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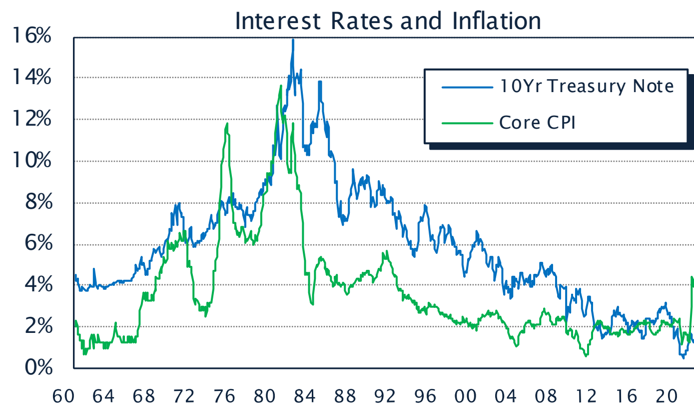
INVESTMENT UPDATE

"Certificates of confiscation," they called them. "Why on Earth would anyone want to mess around with bonds?" they asked.

For those of us of a certain age, who've been "messing around with bonds" for the last 40 years, the reaction above was the prevailing attitude towards bond investors when we first got into this crazy business. We heard it all, "Bonds are for chumps," they'd say, or "Why not just bury your money in the back yard," or "Don't do it—you're young and have your whole life ahead of you!"

And at the time—the early 1980's—these folks were only speaking from experience. Bonds, it was true, had been disappointing investors for decades. Ever since the early 1960s interest rates and inflation had been on upward trends and bond prices, moving as they do in the opposite direction of rates, had suffered a long and painful decline. Bonds were an important component of almost any institution's investment program, offering stability and income. But they had proved to be less stable than anticipated, and falling prices had been eating away at the income they provided.



The chart on this page tells the story. Inflation—which reduces the value of a bond's future interest and principal payments—had been low and stable in the immediate aftermath of World War II, but by the mid-1960s was ticking up. The US economy was growing at a rapid pace, while "New Society" spending combined with big increases in costs associated with the Vietnam War put the US budget into a deficit. The US also eliminated the convertibility of the US dollar into gold in 1971, which caused the dollar to sink, increasing the prices of imported goods. The big shock, however, started in 1973, when OPEC cut back on global crude oil supply, which sent inflation on an uneven, but decidedly upward trajectory, as various policy tools failed to rein in spiraling prices.

By the early 80's core CPI was above 12% and bond yields were even higher. The Fed, now under the iron hand of Paul Volcker, sent the economy into a double-dip recession in 1981 and '82 by hiking the Fed funds rate to its highest-ever level, 20%, on two separate occasions, in March 1980 and in May of 1981. As the chart shows, inflation tailed off quickly from there, as Volcker's Fed kept the growth of money supply under tight control, and by 1984 core CPI was back below 4%. Bond yields remained elevated well after inflation measures had collapsed, as it took several years before shellshocked investors were convinced that inflation had been contained.

There are a couple of points here worth exploring. First, with the full benefit of hindsight, it's clear that policy errors helped contribute to the spike in inflation in the late 1970s. Under the guidance of Volcker's predecessors, Arthur Burns and (especially) G. William Miller, the Fed's response to inflation was overly cautious, with modest and delayed rate hikes, and easy monetary policies. Meanwhile fiscal policies were, in a word, hapless, as the Nixon, Ford, and Carter administrations each enacted policies (price controls, gold sales, etc.) that did nothing to quell inflation. Volcker's policies, by contrast, were draconian, but necessary to wring the neck of consumer price inflation.

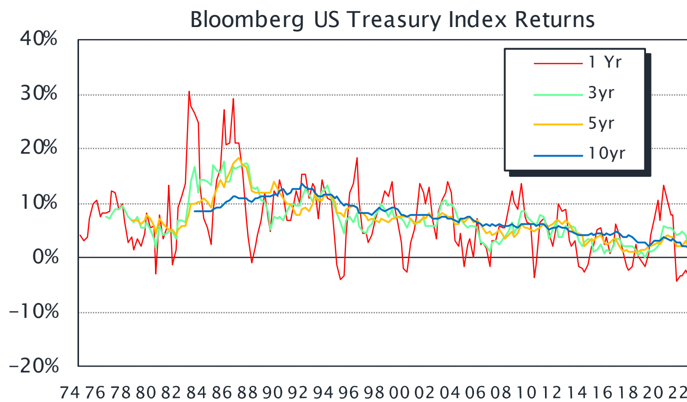
Secondly, in looking back through the discussions and commentary at the time, policymakers struggled with both the economic models of the era, as well as how to measure certain important economic indicators. A glaring example is that there was no real agreement on how the unemployment rate was impacting inflation. Time and again, the Fed failed to recognize that wages were being driven higher due to tight labor markets, and that restrictive monetary policy was needed, even if it caused economic growth to stall to recessionary levels.

If any of this sounds familiar, it's because some of these same policy mistakes were made 40 years later, and as a result the bond market has been punished once again. We've written about it before, but the Fed made significant revisions to its monetary policy framework in 2020, which led to policy errors reminiscent of the Burns/Miller-era Fed. Chief among these missteps was that the Fed would now place increased emphasis on achieving "full employment," by allowing US

economic growth to remain unchecked deeper into the economic cycle. By allowing the economy to run hot, the Fed hoped that inflation would rise modestly, and would average 2% over the long term. This 2% inflation rate had been more of a ceiling than a target throughout most of the new century, but was especially sticky below 2% following the global financial crisis.

The Fed found its hands tied with inflation and rates stuck at very low levels, even during economic expansions. Every time the economy weakened, the funds rate was eventually lowered to zero and the Fed had no choice but to put in place huge government bond purchase programs ("QE") to further stimulate the economy, a scenario it was keen to avoid in the future.

Obviously, the Fed's timing could hardly have been worse. Just as it was decreed that inflation fighting would be de-emphasized in favor of economic growth, Covid relief spending, eventually totaling $5 trillion—roughly equivalent to 1/5th of annual US GDP—was doled out to households, businesses, nonprofits, and into various local and federal government programs. Meanwhile supply chains and production facilities were disrupted, if not completely shuttered, to help contain the spread of the virus worldwide. Flush with cash, and with supplies curtailed, consumer demand exceeded the available supply of countless goods, lighting the inflation fuse that the Fed is now trying desperately to contain.



So, let's go ahead and call it: The great 40-year bull market for bonds has ended. This bout of inflation is likely to persist, at least for a while, as the changes in global trade resulting from Covid-era disruptions will take a number of years to play out, as companies re-think the use of outsourcing, "just in time" inventory methods, and the too-distant supply lines that generated savings and kept prices low for so long. Likewise, US workers have regained bargaining power that was lost in the globalization of labor which occurred over recent decades. These changes—and others—will take years to play out, and will exert cost pressures for both manufacturing and service industries, costs that those companies will try to pass on to consumers.

But—and this is a big but—the end of the bull market for bonds does not imply that "bonds are for chumps"; far from it. And that's because the people that were so disillusioned with bonds 40 years ago were wrong. Bonds weren't a poor investment in 1980 or even in 1975; in fact, returns for bonds in the Big Lapel Years were, by almost any standard, pretty darn good, if a little volatile, as the chart on this page demonstrates. The Bloomberg Indexes (then known as the Lehman Indexes) only go back as far as 1973, so while we can't see returns prior to that, the chart begins as inflation pressures are already boiling, and graphs trailing one-, three-, five-, and ten-year returns for US Treasuries. It's clear that returns to bondholders during the 1970's and 1980's were pretty good, despite the volatility evident in the one-year returns.

The total return for US Treasuries for the final seven years of the 1970s was 5.8% on an annualized basis, which compares favorably to the 6.6% annualized return of the S&P 500 over the same time period. If that doesn't quite square with the prevailing anti-bond attitude of the time, the 1980s annualized Treasury return of 12.2% for the decade ending 12/31/1989 must have been a bitter pill for the bond haters. Even the 1990s and 2000s average returns of 7.4% and 6.2% look pretty good, but in the post-financial crisis era, ever-lower inflation (and inflation expectations) drove bond yields—and bond returns—lower still.

The main point here, in case it's not obvious yet, is that inflation, per se, is not the destroyer of bond returns; it's the combination of high inflation and low bond yields that leads to poor bond returns. Turning back to the 1960s and 1970s, we can see what saved bondholders was that interest rates never dropped to the microscopic levels that have characterized our market over the past decade or so. Even in the early 1960s, when inflation was barely 1%, 10-year Treasury yields were over 4%. By the time of the first OPEC gas crisis, 10-year yields were at 8%. This relatively high level of income that bonds offered helped offset the price markdowns that bonds were experiencing as inflation rose and bond prices fell. And, by contrast, the lack of income and yield that's been the hallmark of the US bond market in recent years meant that bond investors were extremely vulnerable when inflation made its unwelcome appearance in this post-Covid period.

The Fed has been taking giant steps to restore the balance between its dual mandates by bringing inflation down. That's good, as current inflation is so high that it's curtailing growth and disrupting business and household spending plans. But we're not rooting for the Fed to drive inflation back down to pre-Covid levels; a little inflation—and modestly higher interest rates—are the key to good bond returns. If we've learned anything over the last year, it's that it's possible for yields to fall too far, robbing bond investors of the coupon income that's vital for steady bond returns.