CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

August 12, 2013

The Markets Adjust to Tapering

The process and timing of the Fed's 'tapering' of its asset purchases appear to have been accepted by markets without too much stress. Bond yields have risen--and will surely rise further--but most stocks have recovered from their sharp declines of May and June.

The slowing, then the cessation of asset purchases by the Fed, then, presumably, the raising of short-term interest rates, are the markers for the end of the three decades long bull market in bond prices.

By

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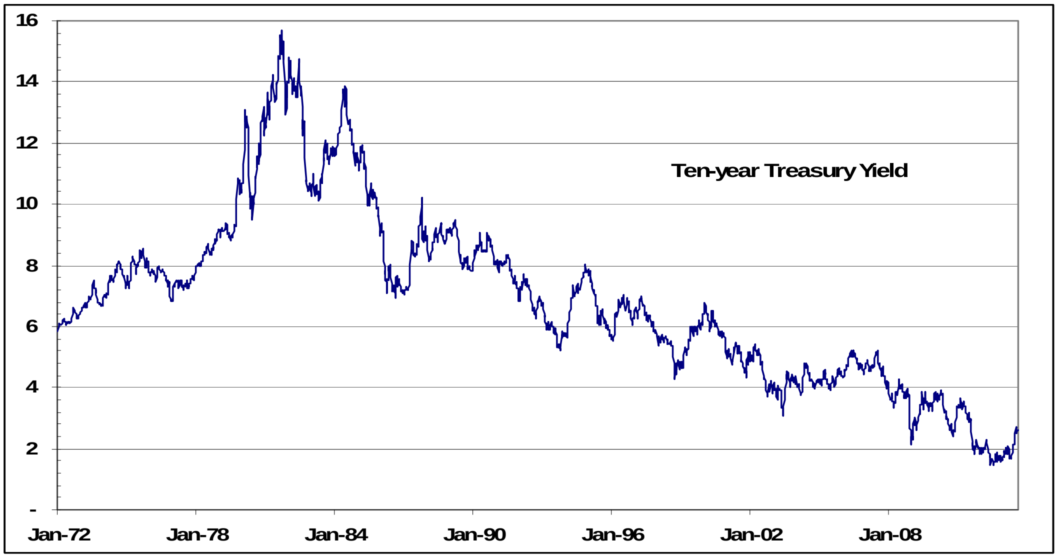
In our last letter, we wrote of discussions by Federal Reserve Board chairman Bernanke about the ending of the Fed's policy of buying $85 billion per month of US treasuries and mortgage-backed securities, the so-called 'QE3.' With his first comments in May on what has come to be called 'tapering' of the rate of these purchases, prices of bonds around the world fell sharply and yields rose. Stock prices stumbled for a period of weeks, especially in emerging markets. This wrought a significant change in the justification for investments: The one-decision 'flow trade', whereby investors were willing to buy investment assets of all kinds on the assurance that the major central banks were providing abundant liquidity, gave way to the realization that the flow of excess liquidity would come to an end and that investment decisions need be supported by fundamental considerations of economic growth, corporate earnings, and the like.

Since the sharp decline in all assets in the weeks after Mr. Bernanke's first discussion of the matter, bond markets have stabilized. US stocks have done better, fully recouping the late spring losses and moving to new highs. Mr. Bernanke and other Fed officials have discussed their plans more fully and the view has developed that the Fed may begin to 'taper' next month. Because Fed officials have insisted that the commencement of tapering is dependent upon evidence of sustained economic growth, weaker than expected economic reports would probably push the beginning of tapering beyond September.

The actual date of the beginning of the tapering is probably not terribly significant in itself. In fact, it was the announcement of the inevitable, if gradual, ending of the Fed's unprecedented series of monetary policies occasioned by the financial crisis and recession that put an end to the extraordinary, once-in-a-lifetime bond market rally. This has long-term consequences for investors; I begin a discussion of these in this letter:

The ten-year US treasury bond, the world's bench mark for essentially all tradable bonds, stood around 1.7% in May before Mr. Bernanke's first comments. In the last few weeks, it has traded around 2.6% most of the time. While this is a very large percentage increase in its yield (and gives rise to a correspondingly large decrease in its price), its yield is still quite far below what it would normally be without the Fed's monetary largesse. The yield on the ten-year treasury should roughly approximate nominal GDP, that is economic growth without accounting for inflation. Nominal GDP is now about 4%; thus we might expect most bonds to move lower in price and higher in yield, barring significant changes in the economy, over the next many months. The move may be halting and irregular, but such is the likely path.

The long bull market in bonds. It is perilous to announce the end of a bull market, but it is tempting to look back and note its extent and duration. Recall the term 'stag-flation' that gained currency in the 1970s after the Arab oil embargo that followed the revolution in Iran. Stag-flation described the miserable combination of high inflation, partly a result of the quadrupling of oil prices, with economic stagnation, marked by the long mid-70s recession and the pair of early-80s recessions. In 1981, bond yields on US treasuries were at unheard of levels, 15.2% on the thirty-year and 15.7% on the ten-year. Paul Volker had recently been appointed chairman of the Fed (by Jimmy Carter, as we might remind readers). He began his long and ultimately successful campaign to wring inflation out of the system and the expectation of ever-higher prices out of our ways of thinking. His monetary tightening brought on the second of the pair of early-80s recessions, but it began the process of lower and lower interest rates. The nearby chart illustrates the falling yields on the ten-year treasury bond from then to now. Apart from noting that as bond yields fall, the prices of bonds rise, there is nothing to say about the chart except Wow! In May 2012, the yield on the ten-year fell to 1.4%, a level we are unlikely ever again to see. At this writing, the yield has risen to 2.6%



Core's investments. The end of the bull market in bonds means various things. Among these is that bond investors must be discerning in their fixed-income investments. Moreover, conservative investors like ourselves may no longer reflexively view bonds as safer investments than stocks. A more nuanced view is needed. In light of the changed environment, we have cut our overall investment in bonds, but we have added to our investment in dollar-denominated emerging market government bonds. Our reasoning is that the high yield on these, now 8.1%, is quite safe and unlikely to be cut any time soon. This is a closed-end fund and is now trading at a 10% discount to the underlying value of the bonds in its portfolio. This discount is considerably wider than its average discount. It will likely narrow in coming months, causing its price to rise. The decline in the price of this fund was far greater than warranted by the increase in the yield on the ten-year treasury, and reflects a somewhat mindless stampede of selling in all emerging markets investments.

In a similar sell-first-and-think-later approach, Mexican stocks fell sharply in May and June, tarred with the same emerging market brush. We have added to our investment there, on the thesis that US manufactures are increasingly using Mexican facilities rather than Chinese or other Asian manufacturers, because of the advantages in shipping and speed in handling small changes. We have added to our equity investments in Germany. Europe's economy, while still weak, appears to have emerged from recession. European stocks trade at an unusually large discount to American ones--understandably so in light of the Euro crisis--but one which is greater than seems warranted. We have taken a position in large US banks, ever the villains of the piece, but likely beneficiaries of the rise in interest rates.

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