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Federal Reserve Perspectives

Andrew W. Bischel, CFA
CEO & Chief Investment Officer

Which Is It – Bye Bye or Buy Buy Bonds?

It has been an absolutely miserable year for Treasury bond returns as well as other corporate benchmarks. Furthermore, bonds have failed to act as a counterbalance to risk in stocks and the stock markets. This environment leaves one to wonder, can it get any worse?

Here is a sample of the troubled year experienced by both bonds and stocks (as represented by the S&P 500):

Bond/Stock	Total Return % Year to Date 9/23/2022
30-Year Treasury	-29.8%
10-Year Treasury	-15.9%
5-Year Treasury	-10.0%
2-Year Treasury	- 3.7%
Bloomberg U.S. Aggregate	-13.8%
Bloomberg U.S. Corporate	-17.2%
S&P 500	-21.7%

Source: Return calculations from Bloomberg data

The market has continuously underestimated the Federal Reserve Board's resolve to kill the price inflation beast. This is not surprising given that the Fed has "blinked" repeatedly over the last decade and more. When stocks took a dive, the Fed relented from its tightness and shifted to monetary ease. Modern Monetary Theory (MMT), whether the Fed will admit it or not, has been the operative model of Fed policy for a decade. "Lower for longer" was the operative expectation the market believed. It is evidenced by the Fed's maintenance of its Zero Interest Rate Policy (ZIRP) in ten out of the last thirteen years. Why believe the Fed now when just a year ago, Chairman Powell repeatedly stated the price inflation problem was just "transitory?"

Let me make a bold forecast right now: ***The Federal Reserve Board will never return to its former ZIRP Policy!***

They say, "never say never," yet this policy has been so destructive to the proper working of financial markets to allocate risk capital, we should all be pleased if the Fed never again goes to such an extreme. Don't expect it to now reverse course to such an extent that zero interest rates are adopted again. It appears that the Fed has adopted a course of action to avoid the 1970's experience of successive bouts of rising pricing inflation (more on this in a minute). The limitations on future Fed dovishness most likely takes away some of the upside in bond prices as yields hit a higher floor than in prior cycles. Instead of believing interest rates will stay "lower for longer," the market is now "longing for lower!"

The real question is: *Why did the Fed believe that at its 2% inflation target a 0% Fed Funds Rate was somehow justified?* It wasn't. But the Fed and other central banks around the world all believed a 0% rate and even large negative nominal interest rates were required to stimulate economic activity. The Federal Reserve Board is now leading these same central banks out of an era of punishing negative interest rates.

The Fed publishes "dot plots" containing individual forecasts of governors regarding future levels of the Fed Funds Rate. Stock and bond markets have plunged from the idea that the median forecast (and preponderance of individual forecasts) expects the Fed Funds Rate will reach 4.6% in March of 2023. Furthermore, the median doesn't get down to 2.25% until 2025! The caveat—the forecasts of the Governors are not stable, and the Fed is not particularly good at anticipating its own actions.

While the restoration of more normal pricing of credit risk will eventually be a godsend to the markets and to savers, who can again finally get a reasonable return on fixed income investments, the short-term consequences are likely to be quite painful. The U.S. economy is likely to experience subdued growth or outright recession from the massive jolt of higher interest rates.

Nevertheless, if the rate of price inflation returns to the 2% pace, the proper level of the 6-month to 1-year Treasury should be closer to 2.25-2.50% rather than 0%. Treasury bill prices, while containing no credit risk, still should offset the expected rate of price inflation and offer a modest real rate of return. The 2025 dot plot reflects this. At longer Treasury maturities, price volatility rises with interest rate changes, typically requiring even higher real interest rates as compensation. The entire credit yield curve for corporate bonds and bank loans and the general pricing of credit risk feeds off the Treasury yield curve, forcing the funding for risky investments to be properly priced in credit spreads. ZIRP completely distorted this process and led to rapid growth in debt due to cheap costs, with widespread speculation in rising asset prices and excessive debt leverage in both the government and private sectors. This is where we stand today—the Fed's choice is to return markets to a "new" normal or cave once again.

Yet what if inflation isn't so easy to reduce down to the 2% target? What's missing from the 1970's stagflation analogy is the role profligate government spending had in triggering higher and higher amounts of demand stimulation by the Nixon and Carter administrations. Nothing in today's government picture is designed to stimulate the supply of goods and services. It wasn't just Paul Volcker's tight monetary policy that broke the back of the 1970's inflation. It was also the elimination of price controls on U.S. oil as one of President Reagan's first acts in 1981. Oil production was hugely stimulated and prices fell from over $40/barrel (WTI) to near $10/barrel in 1986. Burdensome regulations were reduced and high income tax rates were also cut.

There are no signs that such a sustained reduction in the burdens on "supply" is about to happen. To the contrary, heaps of cash are being thrown into the economy. So what if this stagflationary environment continues? If the price inflation rate can only get back down to 4%, instead of 2%, and even if real interest rates are cyclically low yet still positive, the Fed Funds rate can't possibly get back to the 2.5% level the dot plots forecast in 2025. If the Fed pushed the Funds Rate back to this level in the face of 3-4% price inflation, it would simply trigger another 1970's up-cycle in price inflation. Bonds would not likely see the big returns the market hopes for.

Yet Treasury yields are no long near 0%. Even if Treasury yields stay well above 2%, with the yield on 2-year Treasuries above 4%, and the rest of the yield curve working its way higher toward this same level, bonds now offer something that's been missing of late—diversification protection from equity risk as well as a partial offset to the erosion in value from today's price inflation. So rather than saying "Bye Bye" to bonds, we're much closer to being ready to say "Buy Buy" to bonds.

Andrew W. Bischel, CFA
Chairman & CEO

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