RGA INVESTMENT ADVISORS, LLC

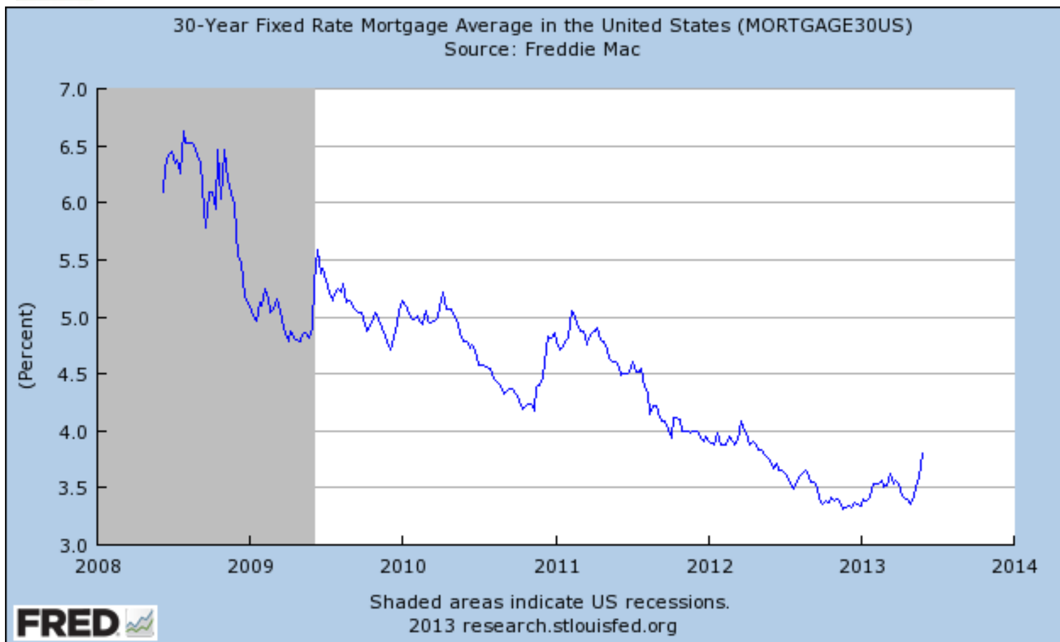
June 11, 2013

The Interest Rate Debate

Those who simply sold this May "to go away" missed out on a decently strong month. The strength was most pronounced in the Russell 2000 and the Nasdaq, two indices with broad-based membership known for their "leadership" status in markets, adding 4.5% and 4.3% respectively. The S&P and Dow trailed, tacking on 2.6% and 2.2% gains respectively.

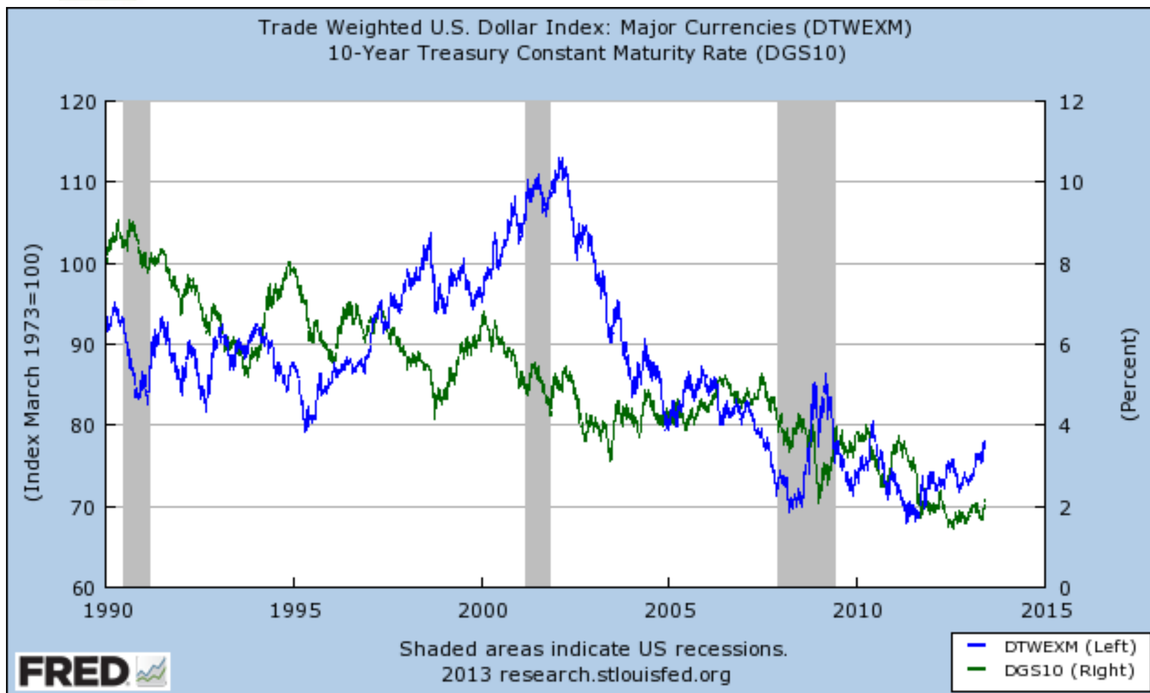
The most notable move across markets was the rise in yields on the long end of the Treasury curve. The 30-year Treasury yield started the month of May at 3.15% and closed the month at 3.27% (this rise has since continued into June).

One of the biggest consequences of this move has been the rise in the average 30-year mortgage rate:



Collectively, these movements have sparked an emotionally charged debate amongst market participants as to the true catalyst. Some argue this is the inevitable comeuppance of the bond vigilantes who will punish countries for long-running deficits, while the loudest prognosticators today argue this move has been driven by hints the Federal Reserve Bank will "taper" its aggressive monetary policy put in place to combat the financial crisis of 2008-09. Meanwhile, others argue quite simply that this is the natural outgrowth of an improving economy, and is more a reaction to events of the recent past, than a signal of a change in the immediate future.

This is not the first time rates have risen on the long-end since the Federal Reserve's policies have been in place. Each instance has come with those fearful of bond vigilantes loudly asserting their stance. This complaint is as wrong today as it has been for the entire recent past. We can see this most clearly by the strength in the US dollar against a global basket of currencies. If bond vigilantes do strike, it is only natural for the currency to be one outlet through which to inflict their wrath.



Many will point to 1994 as the last time bond vigilantes made an appearance in the US, and we can see fairly clearly that the US dollar weakened (the blue line) as the yield on 10 year Treasuries rose (the green line). Meanwhile, today, the US dollar's strength is far more pronounced in the historical context than is the rise in Treasury yields.

Finding meaning in a complex world:

Since we are dismissive of this argument, let's take a look at the Fed tapering verse economy improvement debate. In keeping with our belief that the world and financial markets are "complex dynamic systems" where no one catalyst necessarily supersedes all others, and the interacting forces between overlapping systems sometimes react drastically to small forces, while moving not at all to the largest of forces, we think more time should be spent on the consequences of such a change than explaining the precise reason. However, when some reasons are apparent, and others are clearly falsifiable, we think it's equally important to take an honest look at what is going on.

It's important to approach the extent of the rise in rates in context, as things today have merely regressed to where they were last year at this time. In the grand scheme of things, rates, factually speaking, are on the extreme low end of the historical range of possible outcomes. But we do think this move is substantial enough to warrant our time and a deeper conversation and to raise the idea that perhaps "this time is different."

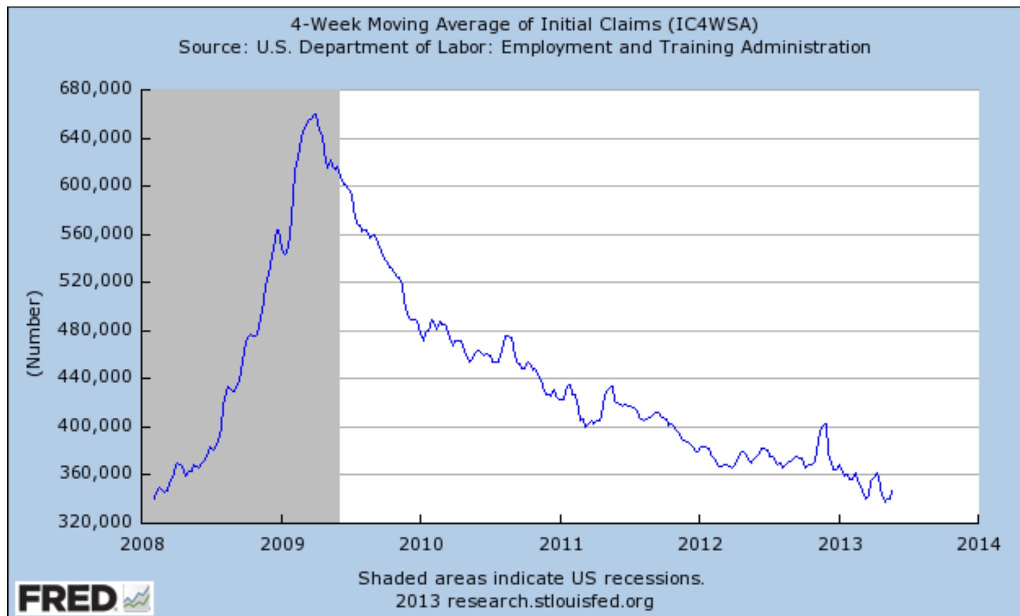
We think financial markets are finally noticing the underlying improvements that we have been discussing on an ongoing basis for so long now. This is a good thing for both your portfolios, and for the economy at large. Confidence itself becomes a compounding force whereby improvements drive higher prices in financial markets, which themselves instill further confidence and investment therefore driving another round of higher prices in financial markets.

Some people call these reflexive forces, others virtuous cycles or feedback loops. Regardless of name, these moves have led to an increased level of gamesmanship in expectations for what will happen next from the Fed.

There's no "taper" without a strong economy:

The very notion that the Fed may "taper" aggressive policy is an implicit acknowledgment that the economy is improving. Yet it's almost comical how many people talk about "tapering" as a bad thing, without ever acknowledging the obvious connection to real, tangible improvements in the economy. The Fed all along has been explicit in telling us that these aggressive policies will remain in place "in supporting a sustainable recovery."[1] To suggest that we are nearing an end to aggressive policy is to suggest we are on the brink of a sustainable recovery. Why is there so much cognitive dissonance that people can't make this connection and instead talk about tapering as a catalyst for fear?

We would argue there really are not distinct schools of thought about the rise in bond yields, but there is a disconnect in the lexicon of the competing camps. We agree that the economy is showing real signs of improvement. The two best developments in the past year have been in the housing market and auto market—the two most abundant durable goods in our economy, with the largest multiplier effect, and these were improvements we anticipated for some time (check out our 2013 Preview for detailed discussion and charts on this matter http://rgaia.com/uploads/files/December_2012_Commentary.pdf). Since these two sectors are also deeply connected to labor markets, it's only natural that the unemployment picture has started to improve in tandem. This is most clearly evidenced in a chart of continuing claims for unemployment insurance:



So where does that leave us with the rise in interest rates?

[1] Ben Bernanke at Jacksole Hole, August 2012 http://www.federalreserve.gov/newsevents/speech/bernanke20120831a.htm

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Since the Financial Crisis began, market participants have consistently been ahead of the curve in both expecting recovery and expecting the Fed to move policy accordingly. In this case, this time is no different. To Bernanke's point about pursuing a "sustainable recovery", he has also hinted that risks of deflation are serious, lingering, and require the Fed to err on the side of pushing a little too far towards inflation rather than the other way around. While Bernanke does not want to "unanchor inflation expectations" (that are now rather moderate across the economy), he is cognizant of the fact that today, there are far more tools at the Fed's disposal to fight inflation if and when it comes than there are to fight deflation. This asymmetry in tools is clearly a driving force behind policy.

From here, we think it's justifiable that the slope of the yield curve gets and stays steeper (in other words, the spread between short-term and long-term interest rates rises) we think this will not result in any policy changes just yet. It will merely be reflective of the resilience of our economy and where things stand on the path towards what has been a very elusive "sustainable recovery." In the meantime, there will be much chatter and consternation wrought with emotion as to what happens next, and that might be just the opportunity we need to reallocate some of your growing cash balances from realizing gains in strong positions this past month.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail. Please feel free to call Jason or Elliot directly at 516-665-7800.

Warm personal regards,

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