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THE GREAT BOND BUBBLE
INVESTMENT STRATEGY
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Our Strategic Concern:

The single most important investment consideration today is the absurdly low level of interest rates around the globe. The ten year bond historically has been the key indicator of long term expectations for inflation partly because many nations did not issue 30 year bonds as is done in the US. As a rule of thumb, over the long-term we expect the level of the US ten year bond yield and nominal GDP to be relatively closely correlated – indicating that rates may rise to more than double their current level as we start printing nominal GDP numbers above 4% on a consistent basis. Below is a table showing the level of interest rates for countries in which we are interested in investing, the current levels of core inflation on a year over year basis, the ratio of government and government agency debt relative to the country's GDP, and finally we also show the percentage of government bonds held by foreigners to see the potential impacts they can have on the local market.

	Country	10 Yr. Bond Rate	Core Inflation Rate Y/Y	Ratio of Debt to GDP	Debt Held by Foreigners
1)	USA	**1.87%**	**1.4%**	**102%**	**34%**
2)	Japan	0.27%	0.0%	240%	5%
3)	Germany	**0.17%**	**1.2%**	**77%**	**62%**
4)	France	0.45%	0.1%	**92%**	63%
5)	Portugal	1.67%	0.3%	**128%**	71%
6)	Italy	1.26%	0.6%	**128%**	36%
7)	Greece	11.52%	-0.9%	**175%**	86%
8)	Spain	1.19%	0.2%	92%	43%
9)	Switzerland	**-0.11%**	**0.4%**	**35%**	**46%**
10)	Brazil	**4.36%**	**7.3%**	**57%**	**27%**

We attribute the low level of interest rates to several factors: relatively slow economic growth, low inflation, and particularly the quantitative easing (QE) by central banks. The Great Recession of 2007-2009 did such damage to so many economies and to so many people, that growth, as is typical following a "balance sheet" recession, has been very slow to recover. Only in the last year and a half has the US experienced "normal growth" of around 3% on average, while China and Europe have been going through structural changes: the former as it shifts from an investment led economy to a consumer led economy, and the latter as it undergoes austerity measures to deal with its debt while reforming its labor laws to make it more competitive. The outcomes of the general elections in Spain and Portugal later this year may well determine the rate of the reforms going forward with a potential risk of anti-reform parties, such as Syriza in Greece, gaining power.

The Great Recession left business with substantial over capacity, and the slow growth subsequently – that occurred world-wide – continues to leave countries with excess labor, commodity, and goods production capacity. Because business has globalized, goods and services can be accessed from multiple, not necessarily local, sources. As a result corporations' ability to raise prices has been minimal at best, and therefore, we have witnessed a very low inflation rate. Following the rise of unconventional oil production and OPEC's subsequent decision to defend its market share rather than reducing output, oil prices have dropped, contributing to the very low or even negative headline inflation rates found in many countries around the world.

Finally, we note that central bankers around the world – in the face of low inflation rates and very low rates of economic growth – have used quantitative easing (the addition of large quantities of money to the economic system through the purchase of various financial assets) to stimulate their respective economies in hopes of producing greater economic growth and inflation. This quantitative easing has several impacts: it causes interest rate and currency declines which is very good for business as it encourages greater exports and the refinancing of corporate debt at lower costs.

QE is also associated with rising stock markets as much of the money, rather than going into business assets, goes into financial and real estate assets. This has a beneficial effect, known as the “wealth effect”: people, seeing their houses, stocks , and bonds rise in value, feel wealthier and spend more. We estimate that the wealth effect in the US from the rise of house and stock prices in 2014 alone, should add around 0.6% to US GDP growth over the next year or so. All in all, since the onset of the first round of quantitative easing by the Federal Reserve in late 2008, the value of US households assets have risen by $26.3 trillion or 37% while the liabilities have declined by $125 billion or 1%. This translates into an impressive $26.4 **trillion** or 47% increase in households’ net worth.

In summary, we believe rates are low because of slow growth, unrealistically low inflation expectations, and Central Bank intervention. Unless we are mistaken about deflation, these exceptionally low rates will not last. And when they do change, if it is suddenly, the impact will be felt in most financial markets.

What Gives the Low Rates the Characteristic of a Bubble?

These low rates, distorted by the Central Banks, imply that inflation and GDP will remain very low. Neither is realistic unless we are headed for a global recession. In some cases, e.g. the US, Switzerland, and Germany, yields are less than the cost of taxes and local inflation for the local investor, giving rise to what is known as a “negative real yield.” The investor knows they are handing money over to a government knowing that for ten years they will derive no economic return but rather a loss! This doesn’t make sense.

Furthermore, the gradual addition of people to the total population and the push of people to raise their standards of living almost ensures a rising demand for goods and services. Eventually this rising demand must come up against capacity constraints with the resulting upward pressure on prices, i.e. inflation. Improvements to productivity may offset this pressure, but if central bankers around the world are dedicated to creating inflation, we are not going to bet against them. **However, at least for now that inflation may be continued to be seen in financial assets rather than the prices of goods.**

Looking Forward:

So we now have the classic situation where the United States is leading the global expansion as Europe begins its recovery and follows the US while Japan and China both piggy back on the US expansion with their exports. Of course both Japan and China are doing their best to stimulate economic activity and we expect they will succeed over the coming year.

The People’s Bank of China is not only trying to boost their economy by lowering interest rates and the reserve requirement, but also by focusing on reviving their housing market directly. Down payments on second homes are about to be lowered to 40% from around 60% to 70%, and the down payments on first homes financed with public housing funds will come down from 30% to 20%. Futhermore, sales of homes purchased more two years ago will be exempt from a 5.5% sales tax (previously only homes purchased more than five years ago were exempt). In Japan, we are seeing signs that policy makers are moving beyond the first two arrows of Abenomics (monetary and fiscal stimulus) by, for example, encouraging greater female participation in the laborforce and relaxing visa requirements for foreign investors.

The key things to watch world-wide are the “harbingers” of inflation. It is no longer sufficient to watch the inflation indices, as the world is already watching these. We must work from the “first derivative,” and look for the changes in those factors of production that are associated with price increases unrelated to qualitative increases. For example, one should be watching for the change in average hourly earnings of US labor and for any declines in global excess capacity to produce various goods and commodities.

We do expect the global economy to steadily pick up steam, and should it do so without inflation increases, one could expect rising stock prices driven by improvement in earnings as well as central bank stimulus. As the global economy improves foreign markets may become more attractive than the US. We do not foresee recession in the US for several years. While the US economy may be slow during the first quarter of this year, its compensating expansion in the second quarter will cause many to expect an interest rate increase by the Federal Reserve between June and September, depending on the data.

The normalization of interest rates in the US is not likely to disturb financial markets except briefly if done without fears of inflation. Rather, at this juncture it will be seen as central bank confidence in the US economy.

Since US government bonds (including agencies) constitute about a third (down from 50%) of the global government bond market, a rise in US government bond rates, which used to be associated with a rise in global bond rates, should still have some adverse impact on foreign bonds, although much less than before? In addition, the impact of a US rate rise should be dampened considerably by the independent actions of Central Bankers in Europe, Japan and China.

However, if we witness rising inflation due to longer term rather than short term factors, one can expect difficulty with almost all bond markets. Given the low coupons on recently issued bonds, a 1% rise in interest rates could mean a lot of price damage. Thus, we are very reluctant to buy bonds; short term money market instruments such as US Treasury Bills may not pay much, but they don’t have much risk of price declines!

Thoughts on Tactics:

In the US, stock market performance could be limited until year end when next year’s earnings results may be anticipated. Until then the expected damage to the earnings of multi-national companies that may occur because of the strong dollar, and the expected normalization of interest rates by the Federal Reserve may keep a lid on the US equity indexes. In fact since the end of 2014, the operating earnings estimates for 2015 for the S&P 500 have come down by almost 10% to an anticipated earnings growth rate of less than 5%.

The global economic improvement, however, will make European and other foreign markets more attractive as the outlook for earnings improvement abroad becomes greater than here. We have seen this already in Japan, China, and Europe, with their respective equity markets rising by 11%, 7%, and 4%, in US dollar terms during the first quarter. Should we see a flow of US funds to foreign markets we should see some improvement in the large multi-nationals as the dollar weakens in response to fund flows. Thus, we don’t expect to make major moves out of these multi-nationals (but see below).

Stronger global growth should be good for commodity stocks, and we would expect some improvement in the oil price by year end as US production capacity gets cut back. We do however, think it is time to expand the foreign stock component (with currencies hedged in certain cases) in those accounts that permit it. Some reduction in exposure to global multi-national companies may be appropriate with an increase in smaller capitalization solely domestic companies.

Given our concerns about market expectations for inflation and interest rates, we will continue to maintain cash positions at current levels.

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