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CAPITAL INSIGHTS

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Bonds Away!

As we are sure you are aware, the financial markets have had a bit of a tough time going anywhere this year. The S&P 500 has been caught in a 6% trading band all year, capped on the upside by a 3% gain and on the downside by a 3% price loss. It has been a back and forth flurry while the stock market up to this point has simply marked time. We've seen a bit of the same in the bond market. After rising 3.5% in the first month of the year, the ten year Treasury bond has given away its entire year-to-date gain and then some as of mid-June. 2015 stands in relative contrast to largely upward stock and bond market movement over the past three years. What's different this year and what are the risks to investment outcomes ahead?

As we have discussed in recent letters, the probabilities are very high the US Federal Reserve will raise interest rates this year. We have suggested that the markets are attempting to "price in" the first interest rate increase in close to a decade. We believe this is part of the story in why markets have acted as they have in 2015. However, there is a much larger longer term issue facing investors lurking well beyond the short term Fed interest rate increase to come. Bond yields (interest rates) rest at generational lows and prices at generational highs – levels never seen before by investors. Let's set the stage a bit, because the origins of this secular issue reach back over three decades.

It may seem hard to remember, but in September of 1981, the yield on the ten year US Treasury bond hit a monthly peak of 15.32%. At the time, Fed Chairman Paul Volcker was conquering long simmering inflationary pressures in the US economy by hiking interest rates to levels no one had ever seen. 31 years later, in July of 2012, that same yield on 10 year Treasury bonds stood at 1.53%, a 90% decline in coupon yield, as Fed Chairman Bernanke was attempting to slay the perception of deflation with the lowest level of interest rates investors had ever experienced. This 1981-present period encompasses one of the greatest bond bull markets in US history, and certainly over our lifetimes. Importantly, existing bond prices rise when interest rates fall, and vice versa. So from 1981 through the present, bond investors have been rewarded with coupon yield (ongoing cash flow) and rising prices (price appreciation via continually lower interest rates). Remember, this is what has already happened.

As always, what is most important to investors is not what happened yesterday, but rather what they believe will happen tomorrow. Although this is not about to occur instantaneously, the longer term direction of interest rates globally has only one road to travel – up. The key questions ultimately being, how fast and how high? Why is this important?

This is important for a number of reasons. First, for decades bond investments have been a "safe haven" destination for investors during periods of equity market and general economic turmoil. That may no longer be the case as we look ahead. In fact, with interest rates at generational lows and prices at all-time highs, forward bond market price risk has never been higher. An asset class that has almost always been considered safe, is no longer, regardless of what happens to stock prices at any point in time.

We need to remember that so much of what has occurred in the current market cycle has been built on "confidence" in Central Bankers globally. Central Bankers control very short term interest rates (think money market fund rates). Yes, quantitative easing allowed these Central Banks to print money and buy longer maturity bonds, influencing longer term yields for a time. That's over for now in the US, although it is still occurring in Japan and Europe. So it is very important to note that over the last five months, we have witnessed the 10 year US Treasury yields move from 1.67% to close to 2.4%, and the Fed has not lifted a finger. In Germany, the yield on a 10 year German Government Bund was roughly .05% a month ago. As of this writing, it has risen to 1%. That's a 20 fold increase in the ten year interest rate inside of a month's time.

To the point, for a global market that has risen at least in part on the back of confidence in Central Bankers, this type of volatility we have seen in longer term global bond yields as of late implies investors may be concerned Central Bankers are starting to "lose control" of their respective bond markets. Put another way, investors may be starting to lose confidence in Central Bank

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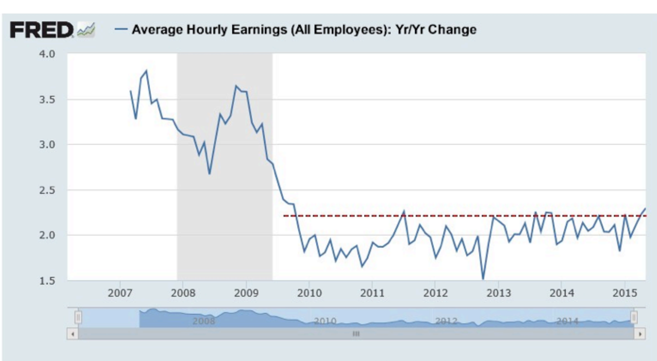
policies being further supportive of bond investments. Not a positive in a cycle where this buildup of confidence has been such a meaningful support to financial asset prices.

You may remember that what caused then Fed Chairman Paul Volcker to drive interest rates up in the late 1970's was embedded inflationary expectations on the part of investors and the public at large. Volcker needed to break that inflationary mindset. Once inflationary expectations take hold in any system, they are very hard to reverse. A huge advantage for Central Bankers being able to "print money" in very large magnitude in the current cycle has been that inflationary expectations have remained subdued. In fact, consumer prices as measured by government statistics (CPI) have been very low in recent years.

When Central Bankers started to print money, many were worried this currency debasement would lead to rampant inflation. Again, that has not happened. We have studied historical inflationary cycles and have not been surprised at outcomes in the current cycle in the least. For the heightened levels of inflation to sustainably take hold, wage inflation must be present. Of course in the current cycle, continued labor market pressures have resulted in the lowest wage growth of any cycle in recent memory. But is this about to change at the margin? The chart below shows us wage growth may be on the cusp of rising to rate of change levels we have not yet seen in the current cycle on the upside. Good for the economy, but not so good for keeping inflationary pressures subdued as has been the case since 2009.



You may be old enough to remember that bond investments suffered meaningfully in the late 1970's as inflationary pressures rose unabated. We are not expecting a replay of that environment, but the potential for rising inflationary expectations in a generational low interest rate environment is not a positive for what many consider "safe" bond investments. Quite the opposite.

As we have discussed previously, total debt outstanding globally has grown very meaningfully since 2009. In this cycle it is the global governments who have been the credit expansion provocateurs via the issuance of bonds. In the US alone, government debt has almost doubled from $10 trillion to over $18 trillion since 2009. We have seen like circumstances in Japan, China, and in part Europe. Globally, government debt has grown close to $40 trillion since 2009. It is investors and in part Central Banks who have purchased these bonds. What has allowed this to occur without consequence so far has been the fact that Central Banks have held interest rates at artificially low levels over this period. We believe the following chart is instructive in terms of describing what has happened, but also illuminates a very important issue for government balance sheets and bond investors in what may be a rising interest rate environment ahead.

The red line in the graph charts total US Treasury debt held by the public. We need to remember that a large amount of US Treasury debt rests inside the Social Security System to "balance the books," but it is debt nonetheless. This is why you see a $14 trillion level as opposed to $18 trillion referenced prior. The blue bars in the chart represent annual interest payments on this Government debt. As you can see, although debt levels held by the public have doubled since late 2008, the interest cost in 2014 was not much higher than we saw in 2007, 2008 and 2011. Of course this was accomplished by the US Fed dropping short term interest rates (the Fed Funds rate) to zero. The US has been able to issue 1 year Treasury bonds at a cost of 0.1% for a number of years. 0% interest rates in many global markets have allowed governments to borrow more both to pay off old loans and fund continued expanding deficits. The bottom portion of the chart is a look at the longer term

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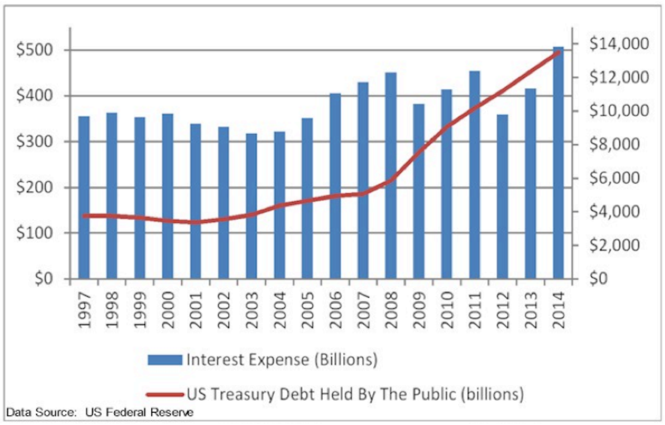
direction of 10 year US Treasury rates. In late 2007, this number was 4-5%. In mid-2012 it had briefly dropped below 1.5%.



So here is the issue to be faced in the US, but we can assure you conceptually identical circumstances exist in Japan, China and Europe. At the moment, the total cost of US Government debt outstanding is approximately 2.2%. This number comes directly from the US Treasury website and is documented monthly. At that level of debt cost, the US paid approximately $500 billion in interest last year. In a rising interest rate environment, this number goes up. At just 4%, our interest costs alone would approach $1 trillion. At 6%, probably $1.4 trillion in interest only costs. It's no wonder the Fed has been so reluctant to raise rates. Conceptually, as interest rates move higher, government balance sheets globally will deteriorate in quality (higher interest costs). Bond investors need to be fully aware of and monitoring this set of circumstances. Remember, we have not even discussed the enormity of off balance sheet US Government liabilities/commitments such as Social Security costs and exponential Medicare funding to come. Again, governments globally face very similar debt and social cost spirals. The "quality" of their balance sheets will be tested somewhere ahead.

Our final issue of current consideration for bond investors is one of global investment concentration risk. Just what has happened to all of the debt issued by Governments and corporations (often using the proceeds to repurchase stock) in the current cycle? It has ended up in bond investment pools. It has been purchased by investment funds, pension funds, the retail public, etc. Don Coxe of Coxe Advisors (long tenured on Wall Street and an analyst we respect) recently reported that 70% of total bonds outstanding on planet Earth are held by 20 investment companies. Think the very large bond houses like PIMCO, Blackrock, etc. These pools are incredibly large in terms of dollar magnitude. You can see the punchline coming, can't you? If these large pools ever needed to (or were instructed to by their investors) sell in order to preserve capital, sell to whom becomes the question. These are behemoth holders that need a behemoth buyer, and as is typical of human behavior, it's a very high probability a number of these funds would be looking to sell or lighten up at exactly the same time. Wall Street runs in herds. The massive concentration risk in global bond holdings is a key watch point for bond investors that we believe is underappreciated.

So does all of this mean the world is coming to an end for bond investors? Not at all. What is most important is to understand that in the current market cycle, bonds are not the safe haven investments they have traditionally been in cycles of the last three plus decades. Quite the opposite. Investment risk in current bond investments is real and must be managed. Most investors in today's market have no experience in managing through a bond bear market, but that will change before the current cycle has ended. As always, having a plan of action for anticipated market outcomes (whether they ever materialize or not) is the key to overall investment risk management.

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