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# LT Bond Yields And Growth To Stay Low Until Deflationary Headwinds Recede - History Says This Might Take A While

Feb. 9, 2015 9:10 AM ET | Includes: TLT by: James Hickman

**Disclosure:** The author has no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. **(More...)**The author wrote this article themselves, and it expresses their own opinions. The author is not receiving compensation for it. The author has no business relationship with any company whose stock is mentioned in this article.

## Summary

- Interest rates have never risen sustainably in absence of above normal inflation and GDP growth - chasing financial stocks in anticipation of rising rates a risky gambit.
- Gross world product decelerating, US remains sluggish and still no signs of inflation.
- How much longer will low rates trump risks of macro weakness, record US profit margins and returns and inflated valuations?
- Fed policy a factor but market determines interest rates.

Since early 2013, we have published extensively about rising market risk, with the ironic caveat that macro and micro headline disappointment would serve to sustain zero-bound interest rate policy and central bank buying longer than the prevailing guidance, thereby supporting risk asset values. The Fed did delay tapering, and now the market grapples with the timing of rate hikes. We continue to expect sluggish US and gross world product demand growth, weak corporate earnings growth and high-and-rising geopolitical risk. The big question remains, at what point does the bearish effect of growth disappointment and deflationary pressure outweigh the leavening effect of ZIRP? Notwithstanding the loose relationship between the Fed Funds rate and the broader interest rate environment, the market sets yields based on expectations for future inflation. The recent periods of quantitative easing (QE) well illustrate the Fed's inability to

sustainably thwart deflationary pressures. The yield trend-line on US 10 and 30-year treasuries has been *rising* during the three phases of QE, and declining when the Fed was out of the market - see Chart 1. Not what the Fed had in mind.

# Chart 1 Yields Have Risen During QE, and Declined Absent QE - Sign of Deflation

*(click to enlarge)*

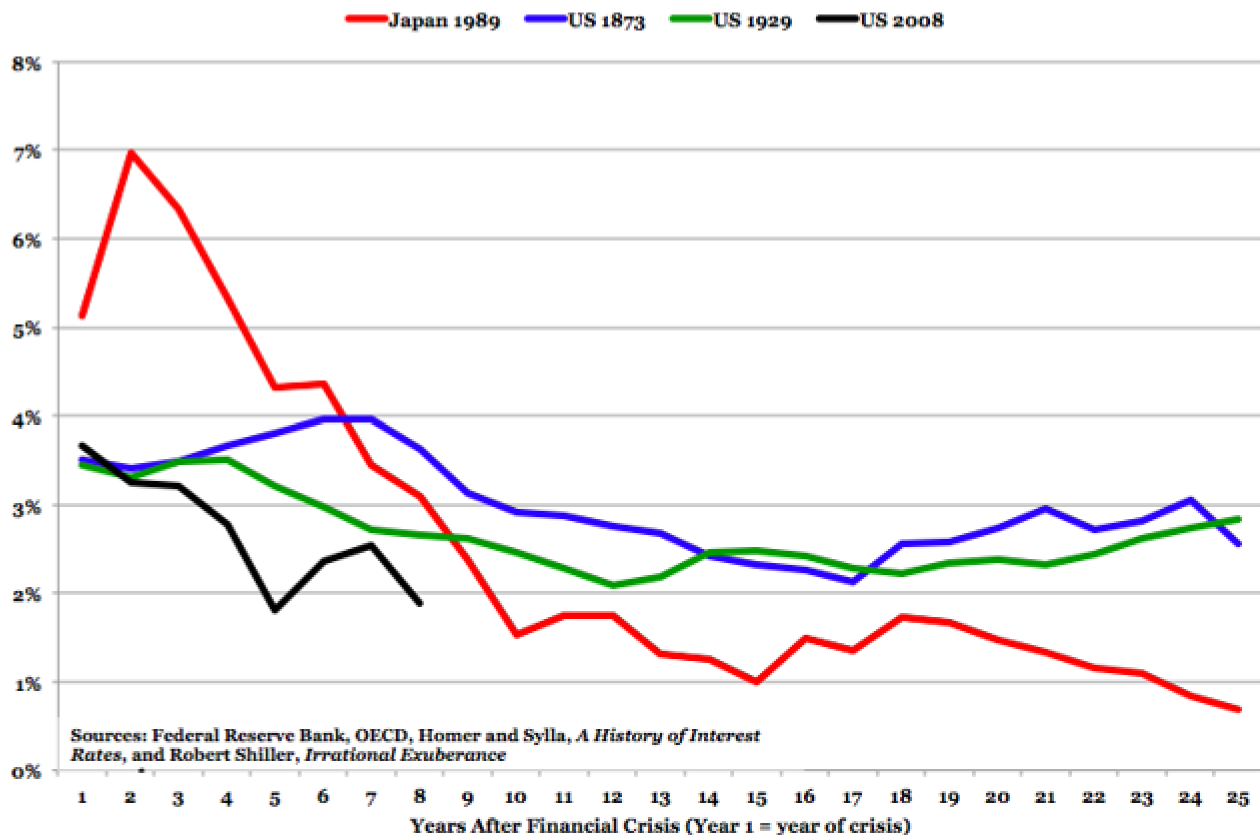
*(click to enlarge)*

How does one explain this seemingly counterintuitive observation? Market expectations for inflation are primarily a function of *actual* inflation trends observed. The best correlation between inflation and interest rates is when the time series for the latter is lagged one year. So, slightly rephrasing the question, why are yields rising in the absence of any signs of inflation during the three phases of QE? A large, transitory buying surge by the Fed, it would appear, was recognized for what it is, artificial upward pressure on bond prices with the promise of future, corresponding downward pressure once the buying surge ceased. Given uncertainty as to the timing of the end to the transitory buying surge, selling into the artificial upward pressure makes sense. Apparently the magnitude of the increased marginal selling pressure exceeded the known increase in Fed purchases, producing higher yields. The rise in yields during the Fed buying periods was not sustained, and indeed, reversed once the Fed pulled back and eventually out.

These trends demonstrate that what ails the US economy - and the European, Japanese and Chinese economies, albeit on relatively different scales - is not monetary in nature, and is therefore unresponsive to monetary remedy. It is about demographics in advanced economies, fiscal deficits, a general lack of confidence among private sector capital allocators, and it is about the enduring effects of financial panic. Depressed bond yields have been known to linger for a full generation in the wake of major financial panics of the past. Bond yields troughed 12 to 16 years post the financial panics of the 1870s (pre-central bank) and 1920s (with central bank) in the US and the financial crisis in Japan that occurred in the late 1980s. In each instance long-term interest rates remained below 3% for twenty-five years after the crisis. We are in year seven.

## Chart 2 Long Term Bond Yields in Years Following Historical Financial Crises

*(click to enlarge)*




Note: this pattern first observed by Van Hoisington and Lacy Hunt of Hoisington Management in their Q2 2013 Newsletter.

Major financial crises produce deep recessions out of which recovery tends to be weak. The current recovery is the worst in the post-WWII era. They prompt deleveraging in the private sector (which dwarfs the public debt markets in size), characterized not only by falling net-debt

levels, but lower capital spending, a decline in economic dynamism reflected in money velocity (at historic lows), and weak hiring trends attended by low real-wage growth. Corporate earnings can be strong out of such recoveries (for a time, off of extreme lows) as they have been during this one, driven by lower depreciation, interest expense and labor costs (relative to sales) and other technology-supported efficiency improvements, with relatively little help from top-line growth.

The sharp earnings recovery post-trough ended in 2011. Record profit margins among US corporations have persisted since and are currently at levels historically portending little and even negative next-four-years earnings growth for the S&P 500 (chart available on request). The sustainability of record profit margins cannot be adequately discerned without the context of returns on capital. Return on fixed assets for non-financial corporations remains at a level not seen since the 1960s and roughly 50% higher than replacement cost while profit margins are 80% above long-term averages. Reversion to the mean on each metric suggests roughly a 33% and 45% decline, respectively. In short, corporate earnings are extremely vulnerable relative to normalized levels and the macro trends.