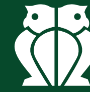


STRUCTURAL BOND BEAR?

Each quarter, we write a commentary about the stock market and generally, it has a pretty short-term focus. In our last report, we repeated our positive outlook for equities as long as we are able to avoid either a recession or tight monetary policy.

However, if you step back from the day to day barrage of facts, there are some longer-term concerns.

In my fifty years in the investment business, I have never seen as much liquidity injected into the system as we have today. Collectively, the Federal Reserve, European Central Bank and the Bank of Japan have made $17 trillion available to the banks by buying government securities and mortgages.

It has resulted in most asset classes ranging from equities and bonds to real estate being overvalued. Nothing is cheap and the only out of favor asset class that may recover some interest is gold.

This gives rise to the concern about what happens as the liquidity gets unwound. Additionally, with interest rates still historically low and fiscal stimulus already spent, we wonder what counter cyclical, stabilizing alternatives remain in the event the economy slides toward a recession. Furthermore, there is no precedent for the large tax cuts and fiscal stimulus that we are seeing in the United States at this stage of an economic cycle. It is hitting an economy that is already at full employment. So, additional jobs are being created and no new taxes will be collected.

However, of our two market fears, a recession and a tight monetary policy, an economic slowdown is the lesser issue. The economy is reasonably stable today. Dual incomes have anchored household spending in a service-oriented economy with limited inventory cycle exposure. This is quite different from what we knew in the 50's and 60's. Furthermore, the last couple of recessions were more a result of a market bubble or an event with the last two being the crash of the technology stocks in 2001 and the housing collapse in 2007.

My fear is that the very low interest rates we have experienced have encouraged excessive borrowing and created an incentive for investors to take on more risk and reach for yield. They have essentially underpriced risk. As a gauge, junk bonds which have historically yielded about 10%, they only return about a 6.5% yield today.

It's hard to believe that these anomalies can be unwound without some unintended consequences. We know that the fiscal stimulus and tax cut effects will wear off over the next couple of years, leaving more than a residue of debt to be cleaned up.

Hence how the Central Banks withdraw liquidity and how high interest rates go will probably be key to the future of all asset classes.

Looking at the facts, we would expect higher interest rates unless the Central Banks reverse their currently stated policies and ultimately we think this is what this will have to do.

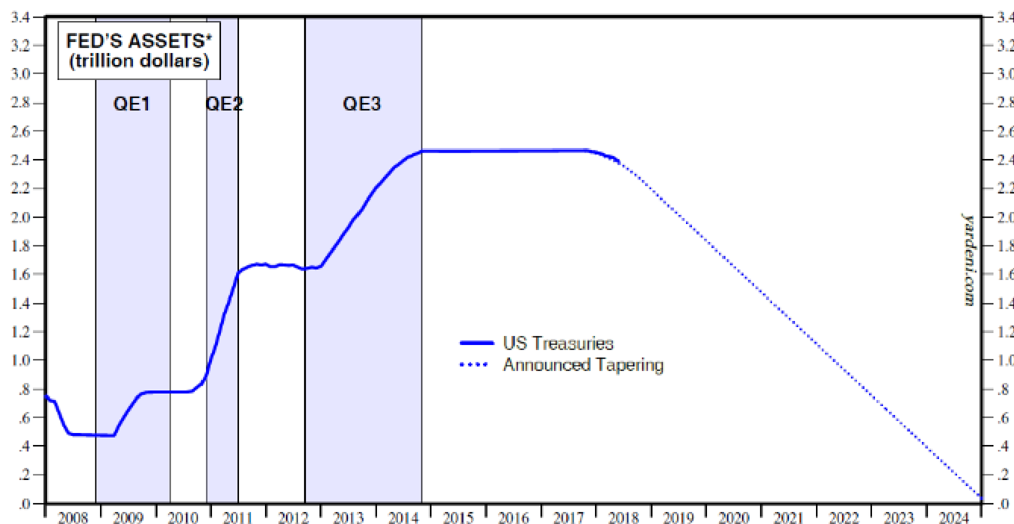
So, let's look at some of these statistics for insights as to where interest rates could go. But be mindful that exercises of looking at supply and demand factors in the debt market have rarely worked with precision. Nonetheless, what we know today is all we have to work with.

Most interest rate forecasts focus on the Federal Reserve and other central banks. So, let's start with the Federal Reserve policy before layering on other factors in the supply and demand for liquidity.

It is well known that the Fed has raised interest rates 7 times over the last two years. Furthermore, they are predicted to raise rates one more time this year which would put the Fed Funds rate at 2.25% and possibly two or three times in 2019.

Irrespective of the tightening over the past two years, relative rates are still historically low while real interest rates remain negative; this is not particularly indicative of a tight monetary policy. More specific to liquidity, it is the Fed's stated intention to reduce its balance sheet by selling some of its government bonds and mortgage backed securities.

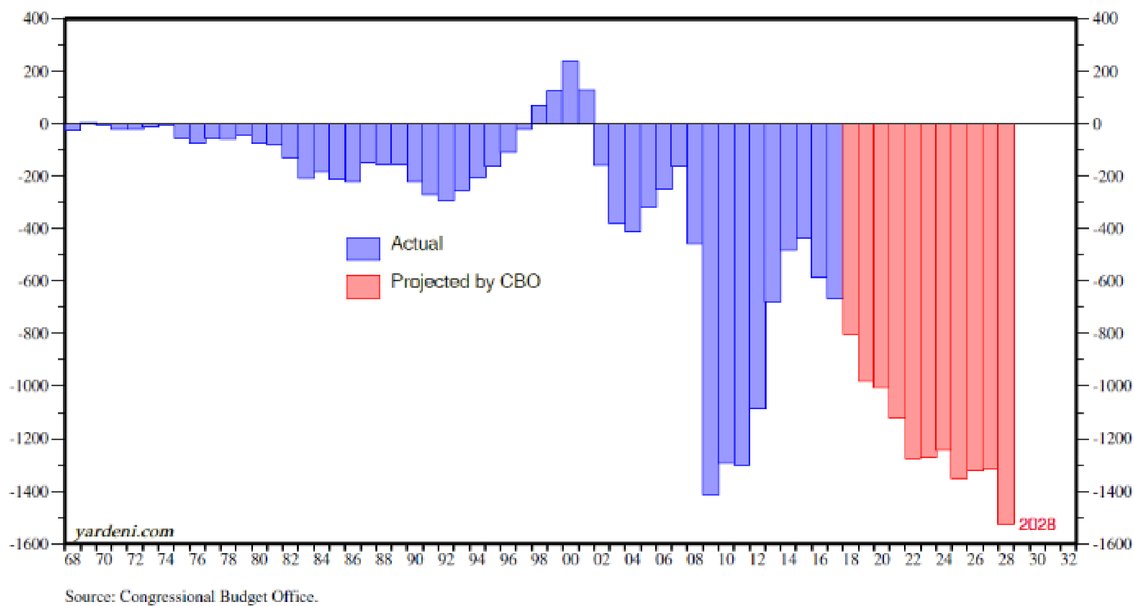
FED's Assets (trillion dollars)



* Average of daily figures for weeks ending Wednesday.
Note: QE1 (11/25/08) = Fed starts buying $1.24tn in mortgage securities. QE1 expanded (3/16/2009) = Fed starts buying $300bn in Treasuries.
QE2 (11/3/10) = Fed starts buying $600bn in Treasuries. QE3 (9/13/12) = Fed starts buying $40bn/month in mortgage securities (open ended).
QE3 expanded (12/12/12) = Fed starts buying $45bn/month in Treasuries.
Source: Federal Reserve Board.

This "tapering" will increase from $40 billion per month to $50 billion ($30 billion of treasuries and $20 billion of mortgage backed securities). Limiting this tapering to just treasuries suggests that additional buyers for $360 billion in government bonds will have to be found next year and every year through 2024. The Fed's balance sheet is scheduled to shrink by $2.46 trillion to below $200 billion by the end of 2024.

US Federal Government Budget Balance Fiscal Years



Source: Congressional Budget Office.

This comes at a time when the annual US Federal Government deficit will average over $1 trillion per year for the next 10 years. This will also add to the supply of bonds.

To date, other Central banks, specifically the European Central Bank (ECB) and the Bank of Japan (BOJ), and The People's Bank of China (PBOC) have continued with monetary accommodation. In the past 12 months, the ECB and BOJ have expanded their balance sheets by 8% while absolute interest rates are still negative. In my opinion, this is one of the primary reasons that US ten-year treasuries aren't trading at higher yields. Foreigners find the higher interest rates in the US more attractive than the rates offered elsewhere. However, this applies only to those willing to take on the currency risk. The cost of borrowing US dollars has increased sufficiently to make a currency hedged transaction move favourable for German and Japanese bonds and potentially works to limit this demand.

Currently, the ECB continues to purchase $30 billion of government bonds each month. This has been cut in half as of October and will be eliminated at the end of the year. That's another $360 billion of demand that will disappear. However, the ECB has stated that they will hold interest rates at current levels until the summer of 2019. We'll see how this policy coincides with Italy's latest proposed budget that expands its deficit and government funding requirements.

Although China still has an expanding monetary policy, they have stopped buying US government debt and in fact, they were net sellers of US bonds in July.

China also factors into our concerns for the global economy and its ultimate impact on the stock market. Their economy is seriously leveraged and the country's economy is struggling to maintain its growth rate. Tariffs are going to aggravate this situation. For perspective, China's bank loans

soared to a record $19.3 trillion, which is twice as much as US bank loans. And the pace of growth has been extraordinary, having doubled since April 2013 and quadrupled since February 2009. In the last 12 months, through August, Chinese bank loans are up $2.3 trillion. Trump's trade war and tariffs are likely to be negative factors for this debt and the potential debt impairment could be what is behind the Chinese stock market sell-off.

Consequently, the Federal Reserve is now withdrawing liquidity and in fact adding to the supply of bonds just as other central banks are about to do the same starting at the end of this year.

The US government is also increasing the supply of bonds as it runs larger budget deficits due to the recently approved tax cuts and increased government spending. Treasury debt issuance will soar to $725 billion in October and $668 billion in November just from maturing issues that need to be rolled over. Government deficits will add $440 billion in the October to December period. Furthermore, Bloomberg estimates that $5.3 trillion in global debt will mature in the fourth quarter.

Overall, since the Fed started raising interest rates at the end of 2015, net interest paid by the US government has soared from $225.5 billion in 2015 to a record high $320.3 billion in the 12 months through August. Over this period, publicly held US treasuries have jumped by $2.1 trillion to a record $15.8 trillion, up from $6 trillion in 2000. The effective interest rates is currently 2.1% up from 1.8% a year earlier and the average maturity is 70 months. So, if the Fed normalizes interest rates to 3%, the current amount of debt will push the government's interest expense to over $500 billion annually by 2020. For a better perspective on how much interest rates could affect the deficit one should consider that the amount of debt outstanding has approximately tripled while debt service costs are only up 25%.

So, government deficits and higher interest rates are about to add significantly to the supply of bonds.

LESS OBVIOUS FACTORS

However, there are less obvious factors that are compounding our supply/demand equation.

The US government's social security system is about to turn ugly. Social security outlays totaled $968 billion last year. However, payroll taxes have exceeded the expenditure with the surplus directed to the Federal Old-Age and Survivors Insurance Trust Fund. This Fund holds roughly $2.9 trillion in intra-government holdings of nonmarketable Treasury Securities. Unfortunately, this money has been spent so the government owes the money to the Trust. Meanwhile, the Trust Fund has stopped buying government debt and is about to start running deficits. Similar to the Fed, this will shift the demand to additional supply of bonds and further increase the federal budget deficit. Current projections showing the trust funds reserves decreasing to $2.189 trillion by the end of 2027. The bottom line is this is a further loss of demand and an addition to bond supply.

Corporate Pension Plans have recently added to the demand for bonds, but this has now ended. These plans hold about $3 trillion in assets and were allowed to make tax deductible pension contributions using last year's tax rates until September 15th. This was a savings of $0.14 on the $1.00 of contribution. This has now ended and coincided with the recent jump in the 10-year treasury yields.

Demographics are also about to become a factor in the bond demand/supply equation.

In the context of a life cycle, you borrow in the education phase, invest in the household formation phase, accumulate in the second half of a career and decumulate in retirement. In childhood, there is no income but school expenses and possibly student loans are likely to add debt. During the household formation years, people are buying cars and houses and they have the cost of raising children. Debt to income is the greatest at this stage. Between 40 – 65, income grows faster than expenses. Net savings reach their highest around 55. In retirement, income falls towards zero and expenses increase with age. This group will grow by 17.6 million in the next ten years.

This population of retirees, children and now new millennial households will increase by 26 million in the next decade. Each group is a structural borrower. The largest savings cohort, 55 to 64, will shrink by 3.4 million people.

The global savings glut created by boomers generation is about to turn into a squeeze.

Defined benefit pension plans are already decumulating. In 2015, they paid out $235 billion but took in only $108 billion. Furthermore, pensions will probably start to shorten their bond portfolio maturities and duration to match the age and requirements of the beneficiaries.

Additionally, the global labour force glut-created in the 1950's by the coming of age of the Baby Boomers, women entering the labour force and the integration of China and India into the global economy is coming to an end. As the labour force growth slows, it could cause a new wave of investment in automation. According to a Bain & Company forecast, this could result in a new wave of investment in automation that could result in $8 trillion of incremental investment.

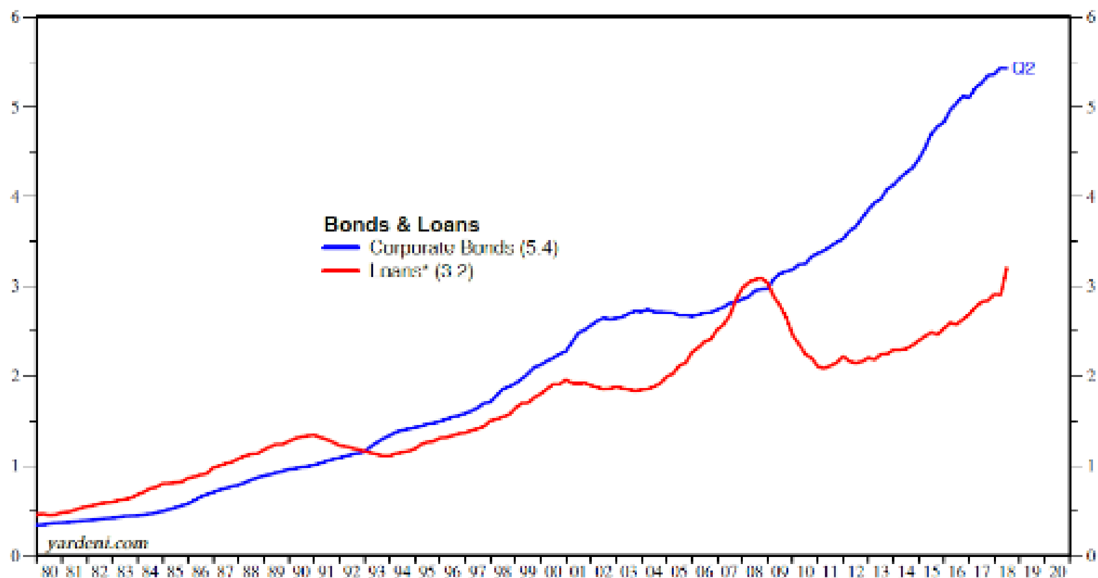
Collectively, these factors reduce the demand for or add to the supply of debt.

Trade deficits are another source of government funding. When foreign companies sell goods to the US they earn US dollars and then often exchange those dollars for their own local currency. Their exchanged dollars often end up being held by that country's Central Bank which subsequently invests them in US treasuries. The most obvious example is The People's Bank of China which holds roughly $1.2 trillion of US treasuries.

Trump's strategy of imposing tariffs to reduce the US trade deficit will also, indirectly, reduce the demand for US bonds and potentially add to the supply if the foreign Central Bank has to reduce their holding. This is currently the situation in China which has recently been a seller of US government bonds. A full-blown trade war will not be good for interest rates.

Lastly, we have corporate debt. The issuance of BBB rated bonds has gone from $700 billon a decade ago to $3.0 trillion today. Collectively, corporate bond debt now totals $5.4 trillion, a quadruple. Meanwhile, 37% of the triple B rated market has a debt to equity ratio of 5x or higher.

Nonfinancial Corporate Business Bonds vs. Loans (trillion dollars, nsa)



* Loans (depository institutions loans, other loans and advances, mortgages).
Source: Federal Reserve Board, Financial Accounts of the United States.

By most tests, the ability of corporations to support this debt is reassuring. Many companies, after the financial crises, took the opportunity to "term out" their debt as is shown by the decline in loans in the above chart. In other words, they increased their outstanding bonds but paid down their bank loans. Today, short-term debt (bank loans) is just 28% of total debt. Close to a record low. This makes companies less sensitive to interest rate changes. However, what is more immediate is their debt covenants and potentially their ratings. Rising interest rates will cause interest rate coverage ratios to deteriorate. Furthermore, the devil is always in the details. Although the overall ratios look sound, there are significant discrepancies between industries. For example, it became apparent when oil prices declined and resource bonds suddenly became challenged. Furthermore, we have seen a staggering increase in funding by private equity and hedge funds. These non-bank lenders are not held to the same standards as the banks and could add to financial instability. Many of these private loans are being packaged into financial products reminiscent of collateralized loan obligations that hurt the financial system in the last crises. Unfortunately, the banks are culpable in this as they are lenders to these private firms. It is estimated this indirect lending has increased six-fold since 2010 to nearly $345 billion. Although it is not on the same scale as the mortgage financing crises we witnessed in 2008, it is a black hole of undetermined size that could pose to be an issue.

ETFs that hold junk bonds could also escalate the liquidity problems. Higher interest rates will affect debt coverage ratios and as they worsen, it suggests that yield spreads between corporate and government bonds should expand. A number of ETF funds hold roughly $410 billion of corporate bonds. Should investors decide to sell these bond funds, there is a question as to who would buy the underlying issues. In the past, the broker-dealer networks normally provided liquidity but have now abandoned the practice, suggesting there could be abnormally large volatility for corporate bond pricing.

If liquidity dries up for corporate debt, the Fed has very little power to directly stabilize the corporate bond market.

This is one of the few factors that could help the supply/demand equation for government bonds as investors would prefer more secure government debt. However, the resulting increase between government bond yields and corporate yields would be bad news for the equity market, corporate bonds and real estate. Higher risk premiums are never good for asset markets.

Needless to say, this is not an extensive review of the factors affecting liquidity and interest rates. Nevertheless, its intent is to expand the debate over interest rates beyond just Federal Reserve policy. From these observations, it appears that the supply of debt is about to increase without any apparent offset other than possibly the Federal Reserve. Regardless, of the short-term swings in interest rates driven by flights to quality, the path to higher interest rates seems to have the wind at its back. Eventually, this won't be good for either the economy or asset values.

Furthermore, the Fed has historically tightened monetary policy until something breaks, the market crashes, then the Fed reverses and loosens monetary policy and the market bottoms out. It's a recurring cycle.

To be long-term bullish on bonds is a bet that it's different this time, which it may be, but only if the Fed relents in time.

GRC/amh
October 15, 2018

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