MV Capital Management Weekly Market Flash

The Bond Bear's Shadow

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They conferred in elegant conference rooms in the classical-style École des Beaux Arts building that houses the Federal Reserve Board, to discuss the problems created by years of pumping cheap money into the economy. The need for that cheap money is no longer a present day reality, they said. In anticipation of a resumption of economic growth we must raise interest rates from the recent low levels that have never been seen in the history of our Republic – a 1.6% yield on the 10 year Treasury! The policymakers acted accordingly, and a 30 year macro bear market for interest rates ensued.

Coming Full Circle

No, that is not a speculative musing about the future, but a recitation of actual US economic history. The year was 1951. The cheap money was the legacy of an economic depression and, more recently, the cost of financing the country's involvement in the Second World War. The US was the world's sole economic superpower and its only viable source of growth, but the monetary policymakers of the day knew that real growth could not come on the back of cheap money. No free lunch they said, rates have to rise. And rise they did, with the 10-year yield going from 1.6% after the war to 15.4% by 1981.

Now we have come full circle. After five years of historically cheap money investors are looking at the bond market, and nightmarish visions of that 1951 Treasury Accord are dancing in their heads. With one day left in the second quarter the Barclays US Aggregate Bond index has returned -2.43% since April 1. The exit doors are jammed with fleeing moneyfolk – in the last four weeks $23.7 billion has left the bond market via net mutual fund outfllows, the most since the days of indiscriminate panic selling in October 2008. By comparison the S&P 500 is up by 3.4% for the quarter even after the recent 5.8% correction.

The Gathering Storm?

That frenetic selling is not helping bonds regain ground. When investors pile out of an asset the managers who run funds holding those assets have to sell to redeem the exiting investors. That selling drives prices down further, leading to more investors getting out, and a vicious circle ensues. There's a bit of that going on now – quite honestly there is not a compelling case to make on the basis of economic fundamentals for the 10 year yield to jump from 1.6% to 2.6% in just five weeks. We imagine it likelier than not that cooler heads will prevail in the near term. But we have glimpsed the shadow of the bear, if not yet the bear itself.

Unfortunately there's not much in the way of safe houses in today's environment. Bonds are down, stocks are off their highs, commodities are faring poorly and there is great carnage in emerging markets. If we are headed towards renewed growth, as we continue to believe is the likeliest scenario, then presumably this too will pass. But it's not a good time for the queasy or the faint of heart.

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