MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

A Powerful Message from the Bond Market

One of the most surprising features of the financial markets' performance since the Great Recession ended in 2009 has been stubbornly low long term interest rates. Irrespective of inflation trends, economic growth rates, or Federal Reserve policy regarding short term interest rates, bond yields continued to grind their way lower until 2016. This represented the continuation of a multi-decade trend that showed no signs of ending when yields on 10-year US Treasury notes hit 1.336% around the time of the "Brexit" vote in the UK that summer.

Many observers have argued that the Fed's massive bond-buying program ("quantitative easing") was responsible for artificially holding long term rates below their "correct" level. From a supply-and-demand perspective, it certainly makes sense that the Fed buying and holding over $3.5 trillion in government bonds and mortgage securities – more than quadrupling their positions – would depress yields. But the Fed stopped buying bonds in late 2014, and that did not halt the fall in yields over the ensuing two years.

We believe that interest rates fluctuate for a variety of reasons over the short term, that they are nearly unpredictable, and that most such variability can be ignored as meaningless "noise". Over the span of years, though, it's important to understand that the yield on a long term bond is actually a market prediction of where short term interest rates (including rates controlled by the Fed) will be in the future. (This can be demonstrated arithmetically.) That does not mean such expectations are accurate, but it is fair to say that changing bond yields reflect changing market expectations for Fed policy: higher rates imply a tighter Fed, and vice versa.

Looking one layer deeper, what can we infer from interest rates about the broader economy? Readers will not be surprised to learn that long term rates also tend to follow nominal economic growth, as shown in the chart on the following page. Although the linkage is somewhat loose in real time, the long term *directional* relationship is unmistakable. Therefore, higher interest rates reflect expectations that the Fed will likely tighten monetary policy in response to stronger economic growth, and vice versa.

Yields on 10-year Treasuries have risen meaningfully over the last two years and as of this writing have reached their highest levels since 2011 (3.1%). This is an important statement about market participants' confidence in the economy – **if the recent burst of stronger growth was not seen as sustainable, rates would not be moving higher. If the market was concerned that the Fed was becoming too tight and risking a recession, rates would not be moving higher.**

If higher rates are finally here, what does this imply for equity investors? After all, the common wisdom is that higher interest rates are bad for stocks because they tend to depress valuations. While it is true that higher rates on risk-free Treasury bonds create greater "competition" for investor dollars, over the last 60 years stronger economic growth and higher earnings usually have been more than enough to offset this factor. JPMorgan estimates that, when yields are below 5%, periods of rising interest rates historically have been associated with rising stock prices. And LPL Financial research demonstrates that the S&P 500 index has risen in 83% of the episodes of rising interest rates since 1962.

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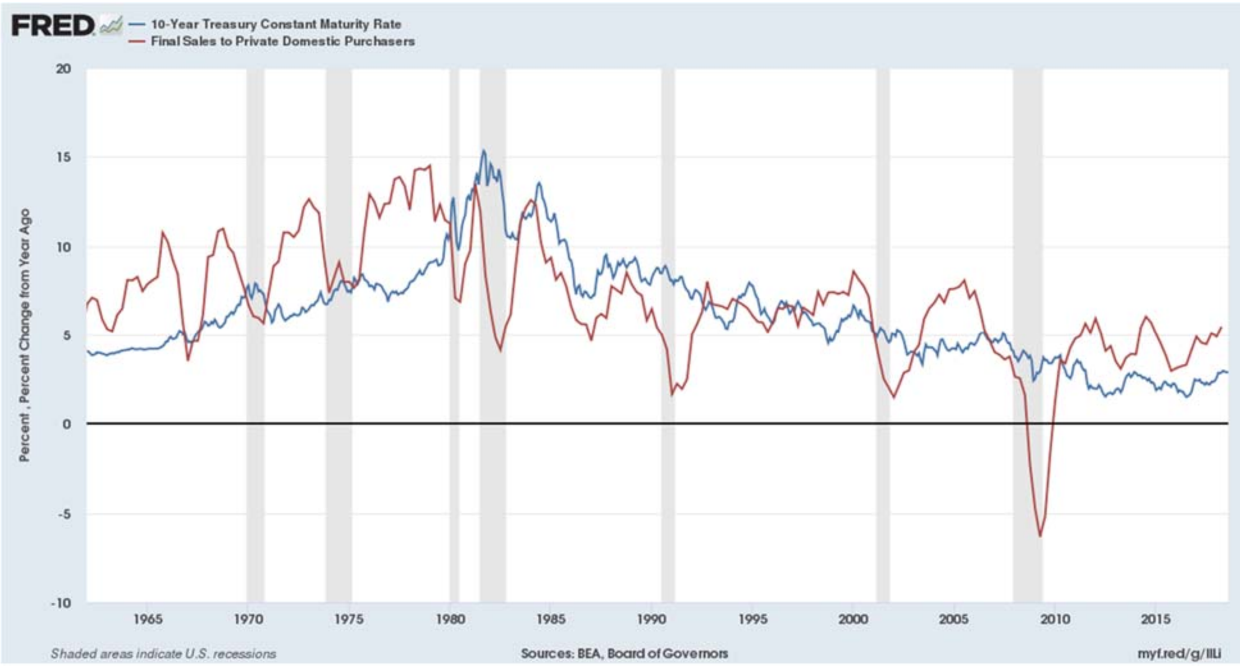
Market commentators have routinely expressed skepticism that the economy could continue to grow as long as it has, let alone strengthen. The bull market in stocks, and the economic expansion, have been described as being "late in the cycle" or "in the late innings" for several years now. Few seem open to the possibility that the economy can continue to grow, yet this is the unmistakable message of the bond market.



As we've discussed in detail in previous issues of *Consilium*, there will be plenty of useful data that can help anticipate the next economic downturn and bear market. There is no reason to act prematurely, thereby sacrificing additional gains that could be meaningful, when there will be ample warning from indicators such as employment, retail sales, and credit spreads. All of these metrics point to economic growth – and the recent rise in interest rates now validates this view.

Sometimes, the game goes into extra innings.

Sources: JPMorgan Asset Management, LPL Financial, FactSet, Federal Reserve Bank of St. Louis