TD Wealth

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Economic & Market Update

What Follows a Generation of Falling Interest Rates?

The general secular direction of interest rates tends to flip once a generation.

It is normally challenging for investors to anticipate the flip.

The last flip was in 1981. How close are we to the next flip?

Much of my earliest interest in economics and investment finance coincided with a peak in interest rates. In that respect, it was the opposite of today's economic environment.

During the late 1970s and early 1980s, inflation, high interest rates, and stagnating growth felt like perpetual problems without apparent solutions. It was hardly believable at the time that we were nearing a turning point.

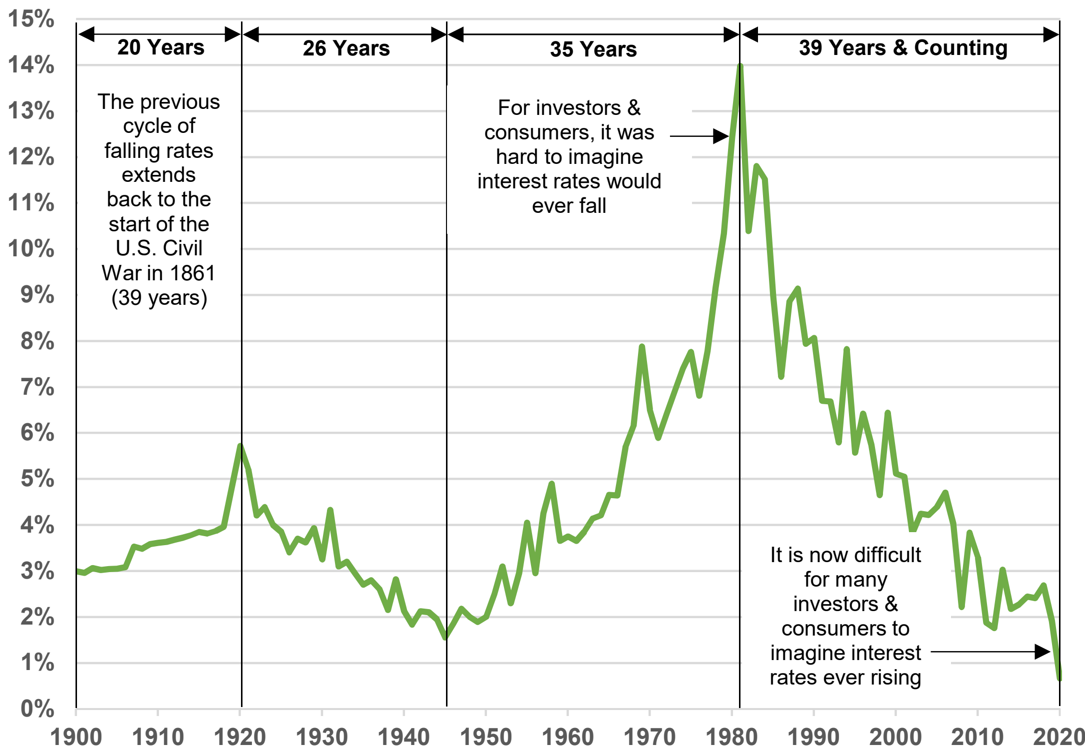
In the autumn of 1979, IBM announced that it was raising $500 million via the issuance of 25-year bonds to the public debt market. IBM ended up paying 9.41%. However, investment bankers overestimated the appetite for the deal and what it would do to the

debt markets overall. The investment bankers took a loss as they were not able to turn around and sell the bonds for a price higher than they paid to IBM. [1] Plus, with what was considered a massive issuance of debt back in the late 1970s, the debt markets became plagued by over-supply, forcing the price of existing bonds down and their yields-to-maturity upwards.[2] It was estimated that if IBM had wanted to issue more 25-year bonds four months after the initial offering, it would have been required to pay more than 14%.[3]

Bonds issued by blue-chip companies would often need to pay over 10% interest in 1979 to attract enough investors.

Chart 1:

Interest Rate on 10-Year U.S. Treasury Bonds - Monthly Data



Source: Bloomberg Finance L.P. and *The Wall Street Journal* as of 10/1/2020

If investors in 1979 knew that rates would soon fall, many would have been willing to buy bonds at lower rates.

But few had any idea that things were about to change.

Clearly, the market was not expecting rates to peak soon and then begin a four-decade decline. If an investor had a crystal ball at the time of the IBM issuance in 1979, it would have been rational to buy as much as one could afford and then surf the price higher as the yield-to-maturity on those bonds declined. However, virtually no one did this, implying that the consensus was for rates to remain high indefinitely.

[1] John H. Allan, "Prices Slide on Reports That IBM Plans Offer." *The New York Times*, September 25, 1979.
[2] James L. Rowe Jr., "IBM Expects to Borrow Money Again." *The Washington Post*, February 28, 1980.
[3] As a comparison, the current yield-to-maturity on IBM's 4.7% Coupon Bond maturing on February 19, 2046 (the closest comparison to the 1979 bonds in terms of maturity) is 2.72%. Source: Bloomberg Finance L.P. as of 10/1/2020.

Most investors could not see any hints that things were about to change. A decade's worth of attempts to constrain inflation had mostly failed. The economy was especially vulnerable to OPEC's ability to ratchet up the price of oil. The war in Vietnam was expensive and contributed to higher interest rates when the U.S. needed to go to the debt markets to finance it. And, President Jimmy Carter looked like he had run out of ideas with respect to restarting the U.S. economy.[4]

Then, things changed.

Paul Volcker, the Federal Reserve Board chair, dramatically increased the interest rates at which banks make overnight loans to each other. This sent a signal to the debt markets that he was serious. Bond investors began to lower their expectations for interest rates into the future. Unions began to accept lower cost-of-living adjustments to wages. And, tax cuts in addition to industry deregulation prompted by the Reagan Administration gave some lift to the economy.

The change in the direction of interest rates in the early 1980's caught most of the market off-guard.

I never remember anyone forecasting any of this in the late 1970s.

So, where's the next turning point? Right now, most of the market can't see it. That may be why investors are still willing to buy securities with such low yields. If they had a crystal ball that indicated rates were going to go higher sometime over the next decade, there would hardly be any buying of low-yielding securities. The logical strategy would be to wait for interest rates and yields to rise before purchasing.

Being caught off-guard by looking in the rearview mirror is a common occurrence among investors at turning points.

Let's assume for illustration purposes that we found a functioning crystal ball and that it indicated that the 10-year interest rates on Canadian and U.S. federal bonds will be around 5% by mid-decade.[5] What could be some of the factors that we would look for that might explain such an increase in rates?

Perhaps the biggest factor might be that there are too many bonds being issued in the public debt markets which could push interest rates higher as borrowers compete for attention from the lenders (similar to the effect that IBM's large issuance had in the autumn of 1979).

[4] The culmination of this was a nationally televised address by President Carter on July 15, 1979 dubbed "The Malaise Speech."
[5] The current rates on 10-Year U.S. Treasury bond is 0.68% and on the 10-Year Government of Canada bond is 0.55%. Source: Bloomberg Finance L.P. as of 10/1/2020.

Alternately, governments could just print money to pay for massive increases in spending instead of competing in the debt markets (assuming they are sovereign federal governments with a printing press). However, if printing money becomes a habit, it can induce inflation. With inflation, creditors (lenders, bondholders, etc.) would demand an inflation premium in order to protect the purchasing power of the money they get back at the end of the loan (or at the maturity of a bond). An inflation premium equates to a higher interest rate.

Factors that might drive interest rates higher in the future don't receive much attention because expectations are often molded by recent experience.

Inflation, and correspondingly an inflation premium, can also be impacted by changes in trade and manufacturing. Since the end of the Cold War, the virtually unbridled expansion in globalization (where manufacturing and services go offshore to seek lower wage costs) has helped to reduce the prices, or keep a lid on the prices, of products and services that we consume. Over the last few years, we have seen growing instances of the opposite: de-globalization. This has accelerated with the growing divide and between the U.S. and the People's Republic of China in terms of trade and geopolitics. A decoupling could increase the frictional costs of global trade (less efficient transportation logistics, higher material input costs, higher wages) which would then need to be passed on to the consumer in the form of higher prices if manufacturers and retailers are to maintain their profit margins.

Currently in the financial press there are only murmurings regarding the potential upward forces on interest rates. Often, our expectations are shaped by past experiences. It has been almost four decades since the world lived with significantly rising interest rates. Generation X (those born between 1965 and 1980) where the last to remember this world. The younger cohort (Generation Y, or the Millennials), which are now entering their decision-making years, can only read about it in the history books, a useful resource but often not much of an inspirational or convincing one. This lack of experiencing what is was like to survive in a high-interest rate world might create the same blind spots that plagued investors in the late 1979 where the consensus assumed that high interest rates would be a permanent feature of the economic landscape. Can current blind spots contribute to investors missing the next generational turning point in the direction of interest rates? Only time will tell.

Will we see conditions change that might drive interest rates higher and end the 39-year downward drift?

Most investors could miss the change just likely they did near the end of the previous 35-year upward drift in interest rates.

Model Portfolio Update[6]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	13.0	None
U.S. Equities	38.0	None
International Equities	8.0	None
Fixed Income:		
Canadian Bonds	24.5	None
U.S. Bonds	3.5	None
Alternative Investments:		
Gold	8.0	None
Commodities & Agriculture	3.0	None
Cash	2.0	None

There were no changes to the specific holdings or the targeted overall asset allocation in the model portfolios during the month of September.

No changes in the investments or the overall asset allocations in the model portfolios over the last month.

Stocks finally experienced a sustained selloff for the first time since the depths of the Coronavirus plunge in March because of frothy valuations, especially for large technology companies, and a delay in further potential trillion-dollar federal relief programs for U.S. consumers. Also, continuing Coronavirus infections combined with the news that some industry sectors that have struggled more than anticipated have challenged the notion that the U.S. was only going through a sharp, but short-lived, "V" shaped recovery.

Stocks finally saw a selloff as valuations become a little too excessive and as political debate in the U.S. stalled the next Coronavirus consumer aid package.

After peaking early in the month, U.S. equities (as measured by the S&P 500 Index) were down almost 4%. Canadian equities (as measured by the S&P/TSC Composite Index, followed a similar pattern and ended the month down 2.4%.[7]

[6] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 10/1/2020. The asset allocations of individual clients invested in this Portfolio may differ because of the relative performance of the asset classes since the last rebalancing and because of differences in the timing of deposits and withdrawals. The Balanced Model Portfolio is part of a sequence of five portfolios ranging from conservative to aggressive: Conservative, Balanced Income, Balanced, Balanced Growth, and Growth.
[7] Source: Bloomberg Finance L.P. as of 10/1/2020.

Gold (valued in U.S. dollars) saw a 4.2% decline from its record high set in August.[8] As noted in the previous issue *The Charter Group Monthly Letter*, gold hardly rides an escalator straight uphill although its upward trend over the last century has been persistent. If it becomes evident that there will more relief for U.S. consumers, the trillions in additional spending could provide more octane for gold prices.

Gold also sold off following the record high set in August. Might be an example of rising too far too fast.

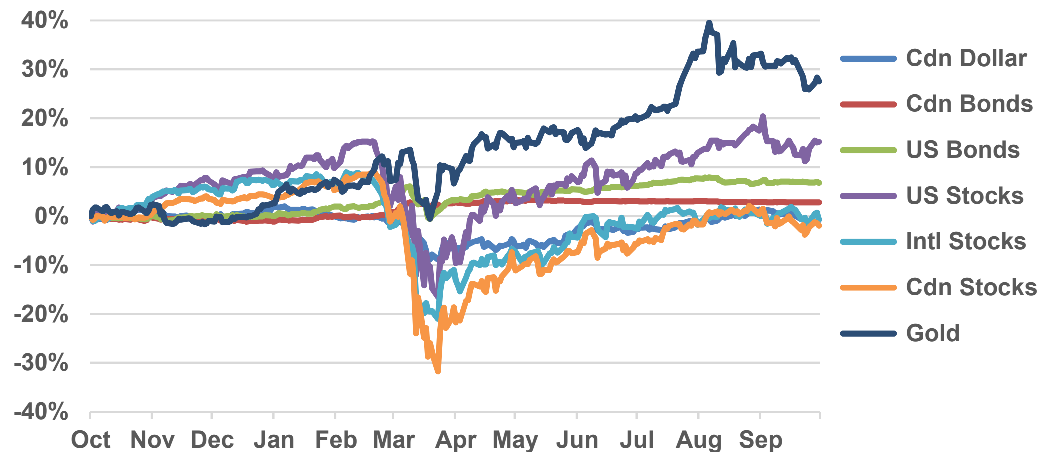
Not much has changed from the last issue of the *Monthly Letter* regarding the state of U.S. elections coming up in November. Polls haven't moved much and it is not clear if there will be a change in control of the U.S. Senate (markets tend to prefer gridlock which occurs if different parties control the White House and the Senate). As a result, the markets have not had much to digest. It is also important to note that markets are more "BNN" and less "CNN" in character. Thus, things like debates and rhetorical drama don't impact markets as much as many people might assume.

U.S. politics and the upcoming election are a big topic for cable news but not as much for the financial news outlets.

Below is the 12-month performance of the asset classes that we have used in the construction of The Charter Group's model portfolios. (**Chart 2**).[9]

Chart 2:

12-Month Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. from 10/1/2019 to 9/30/2020

[8] Source: Bloomberg Finance L.P. as of 10/1/2020.
[9] Source: Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one U.S. dollar; Canadian bonds are represented by the current 3-year Government of Canada Bond; US bonds are represented by Barclays US Aggregate Bond Index; U.S. stocks are represented by the S&P 500 Index; International stocks are represented by the MSCI EAFE Index; Canadian stocks are represented by the S&P/TSX 60 Composite Index; Gold is represented by the Gold to US Dollar spot price.

Top Investment Issues[10]

Issue	Importance	Potential Impact
1. U.S. Fiscal Spending Stimulus	Significant	Positive
2. Coronavirus Geopolitics	Significant	Negative
3. Canadian Dollar Decline	Moderate	Positive
4. Canadian Federal Economic Policy	Moderate	Negative
5. China's Economic Growth	Moderate	Negative
6. Short-term U.S. Interest Rates	Moderate	Positive
7. Canada's Economic Growth (Oil)	Moderate	Negative
8. Deglobalization	Medium	Negative
9. Global Trade Wars	Medium	Negative
10. Long-term U.S. Interest Rates	Light	Negative

[10] This is a list of the issues that we currently deem to be the ten most important with respect to the potential impact on our model portfolios over the next 12 months. This is only a ranking of importance and potential impact and *not* an explicit forecast. The list is to illustrate where our attention is focused at the present time. If you would like an in-depth discussion as to the potential magnitude and direction of the issues potentially affecting the model portfolios, I encourage you to email me at mark.jasayko@td.com or call me directly on my mobile at 778-995-8872.

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Accountability is further enhanced by the fact that we commit our own investable wealth to the same model portfolios in which our clients are invested.

The information contained herein is current as of October 1, 2020.

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