Another Problem with Low Rates

The Federal Reserve’s wealth transfer strategy of shifting purchasing power from savers to borrowers has other unintended consequences apart from plundering the thrifty in favor of the profligate. If you run a fixed income fund, ten-year treasury notes with a 2% handle doesn’t create much raw material from which to manufacture some income for your clients. The inadequacy of the yields jumps out, and many thoughtful bond managers have been drawn, or even forced, to reject such poor compensation and to adjust their positions in anticipation of fairer, higher yields.

Thus has the Pimco Total Return Institutional Fund (PTTRX) missed this year’s rally in bonds. Having concluded earlier in the year that U.S. treasury yields offered scant return for the risk, they shunned them publicly and completely through the debt ceiling crisis and into the most recent bout of risk reduction in the third quarter. It was a completely reasonable view to take – they may not have drawn comfort from the fact that we shared their outlook, but we did and so this article is not about bragging that we outperformed Bill Gross. Pimco’s long track record speaks for itself. The point here is that artificially low yields perhaps added urgency to the quest for better fixed income outcomes than were on offer for a passive investor. Positive real yields of, say, 2% (which would require interest rates 1-2% higher) at least afford the plausible option of passively investing and taking what’s on offer. But since today’s yields reduce purchasing power after taxes and inflation, any red-blooded bond manager is virtually required to shop around for alternatives. For a bond fund as big as PTTRX the bets are necessarily big. Their boycott of the U.S. treasury market caused them to miss a fall in yields from simply ruinous to ridiculous.

Just because a view has been wrong is not sufficient reason to change it. That statement doesn’t apply to traders with leverage, since holding one’s convictions too strongly can lead to bankruptcy. But for the unleveraged, new information is the only thing that’s really important. Bond yields have fallen this year and being underinvested has been wrong – so far. But the new bond yields are less attractive than the old ones, and while economic growth has moderated in recent months the long-term outlook is scarcely that much worse than in the Spring. Active government involvement in the bond market is designed to drive other investors away. Ben Bernanke could as easily hold up a sign during his regular testimonies before Congress saying, “Savers, We Don’t Want Your Money”. What can be more eloquent than the active competition of the government with private savers for its own debt? How loudly should the message be broadcast? If the government wants bonds that badly, let them take the lot. Go elsewhere – senior loans, Master Limited Partnerships, dividend-paying stocks. The government wants savers to consider such alternatives, and will continue to drive them out with derisory yields until they get the joke.

Meanwhile, Bill Gross wrote a rare mea culpa. Well put, and you’ll find no criticism of his past actions here. Pimco have more recently completely switched gears on treasuries and now own them – in fact, if anything based on the aforementioned letter Pimco’s economic outlook is more negative than consensus. Retaining the mental flexibility to move 180 degrees from bearish to bullish is extraordinarily difficult. Most people can only manage moving back to neutral, so kudos to Bill Gross for not letting a few dropped fly balls cause him to lose his nerve. I can’t claim such dexterity – or more accurately, I continue to believe far better alternatives to bonds exist.