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Today's Markets Are in Uncharted Territory

Investing when interest rates (and bond yields) are no more.

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Mentioned: Morningstar Inc (MORN)

The Very, Very Long View

To write that today's bond prices are unusual is to greatly understate the matter. In a recent interview, veteran market observer Laurence Siegel--who formerly worked in research at Ibbotson Associates and the Ford Foundation, before currently serving as director of research at the CFA Institute Research Foundation--states that current interest rates are "literally unprecedented in human history."

Per Siegel's sources, which date back 5,000 years (!), nominal interest rates in countries (or, for most of that history, empires) that were successful enough to be remembered have always been positive. Until the mid-19th century, they were almost always highly positive, at 8% or more. The lone exception was the height of the Roman Empire, where rates briefly hit 4%.

In that context, states Siegel, the negative short-term interest rates that are now offered by Switzerland and Japan, along with the effectively flat rates that exist in other developed countries, are without precedent. Says Siegel, "The idea that you have to pay somebody to lend them money simply turns the universe on its head. Gravity works backwards. Apples fall upwards. I don't claim to understand it." Longer securities aren't much different; Japan's 10-year bond pays a meager 0.10%.

In Theory

Naturally, being a researcher, Siegel promptly attempts to understand what he claims not to understand. His first attempt to analyze interest rates came by considering classic monetary theory, as presented by Milton Friedman and Anna Schwartz, but to no avail. The surge in inflation predicted by monetary theory, following steep U.S. money growth, has not arrived. Comments Siegel, "I've been positioned personally for a lot of inflation in my portfolio since about 2008, so I've been wrong over and over for about 12 years. Please don't take my investment advice!"

(Tell me about it. Every major investment trade that I have made has flopped, because each of those trades involved swapping Morningstar (MORN) stock for something else, and the Morningstar stock has always outgained that something else. As failures go, this has been an excellent one, but the experience has nonetheless been humbling.)

In response to the struggles of conventional monetary theory, Siegel has embraced an updated version, the Fiscal Theory of the Price Level, which Siegel rebrands as "New Monetarism" in a paper he is writing with University of Chicago professor Thomas Coleman. According to New Monetarism, money-supply growth will not lead to inflation if the monetary expansion consists of "exchanging one type of government liability for another--exchanging cash, one liability, for another type, long-term debt." So far, so good.

However, there is a catch. Per New Monetarism, "The fact that bonds have not fallen in price indicates that the public believes the debt will be paid back whole in real terms. For that to happen, the government has to run a primary surplus (revenues minus expenditures other than interest in the national debt) in the future. Market prices are, thus, telling us that--contrary to intuition--future surpluses are rightly or wrongly what the people who buy bonds are expecting."

Hmm. I suspect that *you* do not foresee the United States recording a budget surplus anytime soon. Nor, to his credit, does Siegel. He continues, "I guess I am supposed to believe the market, but I have a hard time with [that part]."

Live First, Learn Later

My point is not to bury Siegel's claim. (He has done the work, not I.) It is instead to demonstrate how bond-market theories have struggled to keep pace with the market's results. (Tellingly, three academics have recently updated the math behind The Fiscal Theory of the Price Level, to account for 2020's valuations.) Forty years ago, the prevailing theory suggested that Paul Volcker's attempt to throttle inflation ultimately would prove successful, thereby sparking a bond rally. Today, the market's results come first, and then the explanations follow.

This is not unusual with investments. For example, from 1871 through 1959, the dividend yield on the S&P 500 always exceeded the income from 10-year U.S. Treasuries. The common argument was that stocks should offer higher yields than government-guaranteed bonds, because stocks carried greater risk. That view held for almost a century, ... until it didn't. (Although now it does once again.) Many thought that stocks had become overvalued. Eventually, those objections ceased, for the simple reason that the marketplace dissented.

Similarly, until recently a figure exceeding 25 for the Shiller Cyclically Adjusted P/E Ratio (Shiller CAPE Ratio) was considered unsustainable. Such amounts had occurred briefly during the late 1920s, the late 1990s, and the mid-2000s, each time presaging a crash. Since 2015, though, the S&P 500 has remained firmly above that mark, which predictably has led to arguments that the statistic should be revised to reflect that conditions have changed.

Looking Forward

While we wait for theory to catch reality, there are a few things to acknowledge about the current bond market. First, current interest rates reflect enormous confidence in the underlying institutions. People wouldn't accept nonexistent (or even negative) yields unless they were absolutely, positively certain of receiving return of their capital. (It is odd that such confidence coexists with the boom of cybercurrencies, which implicitly undermine the claims of sovereign currencies.)

Second, it's a challenging climate for tactical asset allocators, who attempt to profit by knowing when bonds are a better buy than stocks, or vice versa. Such decisions rely either on investment theory, or on repeating performance patterns that have previously occurred. When interest rates move where they have never been before, those compasses disappear. The tactical allocators fly blind.

Finally, such low rates have already caused spillover effects and will continue to do so. All things being equal, low rates also benefit non-bond investments, because their competition has become so weak. (It's not terribly difficult to outgain an annualized return of 90 cents on every $1,000, which is what 3-month Treasury bills now pay.) In addition, easy money facilitates greater borrowing and thus higher leverage. How these factors will play out is anybody's guess.

This isn't to caution against investing. Exiting the marketplace is usually unwise even for the short term, and almost always over the longer haul. Rather, it is to caution against relying too heavily on received wisdom. There are times when investment guides, whether formulated by theory or observation, are relatively reliable. This would not appear to be one of those times.

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