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Higher View

A QUARTERLY NEWSLETTER *of* ALTAVISTA WEALTH MANAGEMENT

Rising Rates:

In mid-1954, right around the time Elvis Presley was recording "That's All Right", the yield on the ten-year treasury note fell below 2.3% before rebounding. Rates would continue upward for three decades. It would not be until the aftermath of the (relatively) recent financial crisis that the ten-year treasury note would again fall to such levels. 2017's readings (once again ranging around 2.3%) pose the natural question: what happens when rates start drifting upward?

Let's start with the natural adversary to rising rates: bonds. Imagine you buy a bond yielding 5% when the market is demanding a yield of 5%. Since the bond yield matched the demand, the bond will have been sold at the exact amount the bond will pay back at maturity, or par value. What happens when the market decides next week that some new data means the bond's yield must rise to 10%? If you want to sell your bond, you will have to sell it for less than par value. This is because a yield of 10% would require the interest you were set to receive plus a discount from par value. As a result, rising rates decrease the value of a bond portfolio. That said, you probably should not cash in your bond portfolio just because rates are low. High quality bonds still provide diversification benefits and downside protection to a portfolio. In addition, interest received can be reinvested at the new higher rates.

Rather than exiting fixed income, we would consider ways to add complementary strategies to dampen the potential impact of rising rates. Options might include investments such as shorter duration bonds which are impacted less by interest rate shifts and/or inflation-linked bonds which benefit when inflation expectations (an important driver of interest rates) increase.

Rising rates have the potential to impact equity investments as well. The primary concerns would likely be decreased liquidity to fund investment and higher discount rates. Less liquidity would likely mean fewer dollars flowing into the stock market to support equity prices. However, if rising rates are correlated with improving economic outlooks, investor demand would likely continue to support the markets.

At a formulaic level, equity values should decrease as rates rise due to rising discount rates. If you view an investment as a series of future cash inflows, then all you need to do is discount those future cash flows by an appropriate rate to determine how much an investment is worth. As rates rise, the amount by which you discount future cash flows will also rise and the cash flows become devalued.

That said, sometimes theory varies from reality. According to analysis from JP Morgan Asset Management, past stock returns were positively correlated with interest rates when the ten-year treasury yield was below 5%. Historically, when yields are low to begin with, rising rates tend to move together with rising equity prices. It is not until rates are higher (over 5% for 10-year treasury rates in this example) that rising rates negatively impact equity returns. On the other hand, we also know that future results often differ from past results as no two economic environments are exactly alike.

Our reading of the situation leads us to resist any sharp strategic shifts. Rates are much nearer to lows than they are to highs, but no one can say with certainty what the path forward looks like. On the equity side of the table, we view rising rates as a possibility worth noting, but not enough to be a primary driver of current positioning. For fixed income, we would lean towards a stance that expects higher rates. This positioning should benefit if the economy continues to expand, without sacrificing the protection of quality fixed income in a down market.

- Logan Bolick, CFA, CFP®

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Under A Full Head of Steam

"When growth is slower-than-expected, stocks go down. When inflation is higher-than-expected, bonds go down. When inflation is lower-than-expected, bonds go up." Ray Dalio, successful fund manager

The equity markets and the world's economies enter 2018 with a lot of momentum. As investors, we have to consider whether climbing stock prices and expanding GDP will continue, slow down or reverse their fortunes. Over the short term, it seems likely that inertia and tax cuts will keep economic growth healthy. The stock market's progress seems less certain (doesn't it always?) but earnings on the S&P 500 seem set to continue their winning ways, providing some support for a fully priced market. Truly good times. The simple principles enunciated by Ray Dalio (above) provide a good framework to discuss the new year's possibilities.

As always there are concerns, and for a full airing of those we start with the Fed. Now under new leadership, we expect the central bank to continue its policy of ratcheting up short term rates and selling bonds as it reverses the extraordinary stimulus it administered in the wake of the financial crisis. The members of the Open Market Committee must negotiate a narrowing, safe middle path between strangling growth with tighter financial conditions on one hand or moving too slowly, which may let the long dormant threat of inflation rise up, triggering a sell-off in stocks and corporate bonds.

We believe inflation may well tick up during the next year, leading to higher rates (and lower prices) in longer dated bonds. As we end December, the 10 year Treasury Bond has edged up in yield to 2.4%, right around where it started 2017, but higher than just a few weeks ago. Inflation readings consistently above 2% could push 10 year rates to 2.6% to 2.9%. Inflation expectations are modest. If inflation breaks above its trend, then increased volatility is in the cards for stocks and bonds in 2018.

Increased volatility is to be expected after what has proven to be the calmest year in decades. Surging profits and news of accelerating growth look to be the predominant influences as we start the new year. Later this year, interest rates and Fed policy may have more to say. Potential wild card risks are present in North Korea, the Arabian Peninsula and the Italian elections. As always, we believe a portfolio diversified among profit sensitive stocks, rate sensitive bonds and inflation sensitive assets provides the best platform to negotiate uncertain, fast moving seas.

We are grateful for the continued trust you have placed in Altavista and the relationships we have with each of you. Stay warm with the winter weather and we look forward to meeting with you soon."

The Altavista Investment Team - Winter 2018