Thackray Sector Report

— Every Sector has a Season —

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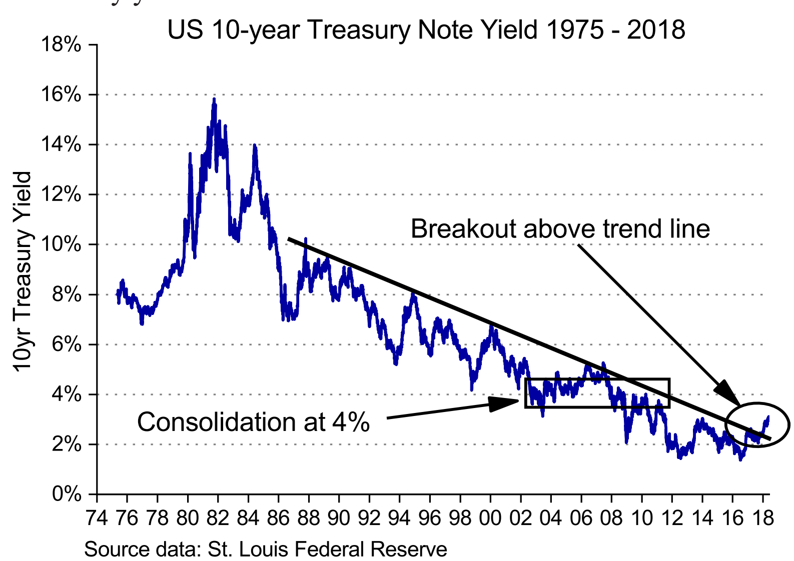
GOVERNMENT BONDS...

Hated by most investors... Government bonds could provide value ahead?

The decline in the 10-year yield has kept on trend until recently when it broke above its trend line and broke above 3%...

Call me a hieratic, but government bonds could be an attractive investment over the next few months! Most pundits and investors think that the US bond bull market has died and bonds are in a nascent multi-year bear market. The chart below shows a steady decline of the yield on the 10-year Treasury Note from 1981 to 2017. The decline in the 10-year yield has kept on trend until recently when it broke above its trend line and broke above 3%. For bond bears, this was the final statement that bonds are dead, kaput. I am not sure when the bond bears believe that bonds will once again be a good investment, but one gets the feeling that they believe it will not be for many years.



Disclaimer: I am not a long-term bond bull...

Disclaimer: I am not a long-term bond bull, but do believe that there will be periods of time when bonds will provide good value and should be considered in a portfolio. I am neither a bond bull, nor a bond bear. Investors should always be wary of locking themselves into a bullish or bearish position. The most boisterous bears or bulls are the ones that often miss opportunities and stay in their positions too long and get hurt the most.

Technically, in the graph above, the break above trend line for the 10-year yield does indicate a possible change in direction or consolidation, but it is not a foregone conclusion. It is possible that the 10-year yield could reverse direction and resume a downward trend. A few years ago, investors commenting on different sovereign bond yields, asked the question, “how low can they go?” Nobody imagined that they would see many countries use negative interest rates. Just because rates are low does not mean that they cannot go lower.

There are a lot of moving parts in determining bond prices, but the basic “bear” position is that the US economy is growing and inflation is increasing. Therefore, the yield on longer term bonds should increase as investors demand greater compensation for holding bonds. A lot of investors mistakenly believe that the Federal Reserve controls the yields on long-term bonds. There is no question that they control the short-end of the curve, but they only have a limited impact on the longer part of the curve. This excludes special targeting programs that are rarely used, such as the Federal Reserve’s Operation Twist in 2011 when the Federal Reserve purchased long-dated bonds and sold short dated bonds. The longer part of the curve is typically impacted a lot more by the market compared to the Federal Reserve. If the Federal Reserve raises its federal funds rate too fast, yields at the short-end of the curve can increase at a faster rate than the longer-end of the curve and an inverted yield curve could ensue.

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The one argument that I get tired of hearing is that if the Federal Reserve is raising rates, this is a healthy indication that the economy is growing. Although it could be true, it is not necessarily true. The Federal Reserve started to increase its federal funds rate in December 2015. In total, it has raised its rate six times, which now sits at 1.75%. One of the objectives of the Federal Reserve is to “normalize” rates after years of intervening in the price discovery mechanism of the market by keeping rates artificially low. The federal funds rate is still artificially low and the Federal Reserve is on a path of rate increases to normalize rates so that if and when a slow down occurs in the US, they will have the tools to be able to help stimulate the economy. Initially, the Federal Reserve actions of raising rates had very little to do with growth and more to do with trying to normalize rates.

Government bond prices already reflect both growth expectations and any indirect affects of the Federal Reserve increasing its federal funds rate. In other words, the future expectations are already baked into the price. If growth expectations change, it is reasonable to expect government bond prices to change. The expectation for higher inflation in the future is already somewhat priced into current bond yields. If inflation expectations change, it is reasonable to expect government bond prices to change.

So why now? Why consider bonds? On a fundamental basis, global growth is slowing. In 2017, the mantra was synchronized global growth. In 2018, the mantra no longer applies. Emerging markets are struggling with a higher US dollar and Europe has started to show signs of slowing. The US is still showing signs of economic strength, but for how much longer. The tax reform package has helped boost the economic numbers and company earnings were particularly strong in Q1. It is possible that this is as good as it gets and the US could slowly follow the trend of slower world growth.

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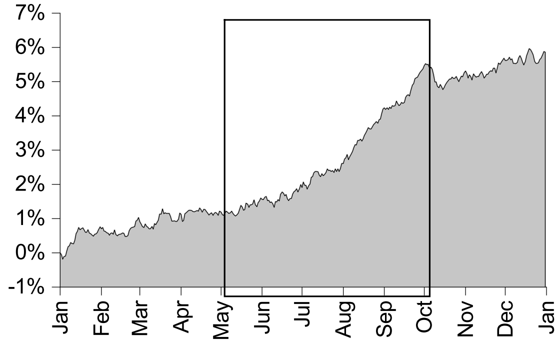
Back in January, the US stock market took off like a rocket. Investors came up with a multitude of reasons on why the trend should be able to sustain itself into the future. Looking back now, most investors can see that the strength of the rally could not be sustained for any length of time. Investors have a similar viewpoint on government bonds. There is a strong consensus to get out of bonds. It is an extremely lopsided trade, with a lot of speculators short US Treasuries. If treasuries were able to rally, a short-squeeze could ensue, pushing US government bonds higher.

From a seasonal perspective, government bonds are favored at this time of the year. Government bonds tend to perform well from May 6th to October 3rd, with the sweet spot being August and September. On the margin, investors tend to look for alternatives to equities in the time period that equities tend not to perform well, in the six month period from May 6th to October 27th. On a risk reward basis, investors are attracted to the security of government bonds. Often, when stock markets correct, bond prices rally. This is particularly true over the late summer months.

US Government Bonds
Avg. % Gain 7-10 yr. (1998-2016)



Source: Thackray's 2018 Investor's Guide

The above graph shows the average yearly gain for US government bonds from 1998 to 2016. Although the time period from late October into early May have produced a positive return, this time period is not as strong as the other six month period (the favorable period for government bonds). The time period in the data sample for the graph above is also one in which interest rates were on average falling. On a go-forward basis, if interest rates are more stable or even, on average rising, the monthly periods that previously provided only a marginal benefit, may not be as attractive as an investment.

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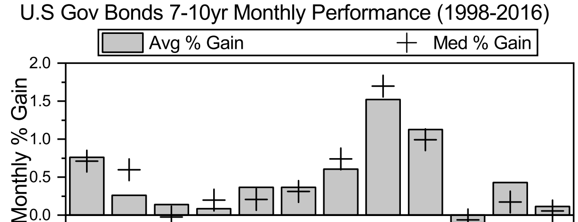
In addition, what makes government bonds particularly attractive in early May to early October is that this is the same time period that the stock market tends to struggle and not produce large returns.

The graph below shows that August and September are the strongest months of the year for government bonds. Although government bonds could perform well in the near future, the sweet spot for the trade starts in late July after the earnings season gets underway for stocks.

U.S Gov Bonds 7-10yr Monthly Performance (1998-2016)



	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Avg. % Gain	0.8	0.3	0.1	0.1	0.4	0.4	0.6	1.5	1.1	-0.1	0.4	0.1
Med. % Gain	0.7	0.6	-0.0	0.2	0.2	0.3	0.7	1.7	1.0	-0.1	0.2	0.1
Fq %>0	68	58	47	58	53	53	74	79	79	37	53	53

Source: Thackray's 2018 Investor's Guide

On a technical basis, government bonds are set up to perform well in their seasonal period. Using the iShares 7-10 Year Treasury Bond ETF (IEF), it can be seen that US government bonds have broken their downtrend. This does not necessarily mean that bonds are necessarily going to continue to rocket higher, but it is a good sign, especially at the start of the seasonal period for government bonds. In the short-term government bonds are becoming overbought, but even so, it does not necessarily mean that they are about to turn down. They can stay overbought for quite some time. If investors start to question US growth prospects, it is possible that government bonds could rally to higher levels seen late last year.

Many investors have taken up the mantra that “bonds are dead.” It is easy to do when the likes of Bill Gross and Jeffrey Gundlach, that have earned the titles “Bond Gurus,” have been preaching this message in the media. Government bonds may not be as attractive as they were ten years ago, but if there is one time of the year that investors should consider investing in bonds, it is from early May to early October, particularly in August and September.