The Long View: Is The Bull Market In Bonds Almost Over?

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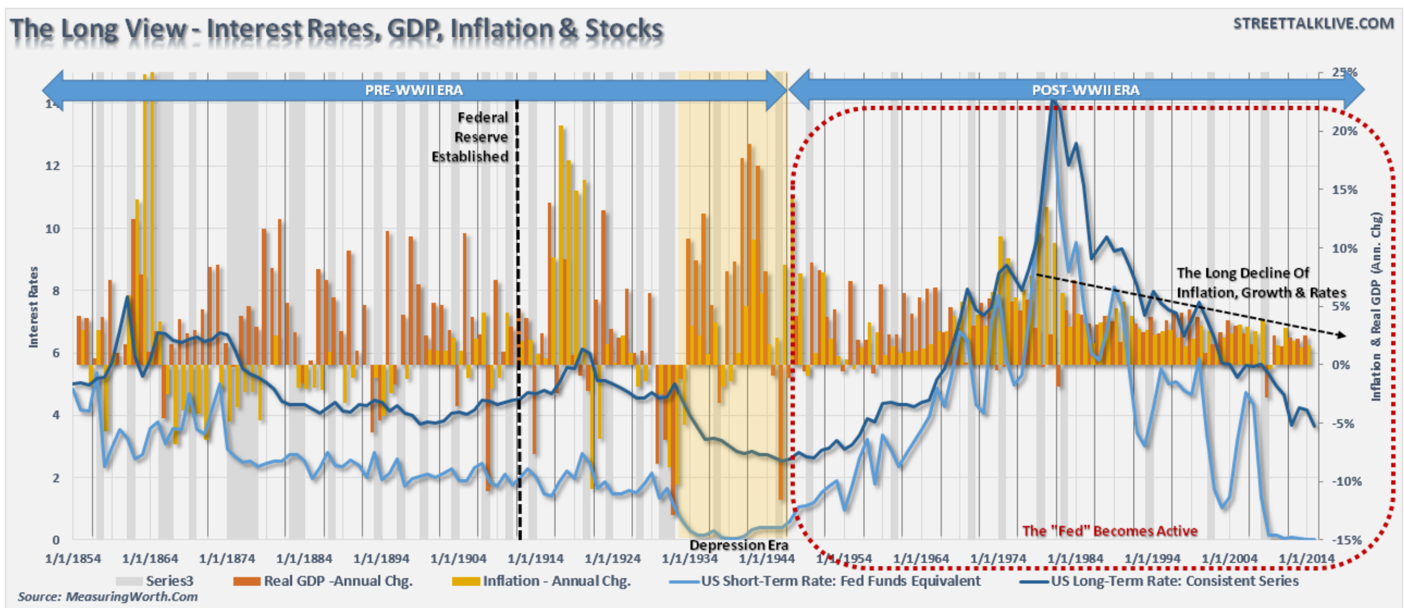
by Lance Roberts
of Streettalk Live

There has been much debate about the current low levels of interest rates in the economy today. The primary argument is that the *"30-year bull market in bonds"*, due to consistently falling interest rates, must be near its end. Of course, this debate has devastated the *"bond bears"* who have consistently been frustrated by lower interest rates despite their annual predictions to the contrary. However, just because interest rates are currently low, does this necessarily mean that they must rise?

The chart below shows a VERY long view of interest rates *(equivalent rates to the Federal Funds Rate and 10-year Treasury)* back to 1854.



While there is much data contained in the chart above, there are a couple of important points to consider in this debate. The first is that interest rates are a function of the general trend of economic growth and inflation. **Stronger rates of growth and inflation allow for higher borrowing costs to be charged within the economy.** As shown, interest rates have risen during three previous periods in history; during the economic/inflationary spike in early 1860's, again just prior to 1920 and during the prolonged manufacturing cycle in the 1950-60's following the end of WWII. Secondly,

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interest rates tend to fall for very extended periods.

However, notice that interest rates fell during the depression era, even though, economic growth and inflationary pressures were robust. **This was due to the very lopsided nature of the economy at that time; the wealthy prospered while the middle class suffered, which did not allow money to flow through the system *(monetary velocity).***

Currently, the economy is once again bifurcated. **The upper 10% of the economy is doing well while the lower 90% remain affected by high levels of joblessness, stagnant wage growth and a low demand for credit.** For only the second time in history, short term rates are at zero and monetary velocity is non-existent. The difference is that during the *"Great Depression"* economic growth and inflationary pressures were at some of the highest levels in history, while today the economy struggles along at just above a 2% rate with inflationary pressures running lower than that.

Let's look at the fall of interest rates since the 1980's in a slightly different manner.

As stated above, since interest rates are ultimately a reflection of economic growth, inflation, and monetary velocity, **the fact that the globe is awash in deflation, caused by weak economic output and exceedingly low levels of monetary velocity, there is no pressure to push rates higher.** In fact, interest rates in the U.S. continue to fall as money is fleeing other countries and associated risk for safety. Let's take a look at the chart of 10-year equivalent treasury rates once again. The dashed black line is the median interest rate during the entire period.

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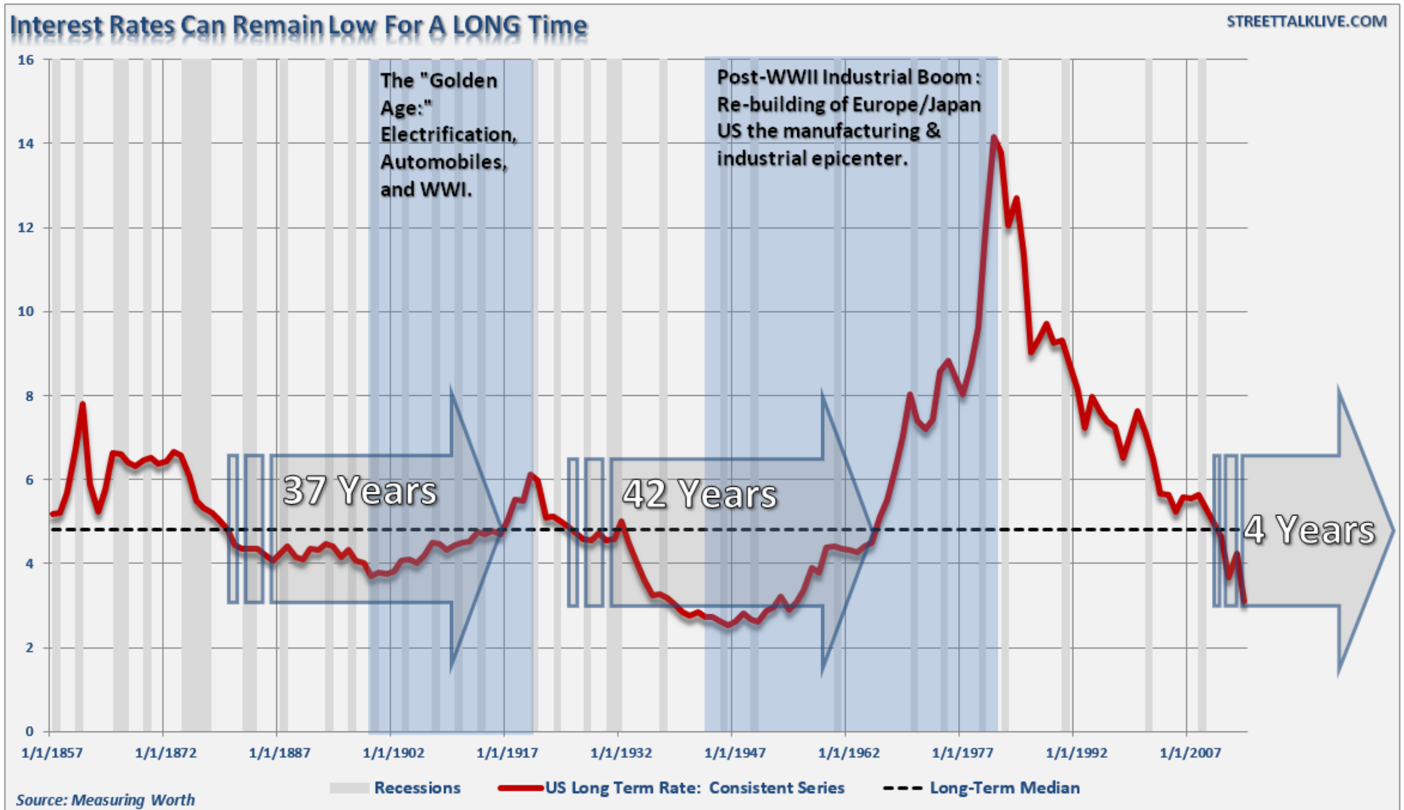

*(**Note:** Notice that a period of sustained low interest rates below the long-term median, as shown in the chart above, averaged roughly 40 years during both previous periods. We are only currently 4-years into the current secular period of sub-median interest rates.)*

As shown, there have been two previous periods in history that have had the necessary ingredients to support rising interest rates. The first was during the turn of the previous century as the country became more accessible via railroads and automobiles, production ramped up for World War I and America began the shift from an agricultural to industrial economy.

The second period occurred post-World War II as America became the *"last man standing"* as France, England, Russia, Germany, Poland, Japan and others were left devastated. It was here that America found its strongest run of economic growth in it history as the *"boys of war"* returned home to start rebuilding the countries that they had just destroyed. But that was just the start of it as innovations leapt forward as all eyes turned toward the moon.

Today, the U.S. is no longer the manufacturing epicenter of the world. **Labor and capital flows to the lowest cost providers so that inflation is effectively exported from the U.S. and deflation can be imported**. Technology and productivity increases suppress the need for labor and wages which has continued to growth rates over time. The chart below shows this dynamic change that begin in 1980. A surge in consumer debt was the offset between lower rates of economic growth and incomes in order to maintain the*"American lifestyle."*

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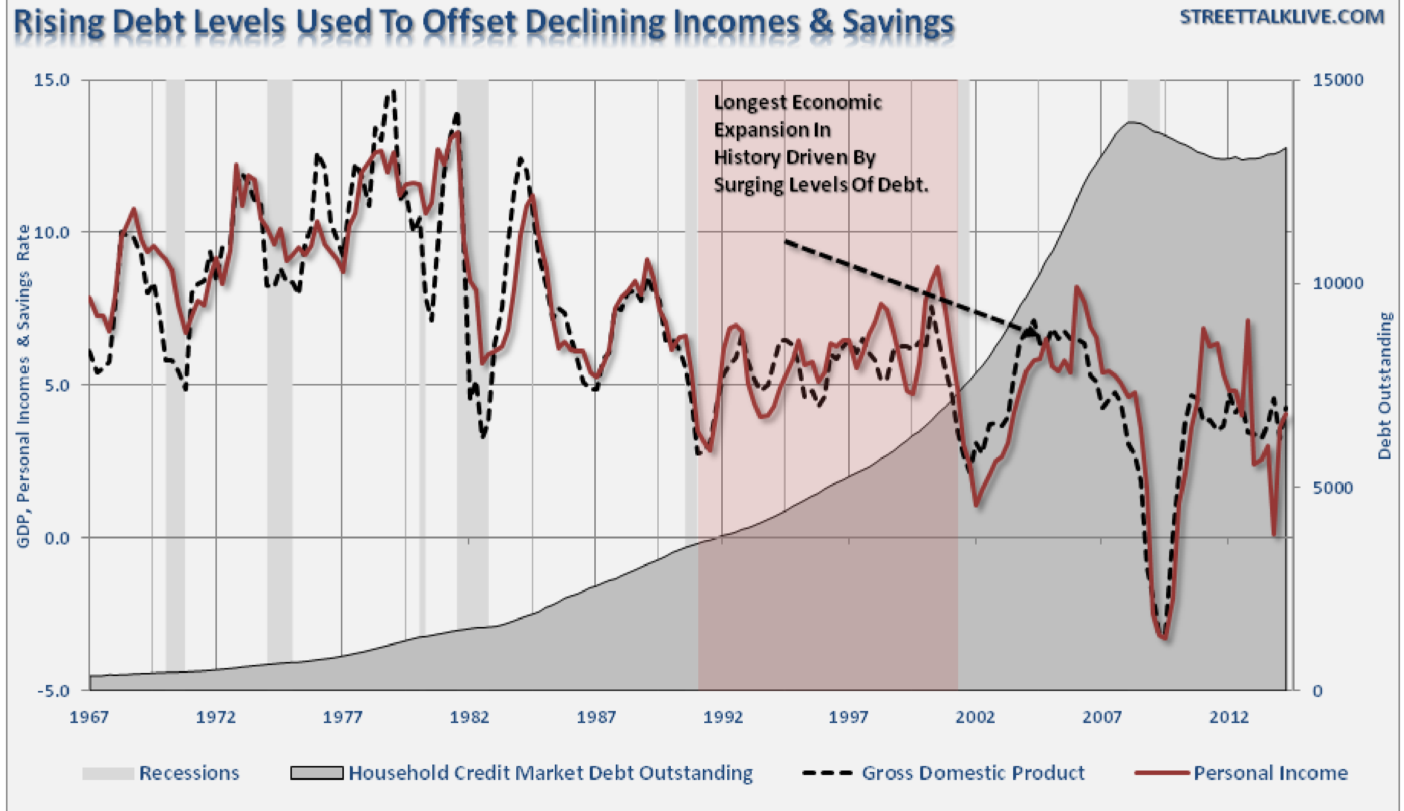

Today, the number of workers between the ages of 16 and 54 is at the lowest level relative to that age group since 1976. As discussed recently, this is a structural problem that continues to drag on economic growth as nearly 1/4th of the American population is now dependent on some form of governmental assistance.

Currently, there are few economic tailwinds prevalent that could sustain a move higher in interest rates. **The reason is that higher interest reduces the flow of capital within the economy.** For an economy that remains dependent on the generosity of Central Bankers, rising rates are not the outcome that *"stock market bulls"* want.

The problem with most of the forecasts for the end of the bond bubble is the assumption that we are only talking about the isolated case of a shifting of asset classes between stocks and bonds. However, the issue of rising borrowing costs spreads through the entire financial ecosystem like a virus. **The rise and fall of stock prices have very little to do with the average American and their participation in the domestic economy.Interest rates, however, are an entirely different matter.**

While there is not much downside left for interest rates to fall in the current environment, there is also not a tremendous amount of room for increases. **Since interest rates affects *"payments,"* increases in rates quickly have negative impacts on consumption, housing, and investment.**

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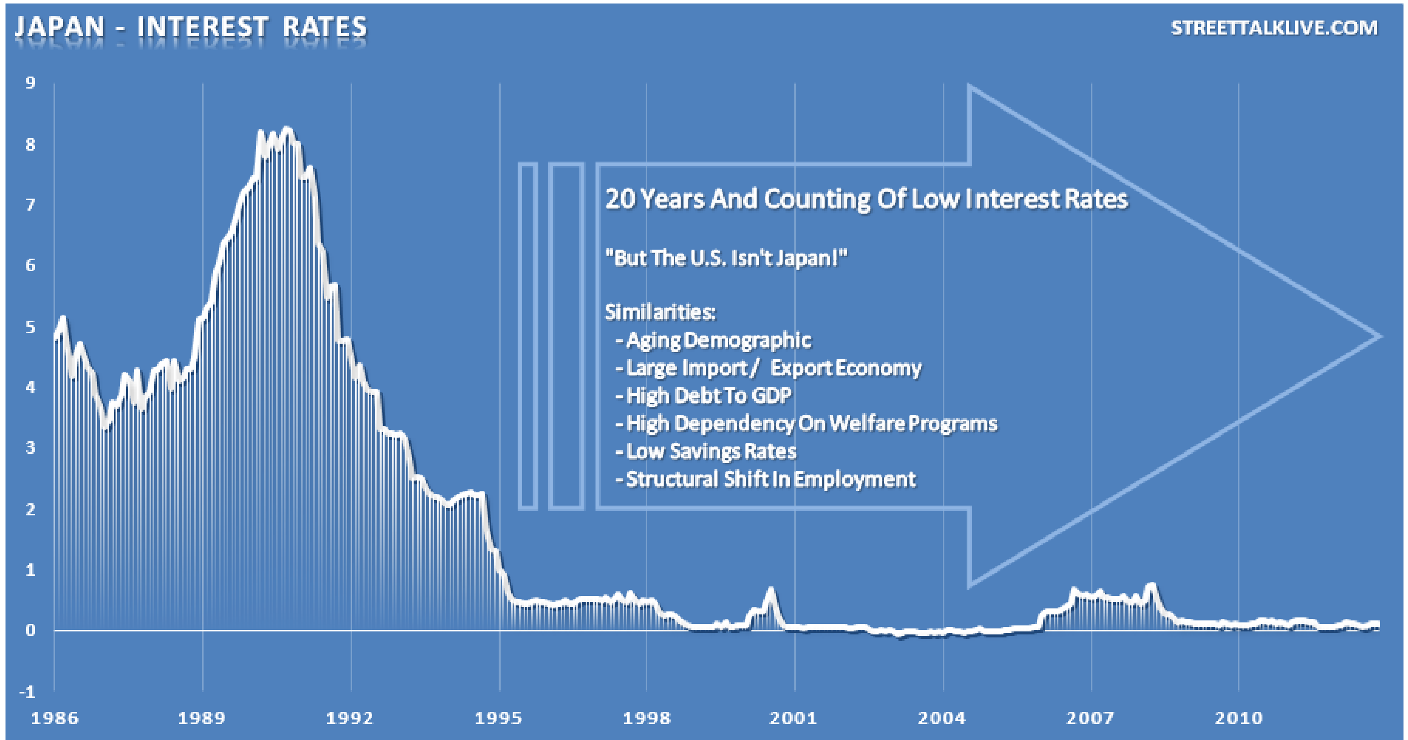
This idea suggests is that there is one other possibility that **the majority of analysts and economists ignore which I call the *"Japan Syndrome."***



Japan is has been fighting many of the same issues for the past two decades. **The *"Japan Syndrome"* suggests that while interest rates are near lows it is more likely a reflection of the real levels of economic growth, deflation and weak wages**. If that is true, then it is also likely true for the U.S. which suffers from similar economic drags. This also suggests that **rates are most likely *"fairly valued"*** and implies that the U.S. could remain trapped within the current trading range for years as the economy continues to *"muddle"* along.

Will the *"bond bull"* market eventually come to an end? Yes, eventually. However, the catalysts needed to create the type of economic growth required to drive interest rates substantially higher, as we saw previous to 1980, are simply not available today. This will likely be the case for many years to come as the Fed, and the administration, come to the inevitable conclusion that we are now caught in a *"liquidity trap"* along with the bulk of developed countries.

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