FEBRUARY 2015

INVESTMENT UPDATE

A milestone, of sorts, was achieved at the end of January, as the yield on 30-year maturity Treasury bonds hit their lowest levels ever recorded in the modern era, at 2.2%. Two-point-two percent. It doesn't sound much better when you write it out, does it?

This low-water mark for US Treasury yields was reached right around the same time that the US Bureau of Labor Statistics (BLS) released the January payroll data, which indicated that 257,000 net new jobs were added in the month; coming on the heels of strong payroll figures for December and November, the three-month average of 336,000 was the highest since Bill Clinton was in office in late 1997. For the record, the yield on the 30-year bond in the fall of 1997 was 6.2%.

	Real GDP	
	2014 Prelim	2015 Forecst
US	2.4%	3.7%
Japan	0.3%	1.3%
Germany	1.4%	1.0%
France	0.4%	0.9%
Italy	-0.4%	0.3%
UK	3.0%	2.5%
China	7.4%	7.0%
Russia	0.5%	-5.2%

The contrast between these two numbers—bond yields and payrolls—is pretty shocking. After all, we know that the strength of the US labor market is the single most important consideration when judging the health of the US economy; the Fed has said so *ad infinitum*. And that's why it's so difficult to understand how, despite what appears to be a strong economy, bond yields are lower today than they were during the Great Depression, or World War II, or even in the wake of the financial crisis of the past decade.

Could it be we're getting something wrong? Maybe the economy isn't as strong as it appears, and these low bond yields reflect this? Perhaps there are technical factors unrelated to economic strength? Or is it something else? We will take each of these questions, one by one.

Maybe the economy isn't all that strong after all.

The recent pace of payroll growth has been very strong indeed, with construction employment rising for the 13th straight month, and manufacturing up for the 18th consecutive month, both sectors having been hit hard in the Great Recession. The growth in jobs has been so strong, in fact, that the BLS reported that more than half a million formerly-discouraged people moved from "out of the labor force" into the ranks of the employed in January (which was the reason why the unemployment rate actually rose by 0.1% in the month, despite the heady increase in jobs). And while we know that (at least) early on in this recovery, many of the job gains were made up of low-paying jobs, Deutsche Bank economist Torsten Slok's recent work shows that of the approximately 11.7 million jobs created over the past five years, nearly 2/3rds—7.6 million—have been above the average hourly earnings rate of $24.75 per hour. What's more, the ratio of good-paying jobs is increasing.

Now, we don't want to go overboard on how strong the US economy is; after all, since the financial crisis, the US hasn't posted real GDP growth in excess of 2.5% in any single year. By contrast, US annual GDP growth exceed 2.5% in twelve of the fourteen years between 1992 and 2006, many of those years by a wide margin. Let's just say that the US economy today is reasonably healthy and fairly stable.

Unfortunately, the same cannot be said for the rest of the world, as the IMF is predicting global economic growth in 2015 to be just 0.4%. Perhaps more importantly, economic growth of our major trading partners in Europe and Asia is looking particularly weak, as shown in the table, with much of the major European economies in near-recession conditions. Even China, which has had double-digit economic growth for decades, has slowed significantly.

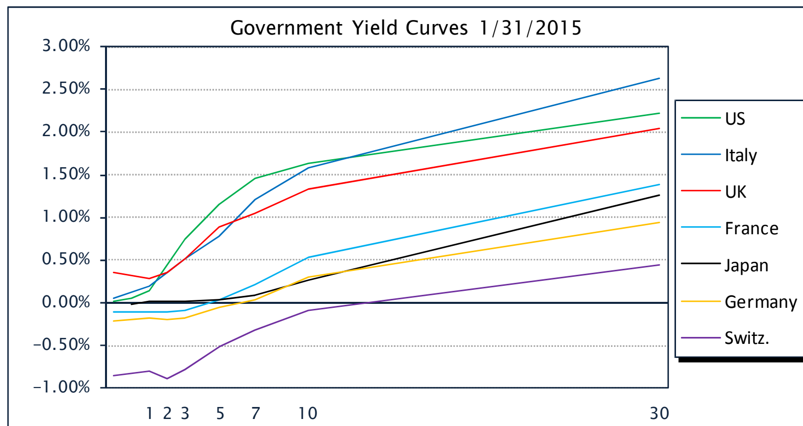
Are technical and other factors suppressing interest rates?

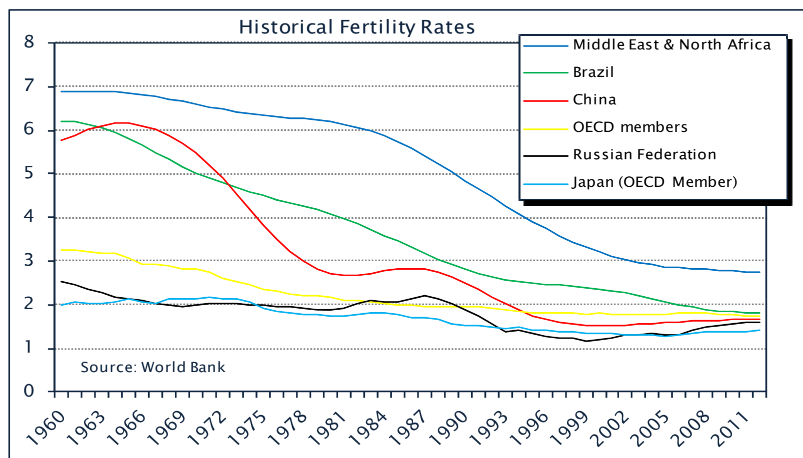
So if US growth isn't an illusion, why are rates so low? The easy answer is "inflation." While short-term interest rates are more-or-less controlled by a country's central bank (e.g., the Fed funds rate in the US), longer-maturity rates are highly sensitive to inflation and inflation expectations. US core inflation (which excludes food and energy prices) right now is only 1.6% higher than it was a year ago, well below the Fed's lower target of 2.0%, and with crude oil prices having fallen by nearly one-half over the past year (and many other commodity prices having also dropped dramatically), expectations for inflation over the next few quarters are very low. With 10-year Treasuries yielding 1.8% and core inflation at 1.6%, that leaves pretty much nothing after inflation for investors. Why would anyone be willing to receive such a paltry "real" yield for 10 years?

For many, the answer is, "Hey, at least they're above zero." Inflation isn't the only factor impacting long-term interest rates; supply and demand are also major considerations. And while there is plenty of supply of US Treasuries, the global demand is even bigger. One look at the next chart explains the situation from the perspective of global fixed income investors. With the slowdown of global economic growth, there is worldwide excess capacity of all the necessary ingredients to

produce goods and services, including the demand for credit. Interest rates keep dropping, but businesses and households everywhere simply don't want to borrow, so rates fall further. Central banks in Europe and Asia are following the Fed's lead (too late, some would say) by using quantitative easing methods to push longer rates even lower.

The result is that interest rates in the US are among the highest of our major trading partners, as shown in the top chart. It may come as a surprise that interest rates in Germany and Switzerland are actually negative—yes, you will need to pay the bank to hold your money—for maturities shorter than five years. Note how Japan, the country who has been the laughing stock of the bond market for more than a decade with their ultra-low yields, now looks positively normal when compared to the major countries of Western Europe. So when investors from these countries look around the globe, trying to decide where to park their money, the US bond market—backed by a relatively strong currency and an economy that's growing at a moderate pace—looks attractive, even with our miniscule inflation-adjusted yields. It's all relative.





<u>What is the root cause of all this weak economic activity?</u>

More than six years into the global economic recovery from the Great Recession, economic growth remains anemic, interest rates are at historic lows, inflation is less of a danger than deflation, and things are not looking like they're going to change any time soon. Clearly, there is something else going on, some larger forces at work. While a full discussion and examination of these larger forces is beyond the scope of this *Investment Update*, we will give you a little something to chew on, and it's one of the recurring themes that we touch on from time to time: global demographics.

We mentioned Japan earlier as the country that used to be held up as a cautionary tale for their slow economic growth and low interest rates, which have been due, in part, to poor monetary and banking policies over the past couple of decades. But we've also observed, with growing worry, that Japan's aging population and low birth rate is quickly becoming the norm among Western economies. As the lower chart shows, fertility rates—the average number of live births per female in a country's population—have been declining for decades. On average, if a man and a woman have less than two children (plus a fractional amount to cover infant deaths) during their lifetimes, they will not be "replacing" themselves before they die. Without immigrants, a country's population will decline when the fertility rate drops below 2.1 or so. It's no longer a Japan-only thing, with fertility rates falling across the OECD (major Western economies); even China and less-developed countries are following suit. This has extremely important implications for global economies, since economic growth can only come from either a rising population or increased productivity.

As the bottom chart shows, "We're all becoming Japan" in this regard; they've just been ahead of the rest of us for the past couple of decades—from both a demographic and economic standpoint. And this presents huge challenges for the way we've been taught to think about economics, the least of which is that we've never had to think about running an economy (or a country) with a shrinking population, particularly when there are so many retirees, and too few workers.

And this, dear reader, is what we suggest may be really behind the unusually low interest rates we're seeing across practically every modern economy. We've built, on a global scale, a highly-intricate and efficient means of producing goods and services in huge numbers, with the assumption that demand will continue to grow to feed a voracious and growing world population. But if that demand is not there, both because the population is aging and more interested in saving, but also because it's just not growing, we have a global overcapacity problem on a monumental scale. This has been coming for some time, but we were able to paper over it in the last decade by borrowing money and ramping up our spending (and keeping interest rates high in the process); but that era is over, having been replaced by a more sober and mature mindset.