October 2023

Higher for Longer

At the beginning of 2022, we declared, “The previous regime of easy money in search of inflation has ended. While the response is likely to be measured in the short term, over time, interest rates will move higher in an attempt to keep up with inflation.” Since then, the Fed has embarked on a vigorous interest rate hiking campaign that appears to be drawing to a close. Many investors believe the conclusion of this cycle of increasing interest rates will be followed quickly by an interest rate-cutting cycle.

Those hopes were dashed at the last Federal Reserve meeting. We were not surprised. As we pointed out earlier this year, “Chair Powell has made it abundantly clear that he intends to stay “there” for a while. How long will be determined first by the persistence of inflation and secondarily by the strength of the economy. **This is not intended to be a pit stop followed quickly by a return trip to the fairytale land of 0% interest rates.**” At his press conference following the meeting, Chair Powell hammered home his intention to remain “there” for a while. The veracity of his comments helped fuel a selloff in all asset classes, with stocks falling 5% since he spoke and the 10-year treasury yield increasing to 4.58%, the highest since the fall of 2007.

While interest rates are now at their highest levels since before the Great Recession, a little more context is necessary. Since 1954, when the Federal Reserve began publishing its funds rate on a daily basis, the rate has averaged 4.6%. Rates peaked in March of 1980 at 20% and bottomed at effectively 0% in December 2008. Generally, peaks and troughs do not persist for long periods of time. For example, by the end of 1982, rates had fallen back to 8.50%. The real anomaly in this series is the recent duration of 0% interest rates. But for the attempt to raise rates in 2019, the 0% interest rate environment persisted for nearly 14 years!

The duration of this period of ultra-low interest rates was so long that it became embedded in the minds of consumers and businesses as normal. This belief in a “new normal” eventually permeated nearly all aspects of society. It enabled governments around the world to operate with massive deficit spending in their pursuit of noble outcomes ranging from basic income to carbon neutrality and everything in between.

Warren Buffet famously said, “Only when the tide goes out do you learn who has been swimming naked.” The tide has been in for a long time, and as it recedes, more challenges will be ahead. For investors with capital to deploy, these challenges should offer opportunities to prudently invest at higher expected rates of return.

These higher real interest rates allow us to build longer maturity, high-quality corporate bond portfolios. For the past several years, as long-term interest rates moved lower, we chose not to extend maturities at what we felt were very low rates to modestly improve the yield on our fixed-income portfolios. Staying short has positioned our client portfolios to have a significant number of bonds mature in 2023 and 2024. This is enabling us to reinvest those proceeds at substantially higher yields, **dramatically increasing the income generated by these portfolios for longer periods of time.**

The overall fixed-income market, defined as the Barclays aggregate bond index, is working on a third consecutive year of negative total returns. Remember, as yields move up, prices of bonds move down. There have never been three years of negative returns in a row for fixed income. Given the higher level of interest rates, we believe now is the time to extend the duration of our bond portfolios. This is one of those challenges for the market that excites us. Historically, many would have used a rule of thumb that equity returns should be approximately 8% over long time horizons. Currently, fixed-income markets are enabling us to build portfolios that will generate nearly 6% income for several years without having to accept the volatility of equity markets.

As the world adjusts to interest rates that are higher for longer, it is likely that volatility in equity markets and choppiness in the economy will both increase. Recently, economic choppiness has existed mainly due to the impacts of stopping and starting wide swaths of the economy due to COVID. New bumps in the road will likely arise as economies globally grapple with higher interest rates. Further complicating matters is the amount of debt that governments have piled up over the past decade. These bills do have to be paid, and there is no longer an unlimited amount of cheap money being created out of thin air.

Increasing economic volatility is likely to result in an equity market with more twists and turns than we've experienced over the past decade. During the low-interest rate environment, equity markets trended mostly higher with occasional dips that could always be bought. That muscle memory remains intact and has prevented capitulation in large-cap stock indices even as money has begun flowing towards fixed income. This push and pull is likely to continue and result in a meandering and volatile market. This should mean better opportunities for individual stocks to rise and fall on their own merits, an environment we welcome.

Over time, we believe the time spent at 0% will be seen as the anomaly. That enlightenment will not happen quickly, just as accepting it as the "new normal" did not occur instantly. There will be unforeseen challenges to deal with, but that is normal. Very rarely is the world devoid of issues to worry about. While we are holding more cash than usual, we are still finding opportunities to deploy our clients' capital on our terms. As individual stocks reach fair value, we will be happy sellers. If we do not find opportunities to redeploy - we will gladly hold cash, which now yields 5% and once again is a real alternative.

Considering the new set of choices available now is a great time to revisit investment plans and consider modifying them if necessary.