

Interest rates have plunged lately as concerns about a recession in the U.S. economy have risen. This has led many media commentators to suggest the bonds are now wildly overvalued. To wit:

"When evaluating the desirability of government bonds as a long-term investment, it's imperative to compare the prevailing yields of bonds with the earnings yields for stocks."•

While this is a common comparison, it is also wrong. Let's compare the two: **Earnings Yield:**

- *"Earnings yield" is the inverse of P/E ratios and only tells you what the yield is currently, not what the future will be.*
- **Investors do not "receive" an "earnings yield" from owning stocks.** *There is no "yield payment" paid out to shareholders, it is simply a mathematical calculation.*
- **There is no protection of principal.**

Treasury Yield:

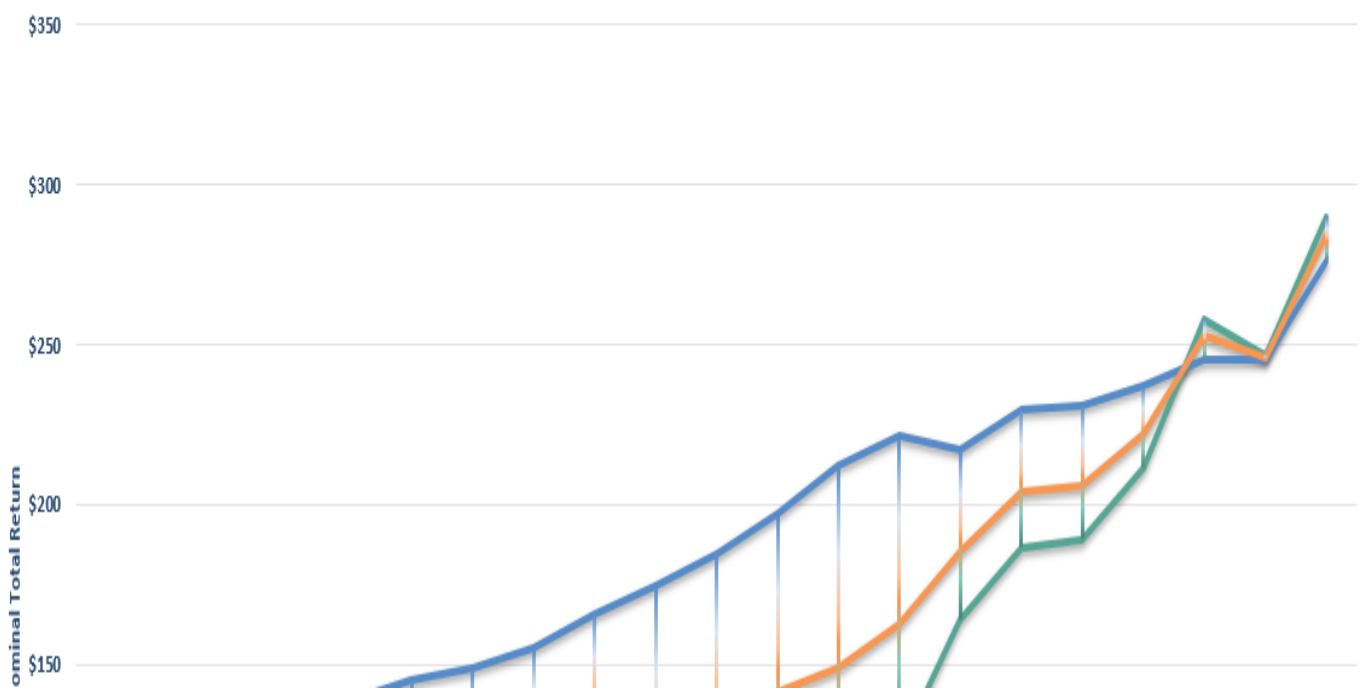
- *Investors receive a specific, and calculable to the penny, "yield" which is paid to the holder.*
- *A Government guaranteed return of principal at maturity.*

As [we noted previously](#), it is essential to align expectations and investing requirements. Stocks have liquidity, and potential return (or loss), but no safety of principal. Treasuries have a stated return, and a high degree of safety. However, in order to guarantee the stated return, Treasuries must be held to maturity and may not be liquid if that is your goal. For most investors, completely discounting the advantage of owning bonds over the last 20-years has been a mistake. By reducing volatility and drawdowns, investors were better able to withstand the eventual storms which wiped out large chunks of capital. Some may look at the graph below and say 'hey, but in the end bonds and stocks are now at the same point'. True, but the heart burn and risk taken with stocks was needless. It is also worth pointing out that stocks are once again grossly overvalued and a large drawdown is probable in the coming years.

S&P 500 TR vs. Barclays US Agg vs 60/40 Allocation, 2000-2018



Growth of \$100 Basis



All risk, all the time, has repeatedly led to bad outcomes for investors unwilling to evaluate the benefits of owning fixed income because they are comparing a "phantom yield" to a "real yield."

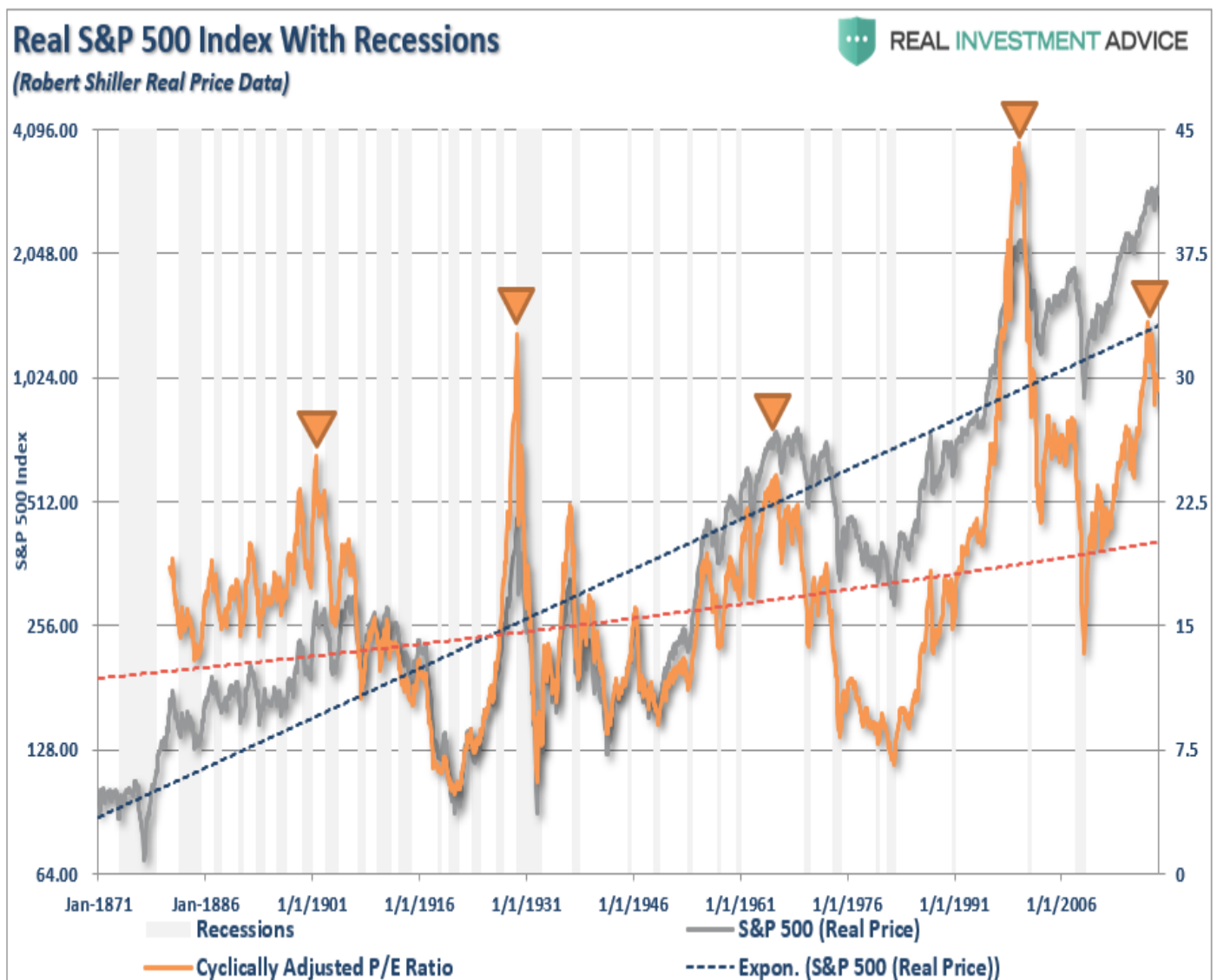
Valuations

However, this does not answer the question of "valuation" as it relates to bonds. For that analysis, we need to look at three factors:

1. Economic growth and inflation
2. Current trader positioning
3. Relative yields

(We are specifically focusing on the U.S. Treasury market since this is the market which is specifically affected by monetary policies.) In April 2017, I wrote an article discussing ["Why Bonds Aren't Overvalued."](#) •As I stated then:

"I agree that stocks are indeed overvalued. Since investors pay a price for what they believe will be the future value of cash flows from the company, it is possible that investors can misjudge that value and pay too much. Currently, with valuations trading at the second highest level in history, it is not difficult to imagine that investors have once again overestimated the future earnings and cash flows they might receive from their invested capital."

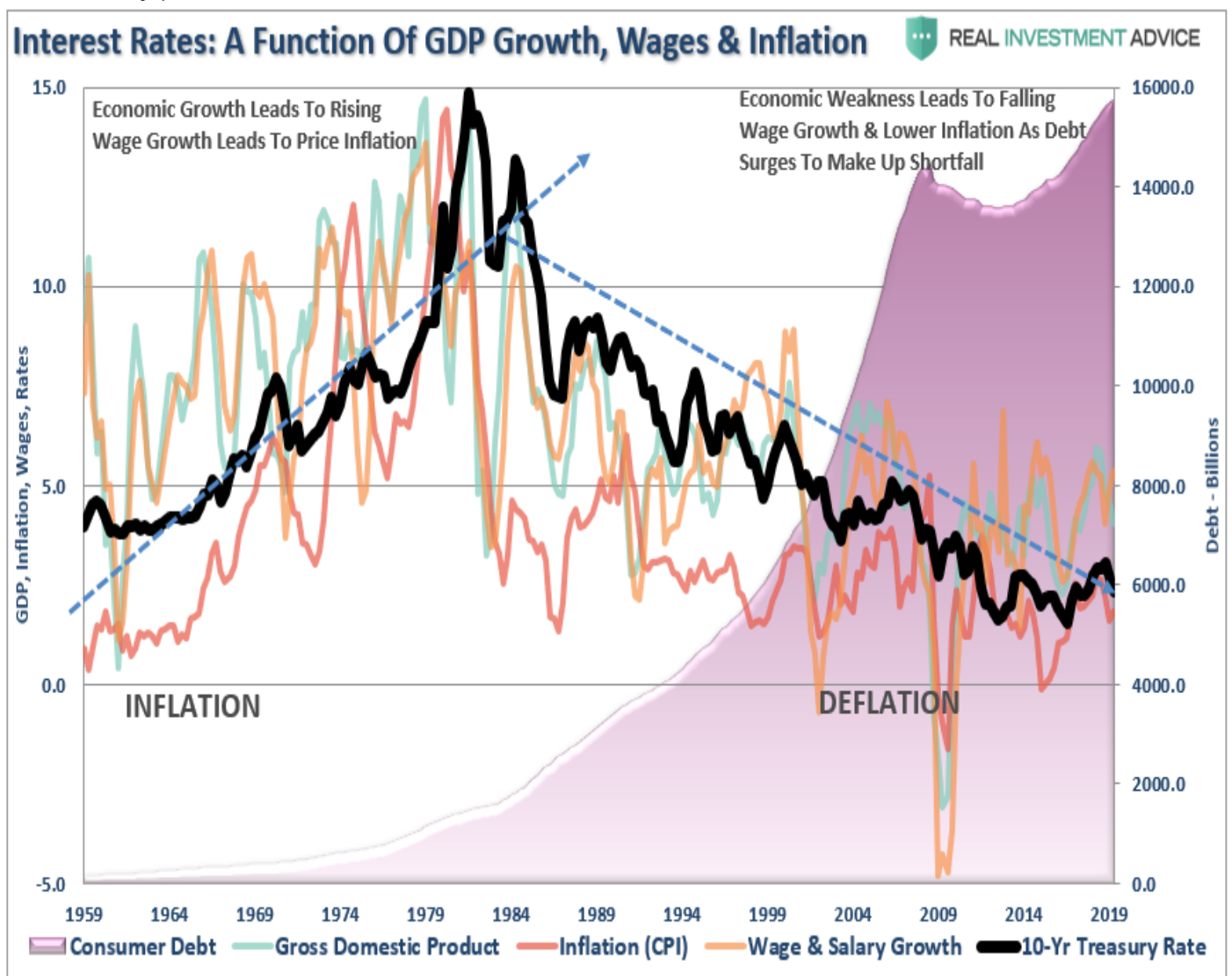


"However, bonds are a different story."

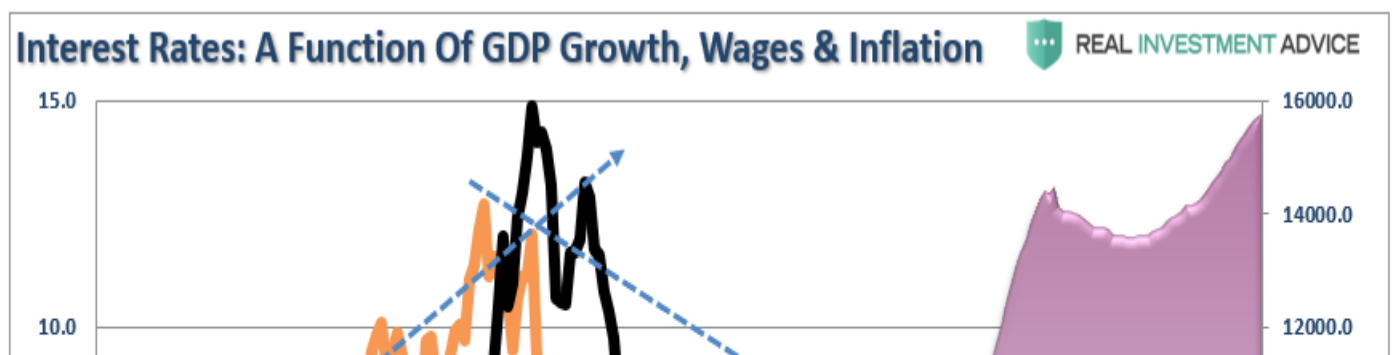
Unlike stocks, bonds have a finite value. At maturity, the principal is returned to the holder along with the final interest payment. Therefore, bond buyers are very coherent of the price they pay today, for the return they will get tomorrow.

Since the future return of any bond, on the date of purchase, is calculable to the 1/100th of a cent, a bond buyer is not going to pay a price that yields a negative yield to maturity. *(This is assuming a holding period until maturity. A negative yield might be purchased on a trading basis if benchmark rates are expected to decline further and/or in a deflationary environment.)*•"

In other words, it is very difficult for a bond to be tremendously "overvalued" as rates are ultimately set by the supply and demand for credit. **As I have discussed many times in the past, interest rates are a function of three primary factors: economic growth, wage growth, and inflation.** The relationship can be seen in the chart below. *(I have included debt, which I will discuss momentarily.)*

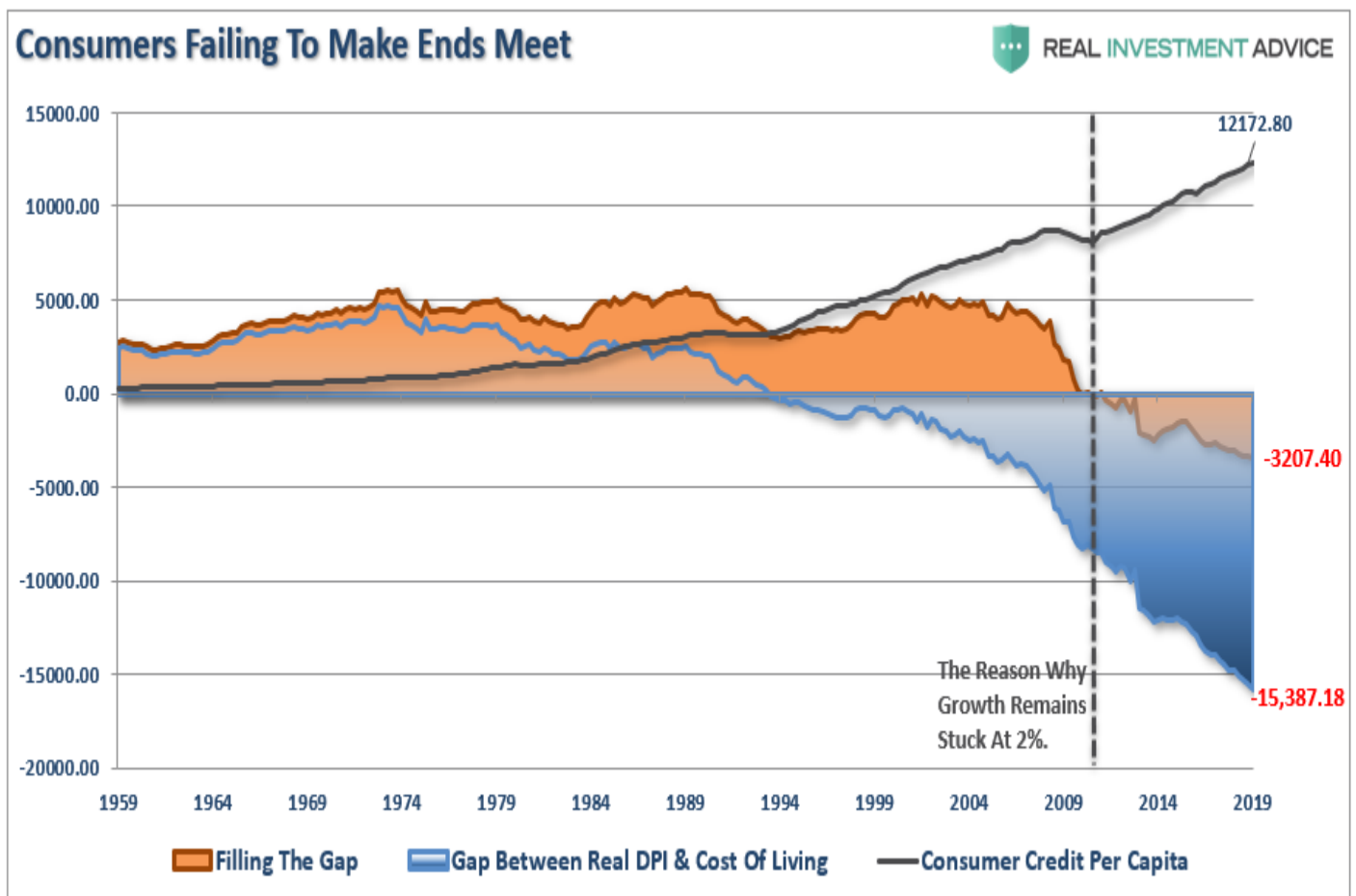


We can clean up the chart by combining inflation, wages, and economic growth into a single composite for comparison purposes.



As you can see, the level of interest rates is directly tied to the strength of economic growth and inflation. Since wage growth is what allows individuals to consume, which makes up roughly 70% of economic growth, the level of demand for borrowing is directly tied to the demand from consumption. **As demand increases, businesses then demand credit for increases in capital expenditures or production. The interest rates of loans are driven by demand from borrowers.** Currently, as shown below, the level of demand is consistent with the interest rates currently being charged. *(Also: note the sharp drop in activity over the last several months which has been previously consistent with recessionary onsets)* The debt is also an important determinant of the "fair value" of interest rates. In an economy that is dependent on debt for consumption (70% of GDP), if interest rates rise, consumption immediately falls given the inability to afford higher payments. As I noted [last week](#):

"This is why the gap between the standard of living and real disposable incomes is more clearly shown below. Beginning in 1990, incomes alone were no longer able to meet the standard of living so consumers turned to debt to fill the gap. However, following the financial crisis, even the combined levels of income and debt no longer fill the gap. Currently, there is almost a \$3200 annual deficit that cannot be filled."



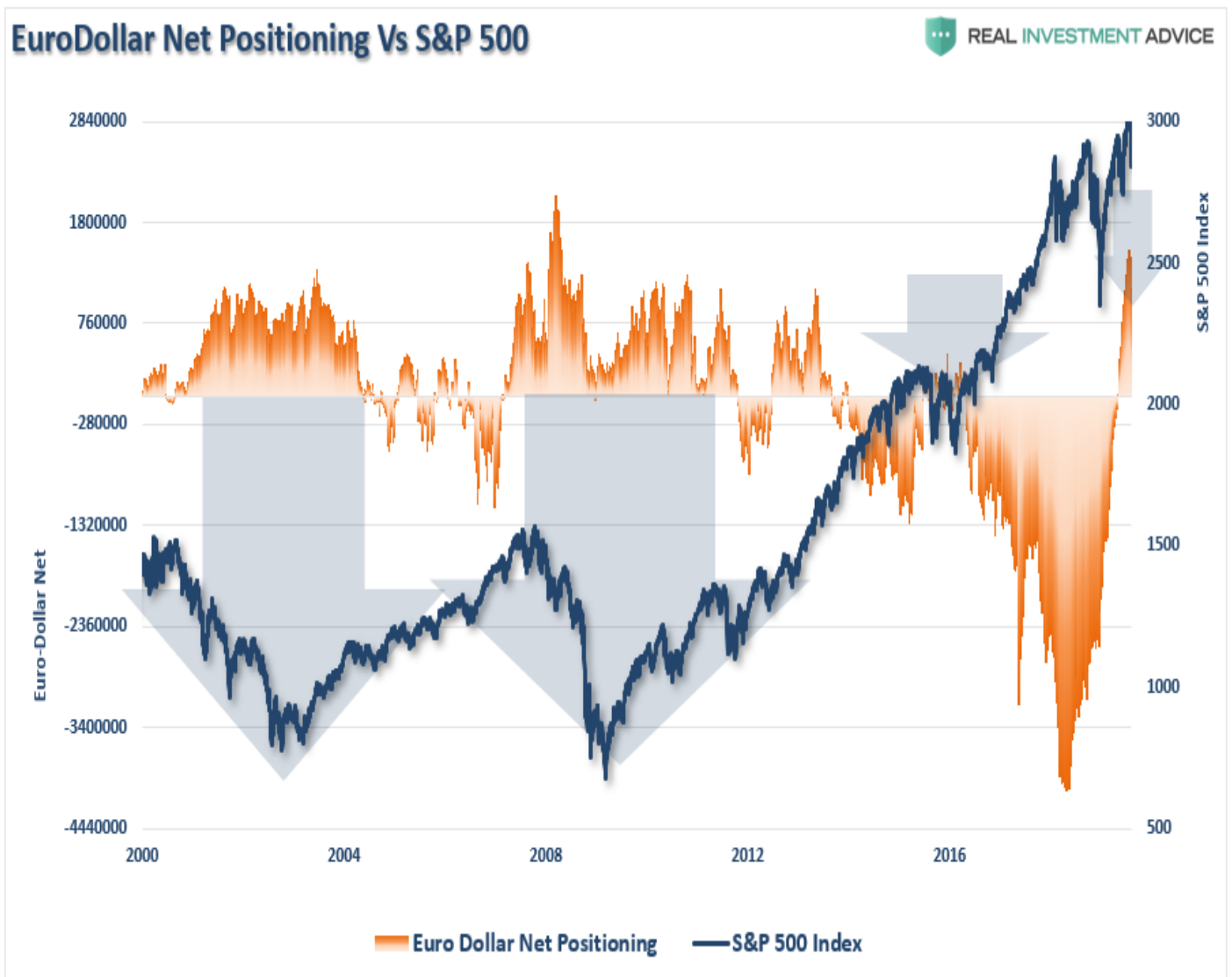
Since **"borrowing costs"** are directly tied to the underlying economic factors that drive the **NEED** for credit; interest rates, and therefore bond values **can not be overvalued**. Furthermore, since bonds have a finite value at maturity, there is little ability for overvaluation in the "price paid" for a bond as compared to its future **"finite value"** at maturity.

Still Way To Many Bond Bulls

Another signal that bonds are potentially still **"undervalued"** can be seen by looking at the Commitment of Traders report to see the net positioning on U.S. Treasuries. I [discussed this](#)

[previously:](#)

[June 2019] **The reversal of the net-long positioning in Treasury bonds will likely push bond yields lower over the next few months.** This will accelerate if there is a ?risk-off? rotation in the financial markets in the weeks ahead. However, as shown in the chart below, despite the sharp drop in rates, traders are still betting on a surge in rates and the net-short positioning on the 10-Year Treasury is at the second-highest level on record. **Combined with the recent spike in Eurodollar positioning, as noted above, it suggests that there is a high probability that rates will fall further in the months ahead; most likely in concert with the risks of a recession.?**



?The chart below looks at net-short positioning ONLY when net-short contracts exceed 100,000. Since peaks in net-short contracts generally coincide with peaks in interest rates, it suggests there is more room for rates to fall currently.?



Despite rates falling to multi-year lows, traders are still at some of the most extreme net-short positioning on rates in history. This net short positioning provides *fuel* for further price increases in bonds, and declines in rates, as traders are ultimately forced to cover their positioning. Since "over-valuation" is mostly a function of sentiment, **given the extreme short-positioning in bonds suggests that bonds are still "under-valued" from an investment perspective.** When the short-positioning is reversed, rates are going to quickly approach zero at which point it will be fair to say bonds are "fully valued."

All Rates Are Relative

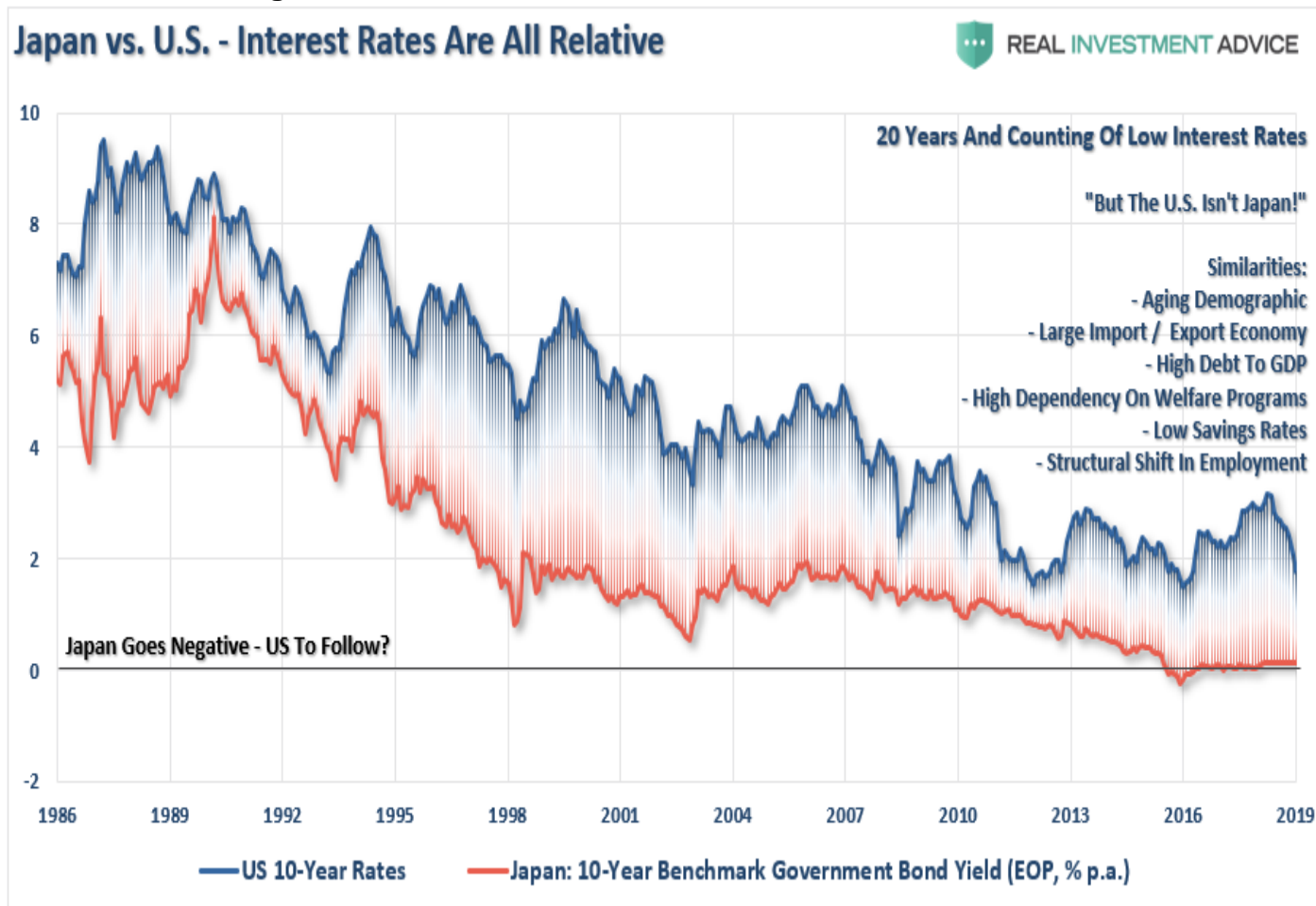
Lastly, rates are ultimately directly impacted by the strength of economic growth and the demand for credit. **While short-term dynamics may move rates, ultimately the fundamentals, combined with the demand for safety and liquidity, will be the ultimate arbiter.**

THE CHART REPORT

Global 10-Year Yields



When you have \$17 Trillion in negatively yielding sovereign debt, money will flow to the bonds with the highest, and safest, yield. **Today, the sovereign debt with the highest yield, and most safety, is the U.S. Treasury. As money flows into the U.S. Treasuries for safety, security, and return, from both domestic and foreign purchasers, yields are driven lower.** *(This will be exacerbated by the short-squeeze in bonds as noted above.)* Take Japan, for example. **Rates can't rise in one country, while a majority of global economies are pushing low to negative rates.** This is simply a function of monetary flows which will find the highest, safest, and most liquid yield. Therefore, given the global status of the U.S.. Treasury as a "safe haven," **the Treasury is "undervalued" relative to the other relatively stable sovereign bonds which currently all sport substantially lower yields.** Not unlike Japan, the U.S. faces many of the same demographic and economic challenges which **suggest that yields are not only "undervalued," but will approach full valuation during the next recession.**



Unfortunately, for the current Administration, the reality is that cutting taxes, tariffs, and sharp increases in debt, is unlikely to change the outcome in the U.S. **The reason is simply that monetary interventions, and government spending, don't create organic, sustainable, economic growth.** Simply pulling forward future consumption through monetary policy continues to leave an ever-growing void in the future that must be filled.

Conclusion

The problem with the statement that **"bonds are in a bubble,"** is the assumption 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 are an entirely different matter.** Since interest rates affect *payments,* increases in rates quickly have negative impacts on consumption, housing, and investment which ultimately deters economic growth. Given the

current demographic, debt, pension and valuation headwinds, the future rates of growth are going to be low over the next couple of decades. Even the Fed's own "*long run*" economic growth rates currently run below 2%. **Bonds are at a minimum "*fairly valued*,"but most likely "*under-valued*" based on the factors set out above.** While there is little room left for interest rates to fall in the current environment, there is also not a tremendous amount of room for increases. **Therefore, bond investors are going to have to adopt a "*trading*" strategy in portfolios as rates continue to trade in a flat line over the next decade.** Of course, that line will be closer to zero than not. Don't believe me? You don't have to look much further than Japan for your answer.