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Globalization vs. the U.S. Business Cycle: The Effects on U.S. Interest Rates

Globalization

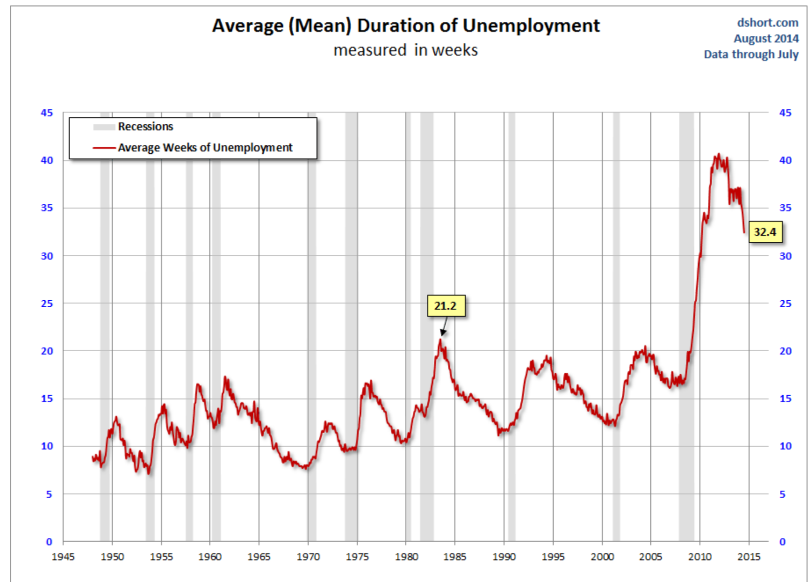
Many investors believed that U.S. interest rates, which started the year at 3.02%, would move north this year and approach 3.50%. But in fact, the opposite has occurred and rates now sit at 2.50% as of August 4th. What happened? This year, Europe joined Japan with another aggressive attempt at further easing of monetary policy, which pushed interest rates lower across the Atlantic. German government bonds (Bunds) are now at an historic low yield of just over 1.15%. Even in troubled Spain, corresponding bond yields have moved below 2.30% to reach their lowest yield dating back 225 years to 1789! Although low, European yields are not the lowest in the developed world. Across the Pacific, Japanese government bonds (JGBs) have an astonishingly low yield of 0.50%. In an era of globalization and rapid money movement, it is hard to argue that current U.S. yields of 2.50% are unattractive compared to corresponding bonds overseas. The 135 basis point (bps) spread between Treasuries and Bunds is rapidly approaching record levels. In fact, the last two times the spread was this wide it soon reversed course leading to one of two results, higher Bund yields or lower Treasury yields. But which outcome is most likely? Let's analyze each case.

Seven years after the onset of the crisis, Europe is still struggling for growth. A weak economy and negligible inflation will force the European Central Bank (ECB) to maintain their accommodative stance at the very least. Recent deflationary fears could even cause the ECB to provide additional stimulus. The outlook for easy (and easier) monetary policy doesn't usually equate to higher interest rates. Therefore, higher Bund yields don't appear likely. It can be argued that two of the world's economic juggernauts (U.S. and Germany) should have similar yields, thus the relative trade and the current 135 bps spread should narrow with U.S. Treasury yields falling.

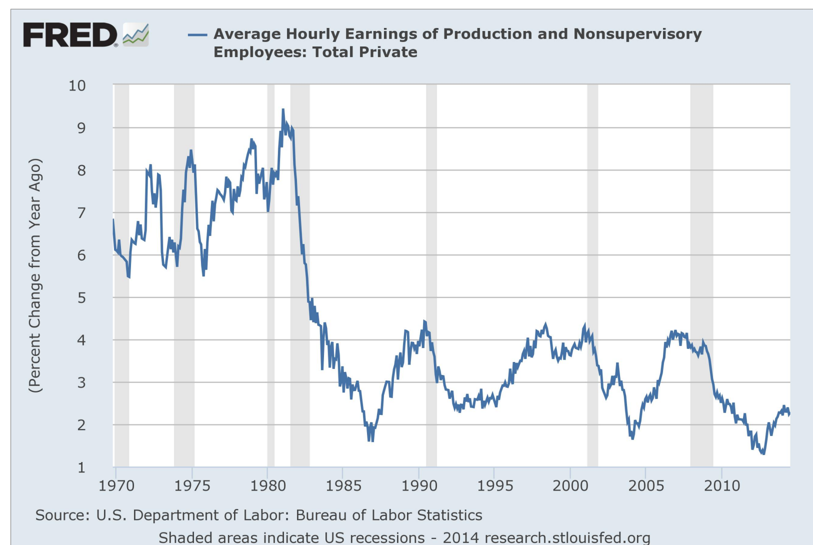
Also it is logical that in terms of safety, the yield on Spanish debt (troubled economy, high unemployment) should not be on par with that of the U.S. (improving economy, declining unemployment, reserve currency of the world, etc.). Thus, according to Guggenheim Partners, these two relative value trades argue for increased demand for U.S. Treasuries from international buyers. Meanwhile, the U.S. Treasuries supply is down as the deficit has shrunk considerably from -10% to -3% of GDP in just the last four years. A lower deficit equates to less borrowing need, thus less Treasury bond supply outstanding. The end result is increased foreign demand in the face of shrinking domestic supply. Econ 101 taught us that Demand > Supply equates to higher Prices ($D > S = \uparrow P$). In bonds, higher prices equates to lower yields, thus European investors 6,000 miles away could cause Treasury yields to move even lower.

U.S. Business Cycle: Job Market

The Fed does not want to make the same mistake they did in the Great Depression which is to tighten monetary policy (i.e. raise rates) prematurely and impede any economic recovery. One of the Fed's mandates is the goal of full employment, so the job market is central to any policy. The good news is that the July employment report marks the sixth consecutive month of nonfarm payroll growth over 200,000—a feat last accomplished in 1997. Over the last six months, 1.47 million jobs were added which is more than any other six-month period since 2006. Traditionally, six consecutive months of strong growth would be enough to signal an all-clear on the health of the economy, as traditionally such job creation would suggest underlying growth in wages. However, this time the Fed believes that there is hidden slack in the labor market and must rely on non-traditional indicators to glean a better sense of the true health of the U.S. labor market—and it's not all good news.



Recently, the Fed focused on other more qualitative factors that they feel can better measure any slack in the labor market. Rather than the headline unemployment number (6.2% as of July), a mélange of other factors are used including not only analyzing those out of work (the duration of unemployment) but also those that do have work (the quality of jobs and whether any job gains are translating into wage pressures).

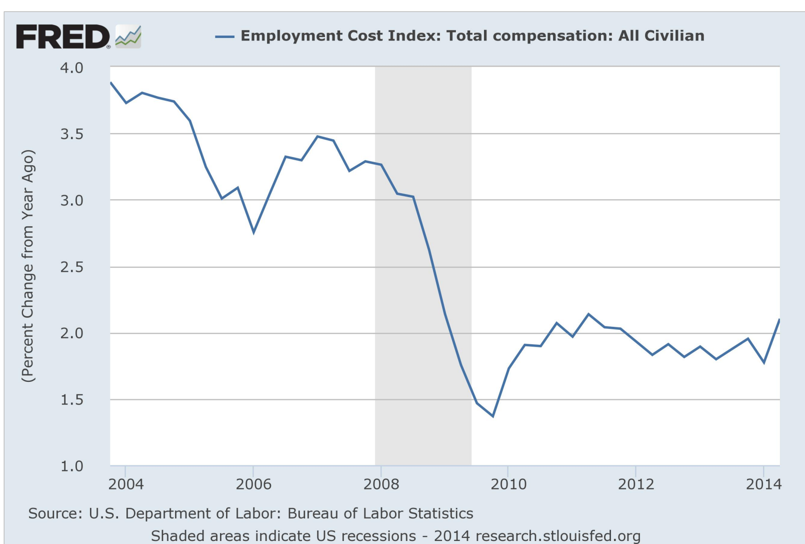


The duration of unemployment in essence measures how quickly and/or easy it is to land a new job. As the chart illustrates, the duration of unemployment remains relatively high at 32.4 weeks. Although the number is less than the 2011 all-time string of highs above 40 weeks, it is still far higher than any previous recession *peak*—suggesting that the labor market is worse now than the depth of any previous recession since the Great Depression. This is not a sign of a healthy economy, thus rates could stay low or move lower.

According to Barron's, the June employment report detailed a 288,000 increase in jobs, but further analysis

shows that 500,000 full time jobs were lost while 800,000 part-time jobs were gained.. Thus the entire monthly increase was driven by part-time labor—again not another sign of a rip roaring economy. In addition, wages grew at a meager 2% annual rate enough to barely cover inflation.

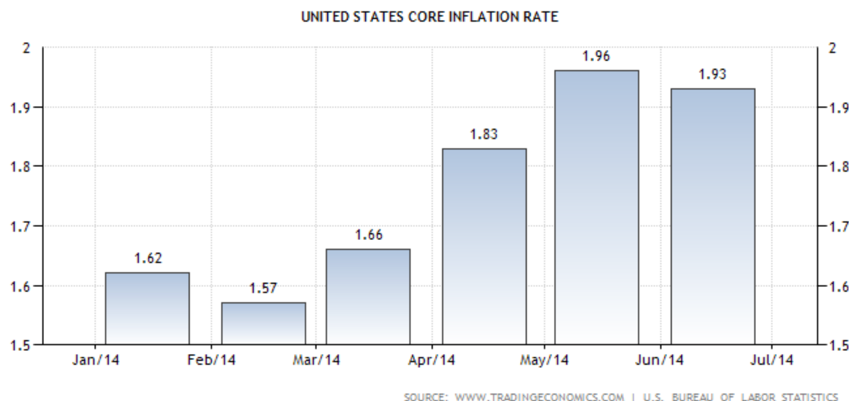
In short, according to these figures; 1) it is hard for some to find work, 2) those that do find work may be forced to work part-time, and 3) employee real wages are stagnant. As such, the economy is nowhere close to overheating and the Fed will be comfortably on the sidelines until job creation reflects full-time employment gains which translate into wage pressures.



But there are two sides to every coin. We just postulated how the job market is weak and will cause rates to stay low but that very argument, the amount of slack in the US economy, is a source of some very significant debate right now. While long-term (duration) unemployment is still elevated, the short-term unemployment rate is now below its long-term average. In other words, those who recently had a job are finding work quickly while those unemployed for a longer period of time are struggling. If those long-term unemployed are now so detached from the economy that they might never find work, then the available pool of talent just became a whole lot smaller. If demand outstrips a new smaller supply pool (D > S), then employers may be forced to pay up (↑P) to attract talent, thus creating wage gains (and possible inflation) forcing the Fed to raise rates. Investors are just now witnessing the first hints of increased compensation as Q2's Employment Cost Index gain was the largest increase since the onset of the crisis.

U.S. Business Cycle: U.S. Inflation

Unlike other global central banks, the Fed has a dual mandate to seek full employment with stable prices (inflation). Thus, investors must acknowledge that the interest rates are subject to both. Inflation has been a non-factor in this recovery with the Consumer Price Index (CPI) recently reaching a low 1.57% in February. But in the last six months, the CPI has



moved up over 1.90%. At this point it is too early to conclude that the trend of higher inflation is here to stay as other measures show a still benign environment, but it bears mentioning as we are just now reaching the Fed's 2% inflation target.

U.S. Business Cycle: The Fed

To put our current environment in a historical context, consider recent thoughts from Liz Ann Sonders of Charles Schwab, "The Fed's suggested natural rate of unemployment is 5.4% (vs. 6.2% currently). The Fed's target inflation rate is 2% (we are at 1.8% presently, based on the Fed's preferred measure, the PCE). We are getting close to both. When we were at similar [position] in 1994, the Fed had been tightening for six months already; and in 2004 they had been tightening for a year already." According to recent cycles, the symmetry of 1994 and 2004 should have extended to 2014 but in reality, this year has brought about only the reduction/removal of Quantitative Easing (QE) and 2015 should mark the first rate increase according to recent Fed projections. To be blunt, the Fed is a horrible predictor. According to Goldman Sachs, the Fed historically has tended to not only underestimate the pace of rate hikes but also the extent of each rate hike. Using the last three cycles as a guide, if either growth or inflation starts to pick up the market will start to price in the possibility that the Fed behaves in the way that they have historically—raising rates farther and faster than current guidance suggests.

	Fed Rate Hike Projection	Actual Rate Hikes
1994	150 bps over nearly two years	300 bps in less than a year
1999	150 bps over 2.5-year period	175 bps in less than a year
2004	325 bps over 3-year period	425 bps over 2-year period
2015*	350 bps over 4-year period	?

Source: Goldman Sachs Global Economics, Commodities and Strategy (ECS) Research, as of April 2014. 2015 is an estimate based on the path implied by the Fed's Summary of Economic Projections and mid-2019 as the likely timeframe for rates to return to the Fed's projection for rates over the longer term, consistent with Fed communications that the funds rate is likely to rise gradually over 2-3 years after 2016.

Conclusion

So what are bond investors to do? As always, in building investment portfolios it is critical to own a basket of diversifying assets then evaluate the probabilities of outcomes against all known risks and finally adjust weightings accordingly. In the short-term, it may not be wise to reposition an entire portfolio to guard against an immediate rise in rates. The effects of globalization (not to mention the potential for greater conflict in Eastern Europe) and worldwide capital flows could trump improving domestic economic data, thus keeping rates low for the time being. Besides, being too defensive in short-term bonds (< 3 years) provides little reward in a Zero-Interest Rate Policy (ZIRP) environment.

Ultimately, we believe that an improving economy and the U.S. business cycle will prevail and interest rates should move higher over the next 1-3 years. Therefore, we would avoid a fixed income portfolio entirely consisting of longer-dated (> 15 years) high quality bonds subject to interest rate risk which would result in lower prices in the face of rising rates. As a result, we believe bond ladders should neither be too short nor too long. Instead, extend maturities out 5-7 years in order to offer attractive real yields, locked in higher yields and price

appreciation if rates should fall near term, all while offering defense in a rising rate environment 1-3 years out as the bond ladder would then consist of 3-5 year bonds as the maturities would naturally become shorter as time progresses. Then potentially, the bonds would mature at the top of the rising rate cycle allowing investors to lock in higher yields for the next leg of the cycle.

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