THE BUTTONWOOD

On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street. There they signed the Buttonwood Agreement, creating the first investment community, which later evolved into the New York Stock Exchange.

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THIRD QUARTER 2012

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Points of Interest

In the second quarter 2012 ***Buttonwood*** I discussed the current state of the bond market and whether or not bond valuations were approaching bubble status. While that debate continues, there are other aspects of the bond market and the current levels of interest rates that warrant some further discussion. As we attempt to position client money in the bond market we wrestle with the fact that the next meaningful direction in interest rates is up. Certainly that is stating the obvious as rates cannot go any lower. The dilemma, as we all know, is that when interest rates go up the value of bonds goes down. This quandary raises the question: when will rates go up and how quickly will they rise?

As is so often the case, we can learn much from history. In this case we go back many decades and dive into the murky world of investment cycles and waves. Theories regarding cycles and waves have been studied for centuries. They are both intriguing and controversial. Many in the world of academia debate their relevance. Even strong proponents of cycles and waves argue about what constitutes a cycle and which ones are relevant.

Perhaps the most interesting cycle data deals with the long term interest rate trends. The basis for much of this data is a result of work done by Russian economist Nikolai Kondratiev (1892 – 1938) who drew international attention for his book ***The Major Economic Cycles*** in 1925.

The Kondratiev theory is based on his study of 19th century price behavior that included interest rates, wages, raw material prices, foreign trade among other data. According to the ***Encyclopedia of Modern Europe: Europe Since 1914,***

The Kondratiev economic cycle theory held that in the beginning of the cycle economies produce high cost capital goods and infrastructure investments creating new employment and income and a demand for consumer goods. However, after a few decades the expected return on investment falls… and people refuse to invest, even as overcapacity in capital goods gives rise to massive layoffs, reducing the demand for consumer goods. Unemployment and a long economic crisis ensue as economies contract. People and companies save their resources until confidence begins to return and there is an upswing into a new capital formation period, usually characterized by large scale investment in new technologies.

In its simplest form Kondratiev stated that economic booms and busts are very long term (secular) in nature and are repetitive. The duration of a K-wave, as they are known, is about 60 years. During each 60 year cycle there are approximately 25-30 years of rising interest rates and a similar number of years where rates decline. The chart that we've included illustrates this. As you can see the duration of each cycle varies to some degree but a clear pattern does repeat itself.

Secular lows with respect to interest rates were made near the decadal marks of 1770, 1830, 1890, and 1950. The most recent cycle, from approximately 1950 (low rates) through today, produced a low of 2.48% in July of 1946, a high of 15.85% in October of 1981 and today's rate of 3.40%. What is very interesting is that when rates hit the late 1940's, early 1950's lows, they were a result of the Federal Reserve capping bond rates at 2% in an attempt to smooth the transition from a war time economy to a peace time economy. The intent was to keep rates low and strengthen the post war economy.

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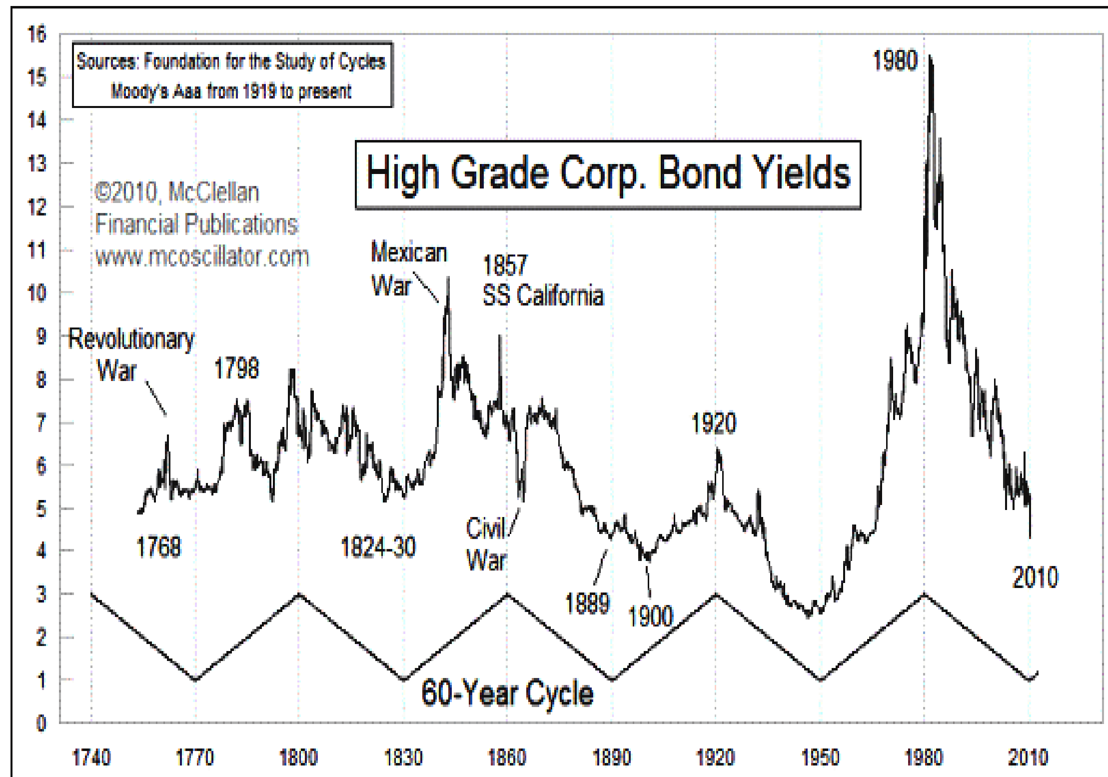
If you believe that we've reached secular low interest rates at this point and you buy into Mr. Kondratiev's work then the question is when do rates turn up and by how much? Both are difficult questions to answer. Clearly there is evidence that rates will not go up significantly any time soon. The aforementioned long- term cycle supports that. Equally significant is the Federal Reserve's recent announcement regarding interest rate policy for the foreseeable future.



The Fed announced that it would buy up to $40 billion of mortgage-backed securities per month and extend historically low interest rates through mid- 2015. The reason for this policy direction is to stimulate the economy and create jobs. This announcement, referred to as QE3, is similar to Fed policy just after World War II, when rates were capped at around 2%. What will likely cause a shift in this policy is the inflation trend. The Federal Reserve has targeted 2% as an acceptable rate of inflation. It would be difficult to maintain QE3 policy if inflation begins to escalate rapidly.

As the Fed formulates monetary policy, it considers **actual** inflation data as well as inflation **expectation** data. Two significant variables in the **actual** inflation equation are personal consumption expenditures (PCE) and core inflation which is defined as price measurement minus food and energy. At this point both are under the 2% figure. The trend also shows no sign of increase, which is consistent with a slack economy.

The inflation **expectation** data is determined, in part, by the difference in yield between the nominal (inflation not factored in) Treasury rate and the Treasury inflation protected security (TIPS) of similar maturity. Without getting into the calculus of this computation, current data suggests that the inflation expectation figure falls within the Fed's acceptable range.

Why all this emphasis on inflation? Because the Fed is steadfastly committed to keeping inflation under control. Over a year ago Mr. Bernanke stated "Ultimately, if inflation persists or if inflation expectations begin to move, then there is no substitute for action. We would have to respond." Clearly the Fed is saying that it would raise rates to keep inflation in check, even if it meant slowing the economic recovery.

In conclusion, the combination of the "where we currently are" in the long term interest rate cycle and the Federal Reserve's commitment to keeping rates low for the foreseeable future indicate that rates will likely nudge up slowly over a long period of time. Certainly there is a very delicate balancing to all of this, and the situation could change quickly, but the bet here is low rates for some time to come.

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