FRIDAY, NOVEMBER 3, 2023

Hello and welcome to another week in the Dividend Cafe. What a week it has been. Very different tale from last week. I'm sitting here in New York City recording middle of the day on Friday. So the market's not closed, but we're up quite a bit Friday. And we've been up every day this week. In fact, up now at this point, 11 or 1200 points from where we were just a week ago. So you've had a really significant rally and it doesn't really make a lot of sense to say, well, it's because of the week or unemployment number we had this morning when most of the rally took place before this morning. And it doesn't really make sense to say, oh, it's because Chairman Powell didn't sound all that hawkish on Wednesday because a lot of the rally had taken place before then as well. Basically with a variety of circumstances throughout the week, the jobs number, the Fed's press conference, the different news events and earnings realities that came to fruition throughout the week. The bottom line is the bond yields dropped. And this is kind of the theme I want to have today in the Dividend Cafe is explain something about the long bond and tie it in to the meetings we recently had with a lot of our money manager partners here in New York City a couple of weeks ago.

If you look back to the market in September, you basically have now had a market turning down about a thousand points as bond yields went up about 30 or 40 basis points. Then a market very quickly going up about a thousand points as bond yields went down 30 or 40 basis points. Then over about a two week period, a market going down 12 or 1300 points as bond yields went all the way back up to 5%.

And then now a market that is up 11, 1200 points as bond yields have come down 40 basis points or so. So if I'm doing my math correctly, you've had about four turns around a thousand points each in the market up and down around 40 basis points, sometimes 35, sometimes 50, either up or down in that 10 year yield. So as bond yields go higher, markets drop. And as bond yields go lower, markets go higher. And that correlation between stocks and bonds is very profound right now. And yet it does beg the question with all these money managers around New York City asking what the Fed will do and when,

I think that you can understand why if as bond yields go, so goes the market, you have a profound impact to risk assets around what's happening in bond yields. And yet it behooves us to ask why bond yields are doing what they're doing. And it really isn't about the Fed funds rate here. It isn't just the short term rate that the Fed controls.

Most of this volatility has been in the long end of the curve. The 10 year bond yield is what I'm referring to as having gone up and down so much in the last, let's call it six weeks. And if there is elevated volatility in bond yields, which there most certainly is, forget if they're going higher or lower. I'm not referring to a directional move up or a directional move down. I'm referring to volatility, directional moves up and down.

If there's higher volatility in bond yields, there's higher volatility in risk asset prices period. And that of course includes perhaps the most prominently so the stock market. And I think that it might be useful to do a little primer on what the yield of the long bond is supposed to be. I think that there's a concept I wanna use called term premium that's important to understand. You basically can give away your money for three months or overnight or three weeks, some really short term rate to a fully 100% credit, risk-free borrower like the United States federal government. And that's gonna formulate what we call the risk-free rate.

And when you talk about the yield you're gonna get to give that same borrower, let's call it the United States federal government, your money for 10 years, you're going to expect a yield that just starting off is equal to what you'd get to give it to them for three months. Then you would think you'd want more for the extra 10 years or nine years and nine months that you'll be separated from your money. That's what we call the term premium, the premium in yield you want for a longer term. And so it could be one year, that has a certain yield, and it could be five years that you would think would have a higher yield and then 10 years. Now in an inverted yield curve, everything gets distorted. Logic is off. People are making less money to be separated from their money for longer. And that has to do with the interventions that come from the central bank. And it has to do with economic recessions in a short term that are not expected to be long-term. And so you get a lot of kind of just, think of it like an infection that comes into the yield curve until it is antibiotics cleared out, all right?

When you get rid of this inversion, a term premium is just simply the reality of the fact that there's some premium, someone wants to give away their money for 10 years versus three months. And what is that premium? Now, let's say you're expecting there to be 3% inflation, so your purchasing power is gonna go down 3% per year over that period. You're probably gonna want the level of inflation to be reflected in the yield, that you wanna get your money back and it can still buy you at least the things that bought you before.

And if there's gonna be a period of economic growth, you have what's called an opportunity cost. You're given your money to the government for 10 years, which means you're not gonna have it to invest in new innovations, new products, new services, new companies, stock market, real estate, what have you. And so the expected growth in the economy, net of inflation, real GDP growth, you probably wanna capture that in the yield. So when you talk about the inflation expectation and real economic growth, these two things put together what we call by definition, nominal GDP growth. So why don't we just say the 10 year bond yield is all things being equal, gonna be equal to the risk free rate plus expectations and nominal GDP growth. Well, we basically do. That is more or less what I think it ought to be. And you can get distortions from a central bank in there, but that is about the formula. Why we break up the nominal GDP into the two categories, inflation and real GDP growth, even though at the end of the day, the expected bond yield may be the same, the ingredients of how you get to that make a big difference. If I were to say to you, there's gonna be 4% inflation for the next 10 years and the economy is only gonna grow 1% beyond that. Or I were to say, there's only gonna be 1% inflation for 10 years, but you're gonna get 4% growth on top of that. In both cases, you have 5% nominal GDP growth and maybe you're gonna get a 10 year bond yield around 5% to 6%, but those are gonna be two very different situations. That kind of economic growth with such low inflation would probably mean you have a really healthy economy, real estate, stocks, businesses, private equity, risk assets, all of that stuff. But if you have 4% inflation and very little real GDP growth, you probably have a pitiful economy, very bad stock and bond returns.

So the ingredients matter. Right now, what is fascinating is that the 10 year is basically just reflecting what the risk free rate is. Inverted yield curve makes it impossible for us to really see what those expectations would be. Where would the 10 year go if the Fed normalized the short end of the curve? And until they do so, it's going to be very difficult to get a real projection. I heard Chairman Powell say in the very room I was sitting in two weeks ago, that they now think we're gonna get more like 2% real GDP growth for the foreseeable future. That is both way lower than we've gotten historically and higher than we've been used to getting.

We can calculate from tip spreads, from treasury inflation protected securities, the implied expectation of inflation. When you look at the differentials between tips and regular treasury bonds, we can see that there's only about 2% inflation being priced in between five and 10 years out. And so if the 10 year is gonna end up settling at 4%, I think you're probably talking about something in the range of 2% inflation expectation, 2% growth expectation. If it's gonna settle lower, it probably means you have lower growth expectation. We certainly spent most of the last 15 years there. And if it were to settle higher, the question would become whether or not that's about nominal GDP that is favored with high growth expectation or nominal GDP favor with high inflation.

Why would I not wanna place a big bet one way or the other? You could go all in on the long bond right now and really assume you're gonna get pitiful growth going forward. And that may be exactly the right bet. And it was certainly the right bet for a long period of time for bond investors to go all in on high duration and let those yields come down around low growth expectations, get the most yield possible, get the most price appreciation possible, call it a day.

But is there an upside risk to economic growth with CapEx, with reshoring, with manufacturing, with nearshoring? Could some of this industrial cycle be a curry to the favor of a little bit better economic growth than we've had on the other side of this Fed tightening?

Is that an upside risk that has to be factored in that favors against going very long duration? I think that's on the table. But do you wanna go ultra short though and be positioned in the exact opposite way? I think that's a very bad idea.

I think that there most certainly are risks that would call for being neither ultra short or ultra long. And so right now, when it comes to bond positioning, you likely are healthier somewhere in the middle of that yield curve, four to six, seven years in duration. And the reason being that there are arguments on both the short and long end that you wanna kind of digest. However, that is secondary to us to what it speaks to the overall state of risk assets. And this is, I think, a common theme, whether it's private equity managers, private credit managers, real estate, and certainly bond portfolio managers that we dealt with here in the city, that they're unable, you could decide, well, the Fed is gonna cut rates here, or they're gonna cut rates three months later than here, or they're going to begin doing quantitative tightening, or they're not going to, or they're waiting for the labor markets early weekend, or they're not waiting. There's all kinds of theories. I have plenty of my own. I share and talk about those Fed expectations all the time. But the reason I bring it up is that we're not alone in the opaqueness that current Fed regime is bringing to asset markets.

Most asset managers in any of these aforementioned asset classes are to some degree, especially with bonds and private credit, are waiting to get a feel for where yields go once the

Fed is normalized. So that at that point, we could see what real growth expectations and inflation expectations look like. And right now, did the 10-year go up to 5% because we're not in a recession? That's definitely part of it. Is the 10-year going back and forth between five and four, four and a quarter, four and a half, up to five, back down, back up, because growth expectations for 10 years are going up and down? That's severely, of course not. So there are all kinds of shorter-term noise impacting price discovery.

But the fundamentals of how a term premium are constructed don't change. We're just having to look at the fundamentals of term premium through glasses that are fogged up by an inverted yield curve. When that fog goes away, we get a chance to see those expectations. And in the meantime, investors, I believe, will do themselves a world of good by focusing, when you're a risk-asset investor, on the underlying risk you're trying to be invested in, not the risk of getting right growth expectations inflation expectations, interest rate direction, yield spreads, any of those things. Getting right the fundamentals of the businesses you're investing in, the underwriting that is a part of your private credit, the underlying asset quality, real estate you're buying, that bottom-up fundamental quality approach to investing is so paramount right now. And even that is still impacted with noise, with valuations, with entry points by what the Fed is doing.

But I think that when we meet with our small cap growth manager, and they don't bring up interest rates or bond yields at all, the entire meeting, same thing with our midstream energy manager, other than anecdotal comment about the cost of capital for some of the companies that are borrowing.

I mean, there's always some adjacent relevance, but the fundamental story that drives a long-term investment thesis cannot be centered around that noise that doesn't even allow us to get a term premium properly defined or understood or dissected, let alone conclusions you draw from that term premium. So I think we ought to be grateful that bond yields are higher and that you at least get some positive carry for where there's a portion of one's portfolio allocated in the bond market. And in the meantime, understand that so many other asset prices are dependent upon this and where you're dependent on valuations going higher, you're at the mercy of a certain outcome that may or may not be the case with this fog over the long bond. But when you're dependent on cashflow growth, fundamentals, let's just call it real enterprise, I think you've hedged away a lot of the noise of what the Fed does. Those are my big conclusions out of this last four to six weeks of volatility. I believed all of these things for four to six years and four to six decades ahead of before that. But my point being, just in this microcosm of this highly volatile six week period we've had with both interest rates and stock prices, you've seen a real application to it.

So we're gonna keep doing what we do. Very beneficial meetings in the city and grateful to use today's Dividend Cafe to try to reinforce a lot of these principles. I hope term premium, long bond, interest rates, I hope these concepts make a little more sense to you than they did 15 minutes ago. And we welcome your questions, questions@thebahnsengroup.com anytime. And certainly what we're trying to do by way of application through this moment, these are the things we obsess with each and every day. So thanks for listening, thanks for watching and thank you for reading the Dividend Cafe. We hope you have a wonderful weekend. Look forward to seeing you at the DC Today on Monday.
