Grandma Ruby

-J. Kevin Meaders, J.D., CFP®, ChFC, CLU*

September, 2022 — We always thought Grandma Ruby was kind of stingy. She never took us to Disney or Six Flags like Grandma Ruth, and we could never turn the lights on when there was daylight outside. The only restaurant we could ever go to was S&S Cafeteria; she left only a couple of quarters as a tip. When she got home from the grocery store, she audited the receipt.
What we as ignorant children did not know at the time was that Grandma Ruby was a child of the Great Depression. Having been born in 1916, she was 13 when the market crashed, and her family lost most everything. She learned to be frugal because she had to be. She learned to shun superfluous spending because she simply had to.

As a kid I would accompany Grandma Ruby on many of her cross-state bank runs. She would drive all over north Georgia looking for the highest CD rates. She would drive fifty miles just for a quarter point. As I sat there in the bank waiting for her to complete her transaction, I often studied the chart of CD rates generally posted. I noticed that a CD maturing in 6 months or 1 year never paid as much interest as a 5-year CD. From bank to bank, year to year, the result was always the same: the longer-term CDs always paid a higher rate than the shorter terms.

This is what we call a yield curve, and a normal yield curve looks exactly that way: longer terms pay higher interest than shorter terms.

But what if the reverse were true? What if a 1-year CD paid more than a 5-year CD?

This is what we call an "inverted" yield curve and this is exactly where we are now in the treasury market. The 2-year treasury note is paying more that the five-year note, paying more interest than a 10-year bond! More than a 20-year bond![i] When this happens, you intuitively know something isn't right.

What "isn't right" is the constant manipulation of interest rates by the Fed since 1913. In fact, it was the Fed (by their own admission) who caused the Great Depression. It was the Fed that kept Grandma from taking me to Disney!

Governmental interference in a free market economy always creates anomalies.

As noted by Professor Mises almost a century ago:

> Every single fluctuation in general business conditions—the upswing to the peak of the wave and the decline into the trough which follows—is prompted by the attempt of the banks of issue to reduce the loan rate and thus expand the volume of circulation credit through an increase in the supply of fiduciary media (i.e., banknotes and checking accounts not fully backed by [gold]).[ii]
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> The appearance of periodically recurring economic crises is the necessary consequence of repeatedly renewed attempts to reduce the "natural" rates of interest on the market by means of banking policy. The crises will never disappear so long as men have not learned to avoid such pump-priming, because an artificially stimulated boom must inevitably lead to crisis and depression.[iii]

So here we go again. The bust of 2008 was created by the Fed's easy money policy following the bust of 2000. And the boom created by the easy credit policy of the 2008 bust has set us up for another bust—which is coming in short order.

As expected, the Fed raised rates again today by 75 basis points (3/4 of 1%), bringing the Fed Funds Rate, the base rate that drives all the other rates, up to 3.25%. "My main message has not changed since Jackson Hole," Powell said today. "The FOMC is strongly resolved to bring inflation down to 2%, and we will keep at it until the job is done."[iv]

We can expect more rate hikes this year as well. The Federal Reserve's "dot plot," its forecast for the path of rate hikes, shows that the central bank will boost interest rates up to 4.6% in 2023 before it ends its tightening campaign.

So, what does all this mean for investors?

It means more of the same pain that we have so far endured this year. It means rates will continue to rise, and stocks will eventually snap when investors finally capitulate. It means that our expectations of a 50% drop off the NASDAQ highs and a 35% drop off the S&P 500 highs will likely finally come to fruition.

So far, 2022 has been a nightmare scenario for investors. Everything is down. Obviously, the riskiest stocks have been down about 25% or more, but also the safer portfolios of high quality, investment grade bonds have seen drops of 10% or more.

The Bloomberg US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, Mortgage-Backed Securities (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

This index, which no bond fund manager can consistently outperform, is down 12.5% year to date![v] This is where many of the most conservative investors are parked—not good.

For the portfolios we are managing, we shifted to more conservative models in 2021 in order to help minimize losses. Though we have suffered some losses too, mainly in our bond positions, we believe these losses to be temporary, since bonds will be in favor again as interest rates plateau, and especially when rates drop again.

How do I know they will drop again? Because they always do after a sharp rate hike. And our current rate hikes are some of the sharpest since the 1980's.

You can see from the chart above that rate hikes are usually followed by a recession (the vertical gray lines) which are in turn usually followed by a sharp rate decrease.

As the Fed continues to raise rates, companies must constantly float new bonds to replace the currently maturing bonds. As those new bonds are issued, they are issued at ever higher rates.

This bond interest is debt service, and the higher the rate, the higher the dollar amount to pay the debt. The more dollars paying debt is fewer dollars for profits and earnings. This translates directly into a less attractive stock, and thus the price of that stock falls.

When enough companies have faced this dilemma, the whole market drops. After a time, the Fed reacts by dropping rates and expanding the balance sheet (create money) and the cycle starts all over again.

Once rates have plateaued, which usually occurs after stocks have sold off considerably, this will be our signal to possibly act. One potential opportunity will be to go out longer term on our treasuries since currently we are on the shorter end.

In 2008, we took a serious inventory of every single investment class available to us, including Euros, Pounds, Yen, Swiss francs, gold, silver, real estate, rare art, expensive wine, 30-year scotch, everything under the sun. It was all down, and down significantly. There was only one beacon of green on the whole planet—U.S. treasuries.

Our expectation is that our treasuries will rally as they did then, just as we approach the bottom of the stock market rout still yet to come. Another opportunity may present itself then, as stock prices often drop too much in a serious downturn. Our expectation is that we will be able to sell our treasuries at a gain and buy stocks when no one wants them.

In the meantime, we are trying to garner interest. We recently invested a significant portion in TIPS, which are treasuries in the 0-5 year range that pay interest based on the CPI (inflation rate). It is important to note that the price of the bonds will drop by the exact amount of the interest payment that is made on the day it is paid. Then, generally, the price of the bonds will inch back up until another interest payment is made, and then likewise drop accordingly.

Another note to consider when figuring the interest payments on TIPS is that the inflation calculation is from one month to the next. So, for instance, we had an increase in the CPI from July to August, but not from August to September (since gas prices dropped considerably).

All the while as rates creep back up, we are taking notice of T-Bills. After today, a six-month T-Bill is paying over 3.5%, and a two-year note is paying over 4%. But rates continue to rise, and demand seems (logically so) to remain on the shorter end (where we are now). Who would want to lock in a 5-year CD today when next month they could be paying more?

At some point, however, this will change. As rates plateau, it may make sense to lock-in a longer term. Then, as rates eventually drop again, the price of these valuable higher yielding treasuries will rise. In 2008, we saw longer term treasuries rally as much as 20% or more.

Our current positioning then is one of patience. We believe the TIPS will generate some more nice interest payments as inflation continues, and especially if the price of oil rallies again—and winter is coming. Do you think Putin is likely to try to choke off the Europeans? I do.

We also believe the Fed will continue to raise rates until stocks drop significantly. During every other drop in history, treasuries have rallied. When stocks tank and treasuries soar—that will be our indicator to reverse our positioning.

If you have any questions of comments, I would love to hear from you. Call me or email me at kevin@magellanplanning.com.

Very Truly Yours,

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[i] https://www.cnbc.com/2022/09/21/treasury-yields-fall-ahead-of-federal-reserve-interest-rate-decision.html?recirc=taboolainternal

[ii] https://cdn.mises.org/The%20Causes%20of%20the%20Economic%20Crisis,%20and%20Other%20Essays%20Before%20and%20After%20the%20Great%20Depression_2.pdf

[iii] https://mises.org/library/cyclical-changes-business-conditions

[iv] https://www.cnbc.com/2022/09/21/real-time-updates-of-the-federal-reserves-big-rate-decision-and-powells-press-conference.html

[v] https://www.bloomberg.com/quote/LBUSTRUU:IND?leadSource=uverify%20wall