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In Pursuit of Value

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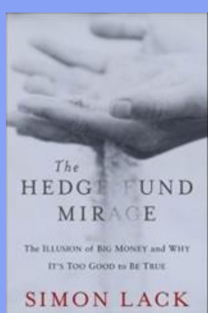
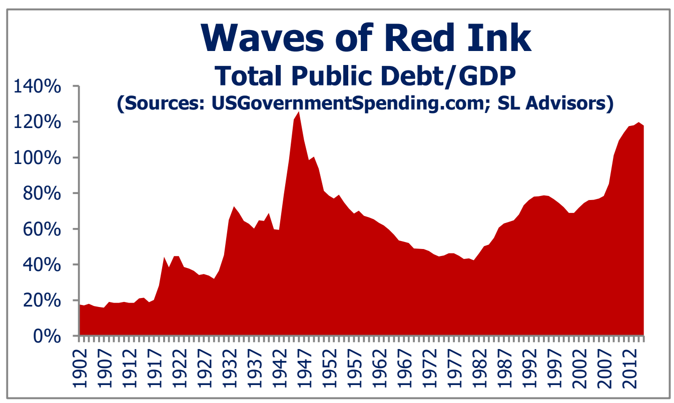


The Politics of Bonds

It's turning out to be a memorable election cycle in so many ways. None of us can recall two presidential candidates with such high negatives as the two presumptive nominees Hilary Clinton and Donald Trump. Many startling comments and resonant soundbites have been made. What struck me recently was how little political energy is being directed towards the Federal deficit.

That the Federal government's finances are not the main topic of discourse is probably obvious, but for those who need persuading, recent articles from the Boston Globe, the Wall Street Journal and the Chicago Tribune reflect such a consensus across the spectrum of political views.

What follows is not intended to be another op-ed, since in this area and unlike Federal finances, there exists a substantial surplus. We offer investment advice and opinions on how to stay ahead of taxes and inflation. The Federal budget affects investors in many ways: the spending choices drive relevant economic sectors; tax policy affects almost everyone, and the amount of debt issued has some impact on interest rates. One of the most tangible results of Federal deficits is on the issuance of treasury bonds.



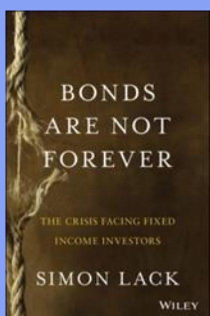
Today's candidates are not talking about the deficit because voters don't care. How should those who finance it and are presumed to be poised to continue doing so feel about the equanimity felt by Americans towards our collective indebtedness? As of February 2016, China was our biggest creditor with $1.25TN in U.S. treasury securities, closely followed by Japan at $1.13TN, according to figures from the U.S. Treasury. In total, $6.2TN of U.S. Treasury securities are owned by foreigners, about a third of the total. The U.S. Treasury reports total debt outstanding of $18.2TN as of last September (the end of fiscal 2015). State and local government debt adds another $3TN in outstandings, and that's before retirement obligations are included. Future entitlements for retiring baby boomers promise to increase total obligations faster than our economy.

Holders of U.S. treasuries value capital preservation above all else. Consequently, they are not commercially driven and a fair return **on** their money is far less important than a return **of** their money. Low treasury yields drag down returns on most other forms of debt, and while bond returns were good for many years, the yield at which you invest today determines your future return. Fixed income investors grasp that past returns are not indicative of the future.

One of the few comments any candidate has made about the deficit was when Donald Trump said, "I would borrow, knowing that if the economy crashed, you could make a deal." He added "And if the economy was good, it was good. So, therefore, you can't lose." Although he later backed away from this position, Trump's astute sense of the growing populist movement that is affecting both major parties was on full display. Regardless of who wins the Presidential election, it seems unlikely that they will possess a mandate for fiscal prudence. In 1993 Jim Carville, Bill Clinton's Campaign Director, noted the bond market, "…can intimidate everybody." Today bond investors are among the most intimidated market participants, meekly accepting pygmy yields that assure a loss of after-tax purchasing power on sovereign and investment grade debt. Does this portend a reaction of some kind?

At the risk of being accused of some immodest self-promotion (since it is the political season, after all), *The Hedge Fund Mirage* isn't the only book around here to have correctly forecast disappointing returns for investors. Avid readers may recall that in *Bonds Are Not Forever; The Crisis Facing Fixed Income Investors*, the case was made that an enormous Federal debt liability passed from one generation to the next would not induce an equivalent compulsion to fairly meet obligations incurred in the past. An increasing proportion of the electorate reaching voting age will declare that they neither approved nor benefitted from previous borrowings, and their inclination to honor them will be based on pragmatic, economic assessment and not moral compunction.

SL Advisors, LLC focuses on investment strategies that provide income without relying on fixed income securities.



Greece's problem is that they didn't borrow enough. If its economy was bigger and its financial demise would have risked more damage on its lenders, the Greeks would have endured less austerity. In the poker game of debt negotiations, Greece's threat to throw itself off the cliff by defaulting was deemed by their Eurozone lenders to be a loss they could absorb. The U.S. Federal government is the definitive Too Big To Fail entity, and while candidate Trump's casual observation of relative negotiating strength doesn't sound like any of the U.S. Treasury Secretaries we can recall, it reflects in soundbite form a populist view which any lender to the Federal government ignores at their peril.

In fact, the crisis facing bond investors is already here. Low rates deny the lender an appropriate after-tax return above inflation, to the commensurate benefit of the borrower. Ultra-low interest rates have been public policy since the 2008 financial crisis, which was fundamentally about excessive debt. Fed chair Janet Yellen, the most dovish leader of our central bank in living memory, is most definitely the right person for the times. Although you won't hear her articulate the view that very low interest rates are a sound public policy solution to excessive debt, the Fed's slothful path to "normalization" of interest rates is the way such a view would be implemented. Heightened sensitivity to the impact of higher rates on GDP and employment is the reflection of an economy which is less able to absorb rising rates than in the past.

At $1.25TN, our obligation to China is as much their problem as ours. Monetary policy that anchors short term rates firmly close to zero is the rational, self-interested strategy of the world's biggest debtor. Or put another way, since every 1% increase in rates raises the cost of servicing our Federal debt by $185BN, why would we rush to pay China and others more?

If you look beyond the rhetoric of Federal Reserve governors and look at their actions, you'll see an enlightened strategy that is pro-U.S. Furthermore, if you consider the populism on full display in this election cycle and consider how the principle of honoring prior generations' obligations is steadily losing resonance, you fear for the creditor. Given the choice between owing $19TN or being owed $19TN, which side would you choose? If the Fed has its Congressional critics with today's interest rate policy, what do you suppose a populist-inspired legislative branch would feel about a more robust monetary policy?

The result for the long term investor should be to abandon any hope of interest rates high enough to cover inflation and taxes. Low rates may be good public policy, but there's little reason for the commercially-driven investor to help the process along by holding bonds. Three years since *Bonds Are Not Forever* advised investors to look elsewhere and forecast growing populism with decreasing regard for our debt, events are still moving in that direction.