Thackray Report

Bonds are Not Dead Yet!

June 14, 2021 Written by Brooke Thackray

The narrative in the markets has been inflation, reflation and a growing economy. The result has been investors steering clear of bonds and many have been declared bonds dead. Probably prematurely.

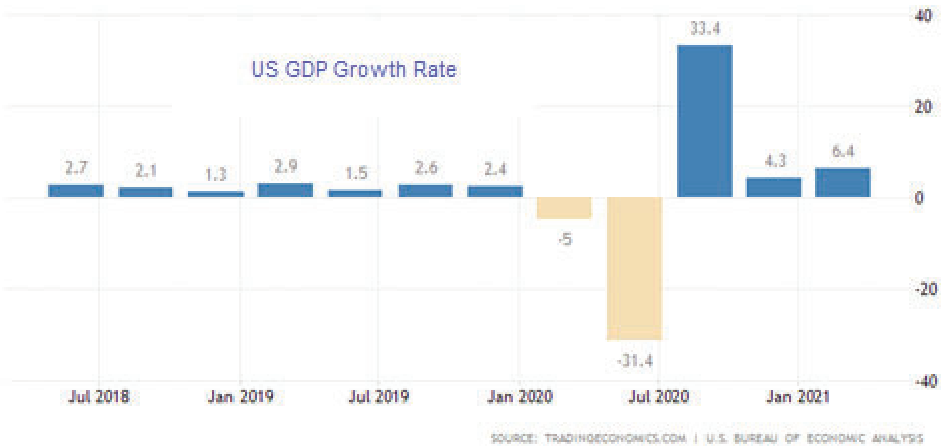
The photo below is a scene from the movie, Monty Python and the Holy Grail (1975). It is a comedy that portrays the real life medieval black plague situation in the 14th century. In this time period, a team with a cart would pass through town announcing a rallying cry, "Bring out your dead." Anyone who had a family member or friend that was dead would dump them on the cart to be taken away. In the Monty Python skit, a peasant is trying to bring out his grandpa and dump him on the "dead" cart. The grandpa declares, "I am not dead." He is still put on the cart anyway. The point is that the majority of investors are declaring bonds dead, but they may not be the case (at least for now).

Interest rates on government bonds are driven by a multitude of facts, but two key factors are the expected growth of the economy and expected changes in inflation rates.

The narrative being promoted with investors at the current time is that the economy is growing at a rapid rate and is going to keep growing at a fast pace in the next couple of years. If the economy does show any signs of slowing down, the Dynamic Duo of the Federal Reserve and Government will pump enough liquidity into the economy to ensure that the stock market will continue to perform well.

Interest rates generally rise with a growing economy as the demand for credit increases, pushing up the cost of money. As interest rates rose off a bottom in the summer of 2020, Powell continued to remind investors that rising rates were a sign of healthy, growing economy. He has indirectly maintained that rising inflation expectations have had nothing to do with rising interest rates and everything to do with economic expansion.

Measuring economic expansion and looking forward to the future is difficult at the current time, more so than usual. A sharp drop in output, because of government's reaction to COVID-19, quickly turned into a fast expansion, which has since dropped to levels above normal. Despite high growth rates expected for 2021 (above 5%), growth rates are expected to head back down to normal levels in 2022. In other words, economic growth rates have been changing much faster than we are accustomed to experiencing, making predictability difficult and setting up conditions for large prediction errors. It is possible that the narrative of continued rapid expansion is subject to being revised downwards in the not so distant future. The graph below shows the recent historical changes in the US GDP growth rate.



In addition, there is an additional narrative that inflation is increasing at a faster rate than expected and that it is getting out of control. Interest rates generally rise with increasing inflation expectations. As dollars are expected to be worth less in the future, due to inflation, lenders demand a higher repayment of dollars as compensation. The graph below illustrates the rising inflation rate, which has generally been greater than expected. It is easy to look at the graph and extrapolate forward and say that the next bar will be higher. It is our human nature to use recency bias in extrapolation. It is highly unlikely that the rate of increase in inflation can be maintained. If you connect the bars on the CPI from March to May, Weimar type hyperinflation would take place within a few years. It is natural for inflation to spike and recede. In fact, in 2020 the inflation rate increased from early in the pandemic before peaking in September 2020, and then leveling off for a few months. Is it possible that the CPI print could be lower in July, August or September of this year?

As the S&P 500 has reached all-time highs, US government interest rates have headed lower. Given that the stock market has headed higher on expected stronger economic growth, it would be expected that interest rates would move higher, but this has not happened. The bond market is not buying what the stock market is selling. The bond market either isn't buying the rapidly growing economy scenario or that inflation is going to continue to rise rapidly in the future.

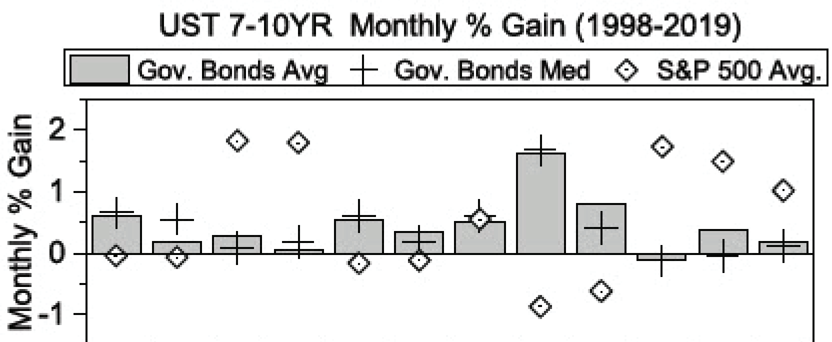
The graph below shows the yield on the US Treasury Note declining from the end of March to June 11 with a closing value of 1.47%. The decline in the yield has occurred at the same time that the GDP has been expanding and the CPI has been rising. The bond market has shrugged off both of these metrics, with interest rates moving lower. On May 17, 2021, I released a report showing that the China credit impulse has been heading lower, which means that it is going to be difficult for global economic growth to continue at a rapid rate. https://alphamountain.com/wp-content/uploads/2021/05/Thackray-Report-2021-MAY-17-China-Credit-Impulse.pdf

Perhaps bond investors are focusing on some of the softer data than is indicating that an economic slowdown could take place in the near future.

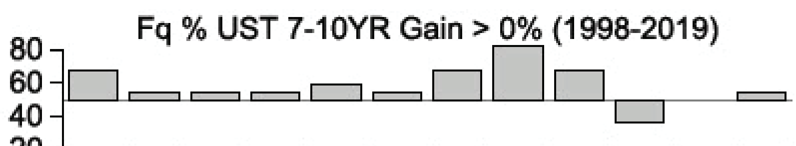
Recently, some of the commodities that have been used as a barometer to forecast higher inflation have seen their prices declining. Lumber has been falling in price since early May. Copper has also been falling in price. Sure, it is possible that some of the commodities are just taking a break in their ascent higher, but lower prices in the near-term should not be discounted as a possibility.

There are different ways to measure inflation expectations. Recently, the University of Michigan Inflation Survey showed that inflation expectations have been receding (Source: Brian Chappata/Bloomberg). The graph below shows the one year inflation expectations.

Seasonal trends support the possibility of government bond yields continuing to move lower. Typically at this time of the year, US government bonds tend to perform well. The sweet spot to the government bond trade is in August and September. The graph below shows that in the month of August, US government bonds have been positive 82% of the time from 1998 to 2019 (*Thackray's 2021 Investor's Guide, page 47*).



	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Avg	0.6	0.2	0.3	0.0	0.5	0.4	0.5	1.6	0.8	-0.1	0.4	0.2
Med	0.7	0.6	0.1	0.2	0.6	0.2	0.6	1.7	0.4	-0.1	-0.0	0.1
S&P 500 Avg	-0.0	-0.1	1.8	1.8	-0.2	-0.1	0.6	-0.9	-0.6	1.7	1.5	1.0



	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Fq %>0	68	55	55	55	59	55	68	82	68	36	50	55

The death of government bonds have been prognosticated for many years. They may die some time in the future, but now might not be the time. The Federal Reserve is going to find it difficult to let interest rates rise. Yes, the Federal Reserve is under pressure to shift slightly away from its ultra dovish stance at its next meeting on June 16, 2021. The subsequent reaction could be negative for US government bonds in the short-term. Nevertheless, if investors ratchet back their expectations for economic growth and decrease their inflation expectations, US government bonds could perform well in their strong seasonal period that finishes in early October.

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