Chart of the Month

August 2019

Despite the recent volatility in stock prices, the most significant news in the financial markets of late involves bonds. To wit, the yield on the 10-year Treasury has plunged 40 basis points (0.40%) over the past two weeks to 1.69%, its lowest level in more than three years.

While the range on the 10-year Treasury has been roughly 1.50% to 3.50% since 2011, the yield pierced its long-term downtrend late last year (as shown in the chart above), suggesting that the period of lower highs and lower lows in place for more than 30 years was over. Nonetheless, after the recent nosedive, the yield is now down 1.5 percentage points since last October and is once again back within its channel and staring at the all-time low of 1.36% in July 2016.

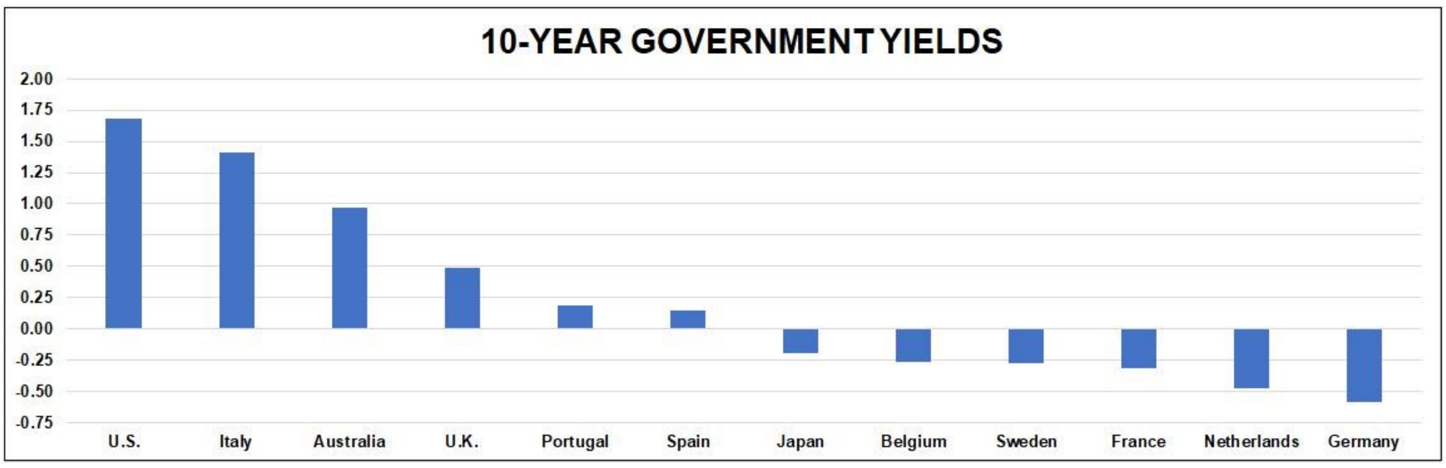
Although the 10-year Treasury is hovering near its record low, the yield is higher than the vast majority of the countries in Europe as well as Japan and Australia (see below). As a result, many global investors find U.S. government securities to be more attractive than their counterparts. The international demand for Treasury bonds is one of several reasons (including the low level of inflation due to the effects of globalization, competition, demographics, and new technologies) why yields are so muted.

Speaking of inflation, the bond market is betting that the rate will average 1.64% over the next decade as measured by the spread between the yields on ten-year Treasury Notes (1.69%) and ten-year Treasury Inflation-Protected Securities (0.05%). The market's expectation is well below the Fed's target of 2.00%, adding pressure for the central bank to ease even further by lowering interest rates in the hope of stimulating the economy.

Meanwhile, there is more than $15 trillion in government bonds around the world (or approximately 25% of all sovereign debt) with *negative* yields. In other words, governments issuing negative-yielding bonds are getting paid to borrow money. Using Germany as an example, if you were to invest $100,000 in their 10-year Bund (at the current negative yield of 0.58%), you would get back about $94,350 at maturity. Yes, you would *lose* $5,650 for the privilege of the German government holding your money for ten years!

The upshot to low rates is that assets (such as stocks and real estate) are worth more because the multiple that investors are willing to pay for earnings is inversely related to interest rates (i.e., the lower the rates, the higher the multiple; the higher the rates, the lower the multiple). Simply put, the *deflation in interest rates* should result in the *inflation of asset values*.

In May, Warren Buffett said, “I think stocks are ridiculously cheap if you believe ... that 3% on the 30-year bonds makes sense.” Of note, the yield on the 30-year bond has since dropped to 2.24%, implying, in Buffett's words, that stocks are even more “ridiculously cheap” today than three months ago. Stocks, however, are only cheap if the economy avoids a recession and corporations continue to increase earnings over time.



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