WCM | WILDE CAPITAL MANAGEMENT

PORTFOLIO UPDATE – APRIL 8, 2019

For most of the post-Crisis decade the "smart" investors have been calling for rising rates. Asset managers have built investment products for that eventuality. Whole investor education programs have been developed around how to invest in a rising rate environment. Tactical asset allocators like ourselves have been short duration in anticipation of the inevitable.

The inevitable is not coming. At least, no time soon.

There are a variety of arguments for why we are locked into persistently low rates, particularly with a domestic economy that has been grinding out slow, steady growth for years. Our situation is unlike Japan's "lost decade" (really two decades) where their rates remained extremely low but their economy stubbornly would not grow. We see a lot of reasons why that was the case, much of it rooted in the fact they do not command their own natural resources, and demographics are working against them. The US on the other hand has a growing and diversifying population, a fully employed workforce, and a steady rise in production and consumption. So, our rates are not held down by a stagnant or shrinking population and economy.

We are finding some of the answers abroad and some at home. Overseas central banks are still pinning very low, and in some cases negative, rates. Meanwhile the Fed has been raising rates here. The result is a "carry trade". Banks, insurance companies, even governments can bring their money here and get better rates with less risk in the world's reserve currency. Borrowing at negative rates and lending at percentage points higher is a pretty good trade. The flow of assets into the US bond market is driving up bond values and therefore pushing down rates.

So why doesn't the Fed just raise rates more? A quick look at how we finished 2018 should answer that question. For as robust as things are, the market does not want even the suggestion that Powell and Co. will take away the punchbowl. Some ill-chosen worlds were enough to fuel a painful round of selling. It is not the job of the Fed to prop up the stock and bond markets, politics aside. But, the markets can be viewed as the canary in the coalmine, and may have been suggesting that the economy, which is the Fed's responsibility, is strong but not strong enough to sustain growth if borrowing becomes more expensive.

Lastly, it may be that the economy (and the markets, too) never really got healthy after the Crisis. In large part thanks to the Fed and the Treasury's printing presses, we collectively never took pain equal to the magnitude of the problem. From a historical perspective, it might have been best for the structure of the economy if the free market had its way and weak businesses, especially banks, went bust. For countless reasons that could not be allowed to happen, so instead we papered over most of the problems with cheap money. So much money that some economists were predicting rampant inflation as the dollar got devalued. Large parts of the country are still underemployed, either because of lack of jobs or lack of good paying, full time jobs. Wealth inequality has gotten bigger, not smaller. The wealth is concentrated in the hands of too few people who could not possibly spend and consume fast enough to inflate the economy. So no runaway growth.

The Fed has signaled it is done raising rates for now. The next time we are likely to seriously be participating in a discussion about rising rates is 2020, and the closer we get to an election the less likely that is to happen unless the economy is truly off to the races. Adding to that, we have found in our conversations with those we believe to be the most astute fixed income strategists that they are consistently saying the same two things – we are later in the economic cycle but it is a historically long cycle, and that over the arc of US economic history, rates are pretty close to long-term normal. Even the grizzled veterans in the financial industry have lived most or all of their careers coming down from the mountaintop of high rates from Volcker's moves to save the economy. Institutional (and market) memory is short. Over the last century, high single-digit rates, much less double-digit rates, were the exception.

The Fed still would like to have more policy room to address future recessions by raising rates now. The closer we operate to zero the quicker the Fed would have to resort to non-traditional means again. But, after a decade of waiting, the time is still not now. Therefore, while we still believe strongly that the long term direction of rates is up, we cannot say how steep that slope is, or when we will start to climb. Because our view is rates will (eventually) rise, we do want to remain shorter duration than the broad market. However, we are moderating the degree to which we maintain that underweight. As such, for both our Core and Disciplined Yield series portfolios, we have reduced our position in both short term Treasury as well as short term corporate bonds by half, and moved the proceeds to the intermediate part of the curve. For our ESG portfolios, the bond allocation has been intrinsically longer and almost entirely not invested in Treasury securities, and therefore no adjustment was needed for now.

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