of inflation.

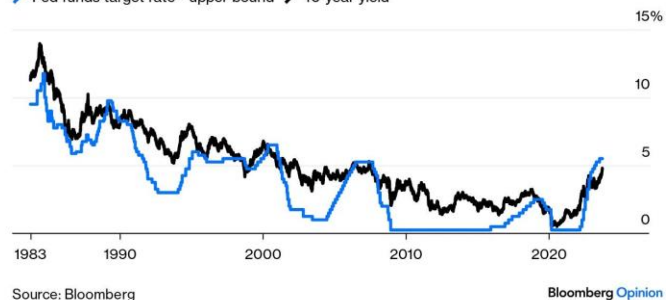


When addressing this very issue of why longer-term yields continue to climb in the face of falling inflation and an anticipated end to Fed tightening, Chairman Powell hypothesized in his October 20th speech to the Economic Club of New York that the catalysts could be "that markets and analysts are seeing the resilience of the economy to high interest rates, and they're revising their view about the overall strength of the economy and thinking, longer-term, this may require higher rates"; that "there may be heightened focus on fiscal deficits", and that quantitative tightening "could be part of it." [10]

In the same speech, Powell conjectured that "if we are going forward into a world of more supply shocks rather than demand shocks, that could make bonds a less attractive hedge to equities, and therefore you need to be paid more to own bonds". It is investors wanting to be paid a higher interest rate to compensate for today's perceived higher risk, and when interest rates move higher, bond prices, by definition, move lower.

To state the obvious, interest rates have already made a dramatic move from virtually 0% to around 5% and literally did so in record time. That is in and of itself evidence that a great deal of this bad news is likely already priced in, and even that the bond market may be getting oversold and ready for a bounce (perhaps even a bear market bottom). After all, inflation-adjusted "real" yields are at the highest level seen since the Global Financial Crisis.

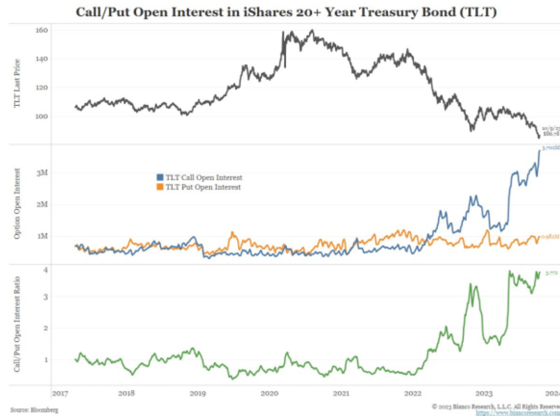
We actually do think that we may be approaching what could be at least an intermediate-term high in interest rates. However, there are two reasons why we don't think that we are there quite yet.



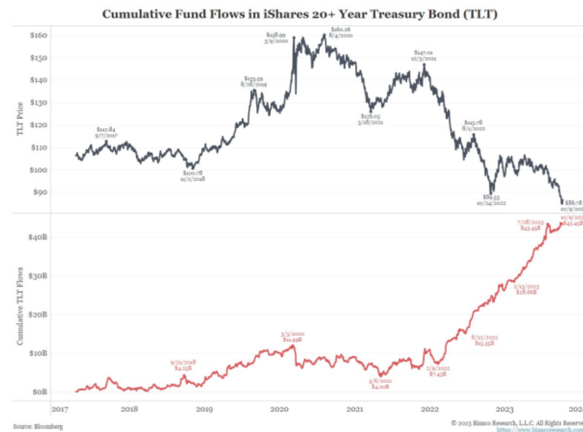
The first is the historic tendency for the yield on the benchmark 10-year Treasury (black line) to peak out near the upper band of the trading range set by the Federal Reserve for the Fed Funds Rate. The yield on the 10-year Treasury is currently 4.99%, while the upper band for the Fed Funds Rate is currently 5.50% and, while not our expectation, could potentially go to 6% or higher.

This suggests to us that bond yields still have the potential to climb another 0.50% or more from current levels (the hoped-for light at the end of the tunnel), but that is obviously just an educated guess.

Another reason why we remain skeptical that we have already reached peak interest rates for this cycle is that we have yet to see signs of capitulation. In our experience, almost without regard to asset class, such severe bear markets almost always end with a capitulatory, "get me out at all costs" bout of panic selling, and we are just not seeing evidence of it. On the contrary, institutional portfolios are positioned to expect lower interest rates, and bond market call options are swamping bond market put options.

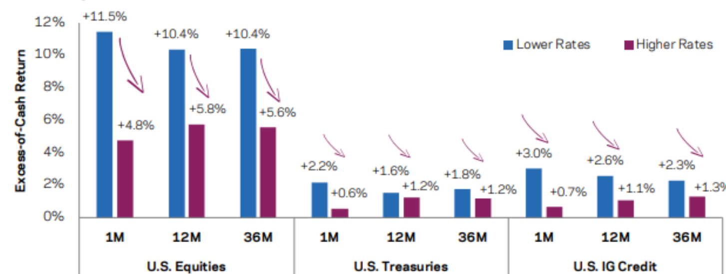


We are illustrating (above and below) an exchange-traded fund (ETF) as a proxy for long-term Treasury securities. A look at this ETF illustrates one of the extraordinary characteristics of this massive bear market in bonds (below). Despite the fact that this fund (just as an example) has dropped in value by approximately 59% since August of 2020 (black line), investors have elected to invest another almost $40 billion into it just since May of 2021, almost like lemmings to the slaughter (red line).



Unfortunately, this is the antithesis of the kind of capitulatory sentiment that normally accompanies bear market bottoms.

Until such time when rates do finally peak and ultimately begin their decline, it is only prudent to keep in mind that the level of interest rates impacts virtually all asset classes from real estate to equities and from debt to commodities, and the impact of higher interest rates is almost always negative.



You can see this very clearly in the returns chart from AQR Capital Management [11] that looks at equities, debt, and credit, and how they each perform relative to rates earned on cash, when interest rates are higher than the trailing 5-year average (red) versus lower than the trailing 5-year average (blue). As you can see, higher rates tend to dampen risk-market returns both significantly and consistently.

Yes, we think that we are seeing the light at the end of the tunnel, but that we are likely not there quite yet. Caution and patience are likely to serve one well in this environment. As Chairman Powell said in last week's speech, "I think we have to let this play out and watch it. For now, it's clearly a tightening of financial conditions, and we'll be watching." [12]

Disclosures

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Definitions

The Standard & Poor's 500 (S&P 500) is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the U.S with each stock's weight in the index proportionate to its market. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index.

The Consumer Price Index (CPI), which is produced by the Bureau of Labor Statistics, is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

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