Sterling Advisors

THE MARKET MATTERS

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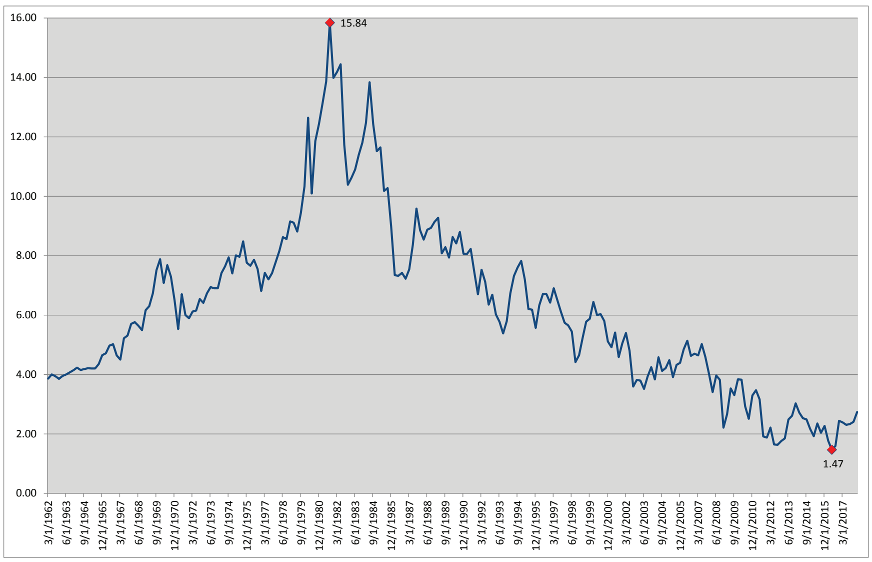
Death of the Bull

The 37-year-long rally in U.S. Treasuries is an extraordinary achievement. 10 Year U.S. government bond (UST 10) yields are almost 13 percentage points below their 1981 highs, falling from close to 16% to roughly 3% today. However, UST 10 yields have grinded more than 150 basis points (1.50%) higher over the past 24 months (Bloomberg). Right on cue, the eternal bond debate has resurfaced: can the bond bull market extend its gains or is the rally finally dead? It's a debate that far predates the tenures of many traders today.

In 2002, UST 10 yields fell below 4.00% for the first time since 1963 in response to the dot-com crash and 9/11 attacks. Fast forward to 2006 and recovery was well underway. U.S. yields were drifting higher – and had been for roughly 4 years. The bond market bears finally had the upper hand, right? Not by a long shot. I became a full-time fixed income trader in late-2008. That year, the U.S. officially entered into the deepest recession since 1929, Lehman Bros. filed for bankruptcy protection, President Bush enacted Congress' Troubled Asset Relief Program (TARP), and the stage was set for a decade of unprecedented monetary stimulus to prevent a global meltdown. A massive flight-to-quality ensued. 1.35% on the UST 10? No problem. The bulls had a lot more room to run.



Graph 1. 10 Year U.S. Treasury Note yields since 1962 (quarterly) Source: Bloomberg

Today, the bond bull-bear debate is raging again. You can see on the far right of the chart above, UST 10 yields are exhibiting an upward bias that started last year. To be fair, we have seen moves of this magnitude numerous times throughout the previous 37 years. A primary reason why this time is different: we are starting from the lowest absolute yield levels ever. There is only so much space between our yields and the zero bound. For our purposes here, we will assume that negative interest rates are only a theoretical option for U.S. monetary policymakers. Thus, the probability is greater that the next major yield move is higher, not lower. Today's low yields make us feel these upward yield moves more acutely. They feel more painful after a decade of stimulus and positive price performance in fixed income.

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In the first five years of the curve, the U.S. Federal Reserve is driving yields higher through their systematic rate increases, 25 basis points at a time. Concurrently, traders are anticipating a boom in short-dated U.S. government bond issuance to fill the budget deficits created by tax reform. Therefore, there is a perceived supply-demand imbalance on the horizon. The Fed and projected debt issuance are working in tandem to support higher yields. The story behind intermediate and longer yields is more convoluted. The overly simplistic explanation: inflationary pressures are emerging – though at a glacial pace and from pretty abysmal levels. We would argue that oil's rally since last fall – up 42% since September (Bloomberg) – is a primary contributor to improved inflation outlooks and higher long yields. U.S. fundamentals remain stable which is freeing the Fed up to actively reduce its support of intermediate yields via balance sheet reductions. There are sound reasons that rates are moving higher right now – quickly on the front end and very gradually on the long end. With these forces starting align, investors are asking if this marks a new interest rate cycle.

It is safe to say bonds cannot rally for the next three-plus decades like they have since the early 1980's. There simply isn't a sufficient buffer between the yield curve and "0" for this to happen. But when we read about the 'END OF AN ERA!' for U.S. bonds, our minds naturally draw a mirror image to the UST 10 chart above that climbs unabated for the next 40 years. If we could see out to 2055, it is highly unlikely that a chart of UST 10 yields is perfectly V-shaped. The broader trend may be one of ascending yields, but it will likely come with multi-year periods of fixed income rallies and economic concerns that fuel flights-to-quality. In fact, if the Fed hikes the U.S. yield curve into an inversion later this year or early next, one would expect intermediate and long yields to fall (i.e., bond prices to rise) in anticipation of an economic downturn. An overzealous Fed is one of the biggest potential threats to equity stability. Geopolitical turmoil is another. Real concerns still exist. Bond yields may rise more than they fall over the next 5-10 years, but we would expect that move to be asymmetrical and choppy. It is critical to stay engaged in fixed income as a counterweight to other asset classes – especially as monetary policy accommodation (which inflates virtually all asset classes) is reduced. As the central bank incrementally removes support, we expect the inverse relationship of stocks and bonds to grow more pronounced. In this scenario, diversification is the best defense. Those investors who have reached for income via dividend-paying stocks over the past 5 years may be over-concentrated in equities. With equities still near all-time highs coupled with some of the highest bond yields in a decade, the idea of rebalancing portfolios to more traditional equity/fixed income weightings is compelling.

We should be so lucky that bond yields spend the next 40 years marching higher. It would suggest a broadly expansionary environment that would support new milestones for U.S. equity indices. A graph of the next several years of UST 10 yields will likely look more like an EKG than the final approach atop Mount Everest. Does this mean the bull market is over for fixed income? Yes – if that means we have to repeat the last 37 years of bond performance to extend it. For that to happen we would need to get to -5.00% UST 10 yields. If we get there, we have far graver questions to answer than whether or not the bond rally can endure.

A quick glance at the UST 10 graph shows the past 37 years can't be repeated. But the yield curve's flat trajectory and sluggish inflation suggest the next year or two of UST 10 yield moves will appear muted in the context of the graph above. Some economists believe the U.S. is facing structural problems that will suppress productivity and wage growth for the foreseeable future. If those theories bear fruit, it would mean the equilibrium state for U.S. yields is probably not too far from when they are today. The Fed may already be approaching the 'neutral' level on the Fed funds rate – the level which neither stimulates nor damages the economy. Short yields should stabilize once the Fed reaches its endgame. Therefore, we may be further into the Fed's rate tightening cycle than we realize. Given the shape of the yield curve, let's hope so. It should look like a huge, flashing yellow light to Fed officials.

So if certain figureheads in the fixed income arena want to declare the bull market dead, go for it. It makes for a flashy headline and generates some nice publicity. But what are they really telling you? That 10 Year yields won't fall by another 13 percentage points over the next 40 years?

Uh, thank you?