MV Weekly Market Flash

Hard Times for Hard Assets

June 21, 2013

Bond rates are rising. This week the Fed met and the world learned the true meaning of "tapering": not a slip of the tongue, but a stated willingness on the Fed's part to contemplate a phasing out, over time, of the QE programs that have kept assets afloat through the near-crises of the past several years, from the Eurozone turmoil to Washington's repeated fumbling of its role on the world economic stage. The 10 year yield as of this writing is just under 2.5%, about 50% higher than where it was at the beginning of May. Bond traders are smelling the end of an era, battening down their durations and searching for ways to be low-correlated to the Barclays US Aggregate.

Lusterless Commodities…

Here's what else is not finding favor in the current environment: commodities of all stripes from gold to industrial metals to energy. It's a far cry from the distant days of the last period of sustained rising interest rates in the mid-late 1970s, when gold rushed to an all time (inflation-adjusted) high and real-return or "hard" assets generally were the only bright spot in investment markets. Gold is down by more than 10% since the beginning of May and more than 30% off the nominal highs reached in late 2011. Households notice that gas prices haven't been jumping in typical fashion as the summer driving season gets underway. Prices of copper, aluminum, natural gas and other commodities are similarly depressed.

…With Subdued Inflation

There are some good reasons why commodities are in a slump, first and foremost of which is that inflation is not a high-level threat in the near term. Real assets tend to do well when inflation is high and the US dollar is weak, neither of which is a present reality. Rising rates aren't driving investors to real assets because the rising rates – for now anyway – have little to do with inflation and lots to do with a long journey back from the artificial low-rate policy regime of QE. Simply put, even after the recent run-up rates are historically low and thus even in the absence of inflation more prone to rise than fall.

The Slow Return to Market Economics

Low inflation and the Fed's desire for an orderly transition from QE mean that the road to higher rates will more likely play out over time than overnight (the one big caveat being an excessively negative momentum cycle in bonds exacerbated by high frequency trading programs). Eventually rates should fall in line with real economics: how much money is coming into the economy and how much output (goods and services) is being created to meet that demand. When too much money chases too few goods inflation will result, rates will rise and real return assets will offer value. Then activity will slow, rates will fall, borrowers will take advantage of lower rates and the cycle will begin again. That's how the system is supposed to work. It will be a refreshing change to get back to it after the looking-glass world of QE.

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