FCI ADVISORS

PERSPECTIVES

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Acknowledge New Eras

By Bill Koehler, CFA, President and CEO

Recording artist Taylor Swift has visited Kansas City twice in the last few months, the first being in July, when her "Eras" tour enthusiastically entertained adoring, capacity crowds. She has described her current "Eras" concert tour, her sixth such tour, as "a journey through all her musical eras." Just as her career passes through various "eras," we should acknowledge "new eras" arise in the capital markets too.

In the world of finance, it's quite probable a "new era" is upon us with regard to interest rates, one in which interest rates may be "higher for longer." This would be quite a change from most of the last 42 years, when interest rates declined from a high of 15% on 10-year Treasury notes in September 1981 to a low of 0.32% in March 2020. Yields on 10-year Treasury notes have since risen to 4.88% as of October 6, 2023, albeit still below levels of June 2007. Additionally, the Federal Reserve has raised short-term rates 11 times since March 2022 to slow inflationary pressures.

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Though many investors hope rate *hikes* might at some point, sooner rather than later, turn into rate *cuts*, that likelihood appears to be lessening. The prospect of an elongated higher-rate era has become more probable. In fact, the Federal Reserve told investors and traders as much on September 20 when Chairman Powell messaged any relief from the current level of borrowing costs would not be coming soon.

What Drives a "New Era"?

An excerpt from a recent essay in Financial Times by Ed Yardeni, Chief Strategist at Yardeni Research, may better explain why a new interest-rate era may well be upon us. In this passage, he discusses how government spending, financed by government debt issuance, is leading the Fed to continue raising rates to eradicate the inflation caused by that spending. He also highlights how the "bond vigilantes," investors and traders who helped keep government spending in check in the 1993 to 2001 era by refraining from buying government bonds unless properly compensated with a higher rate, may be reappearing now.

Ed Yardeni I October 4, 2023

Currently, monetary policy has been on the right course, with the Federal Reserve focusing on fighting inflation, which soared in 2021 and 2022 after [the] Treasury department provided a third round of pandemic relief checks to millions of Americans in early 2021. That fueled a consumer buying binge that was already under way in response to the first two rounds of checks under the [prior] administration during 2020. The buying binge caused prices to soar.

The Fed reversed course in early 2022 and aggressively tightened monetary policy to fight inflation. That same year, the [current] administration succeeded in enacting fiscal spending programs that significantly worsened the projections for the federal budget over the next 10 years. Nevertheless, the deficit narrowed briefly during 2022 and early 2023 because individual income tax receipts were bolstered by taxes on capital gains when lots of investors sold their shares during last year's bear market.

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This year, inflation caused the government's outlays on social security to rise more rapidly since they are indexed to inflation. More worrisome is that the Fed's interest rate increases in response to inflation are causing the Treasury's outlays on net interest to soar. Meanwhile, tax revenues have turned down following last year's temporary windfall. So the federal deficit has ballooned to $2tn over the past 12 months through August. . . . [T]here's no debating that the rising deficit will require the Treasury department to issue lots more Treasury securities.

In recent weeks, the bond vigilantes have been challenging [the current administration's] policies by raising bond yields to levels that threaten to create a debt crisis. In this scenario, higher yields crowd out the private sector and trigger a credit crunch and a recession. Since the root cause of the problem is profligate fiscal policy, the government would have to cut outlays and boost taxes to placate the bond vigilantes, which would exacerbate the recession.

Future Issuance and Refinancing

Later this quarter, the Treasury will state the amount of debt it will need to issue before the end of the calendar year. On July 31, the figure announced for the third quarter was up 25% to over $1 trillion. The bond market (and stock market) will be watching the upcoming number closely. Regardless, 50% of all government debt matures before 2027 and much of it will have to be refinanced at higher rates.

FCI professionals do not know if a recession is a certainty but we do agree with Ed that the Treasury is going to have to issue much more debt if current trends persist. To persuade the markets to absorb more of this increasing supply, the Treasury may have to pay over 5% for 10-year maturities. On a positive note, we anticipate demand would be strong at this level as the U.S. dollar remains firmly entrenched as the world's reserve currency.

New Era Preparation and Opportunities

One of the ways investors can mentally and emotionally prepare for a new interest-rate era is by simply acknowledging it. This can be challenging when the difference from the prior 42-year period (or even 15-year period) is so stark. However, recognizing that bonds can now provide better return opportunities from current levels is helpful. Balanced portfolio investors, in particular, no longer have to rely only on stocks to supply the "heavy lifting."

We also recommend understanding the historical risk and return patterns of bonds and stocks over time, particularly in past cycles where interest rates were more elevated. Knowing capital markets have weathered higher rates in the past and actually provided competitive returns can inform a productive mindset.

Knowing capital markets have weathered higher rates in the past and actually provided competitive returns can inform a productive mindset.

Concluding on the notion of new eras, Taylor Swift was in Kansas City a second time in September for a NFL football game. Her mere presence may have ushered in a "new era" in the melding of sports, entertainment and business as 24 million TV viewers watched to see a glimpse of her in a suite. A week later, another 27 million viewers tuned in to watch her attend a second Kansas City game in New Jersey, the second largest viewing audience since the Super Bowl in February 2023.

New eras will keep arising. We can all benefit from a reminder to acknowledge them.

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