

July 26, 2019

*“Do I contradict myself?
Very well then I contradict myself,
(I am large, I contain multitudes.)”*

– Walt Whitman, *Song of Myself*

As the S&P 500 Index reaches all-time highs with an extraordinarily high valuation by most measures, how can the 10-year Treasury bond yield simultaneously be declining towards all-time lows? Usually, stocks go up when investors are increasingly bullish about the economy, while Treasury bond yields typically fall when investors are increasingly bearish about the economy and inflationary prospects, but rising stock prices and falling bond yields are both happening at the same time today. The apparent contradiction is difficult to reconcile.

It may well be that we are witnessing a temporary anomaly which occasionally surfaces in the financial markets. For example, oil prices skyrocketed to \$144 per barrel in 2008 at the same time that the housing bust and the Financial Crisis were starting to accelerate. How could oil prices have risen to record highs just as aggregate demand was falling off a cliff? That anomaly corrected a few months later when oil prices declined by more than 75% to \$34 per barrel.

Just as the oil price surge in 2008 turned out to be a temporary phenomenon, the conflicting signals between the stock and bond markets today may also be a short-term anomaly. If the stock market is correct and the bond market is mistaken, then bond yields should start to increase. On the other hand, if the bond market is right, and the stock market is wrong, a correction in the stock market would likely be coming soon.

However, what if it is not an anomaly?

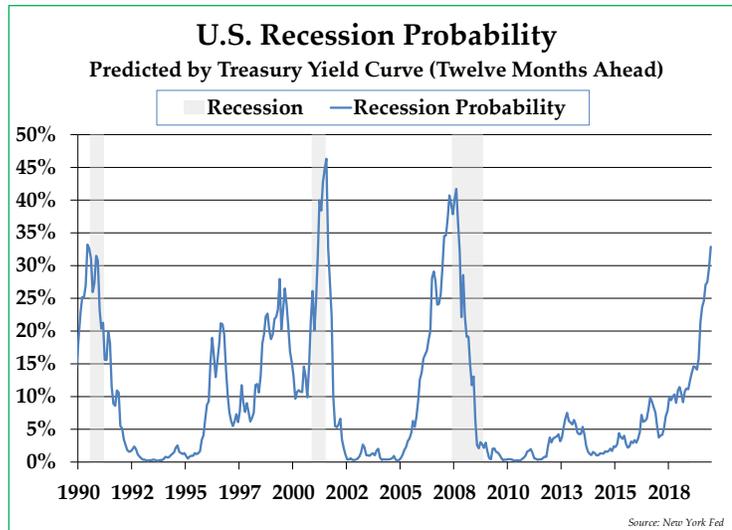
The Bond Market

A fundamental axiom of bond investing is that when bond prices increase, *ceteris paribus*, bond yields decline. Conversely, when bond prices fall, bond yields rise. Needless to say, this relationship can be somewhat counter-intuitive. From November 2018 through June 2019, 10-year U.S. Treasury yields declined from 3.23% to 1.99%, which is the lowest yield for 10-year Treasuries since 2016, a year in which 10-year Treasury yields hit a new all-time low of 1.36%. It seems strange for yields to compress in the face of a rising stock market, but several reasons could explain this phenomenon:

- **Increasing Recession Concerns**

Investors tend to buy U.S. Treasuries when they think a recession is imminent. The Treasury yield curve, which is currently inverted, is warning that a recession might be coming; the Federal Reserve Bank of New York uses the yield curve as an indicator to estimate that the chance of a recession within

the next 12 months is as high as 33% (see chart to the right). The longer the yield curve remains inverted, the more likely it is that a recession is soon coming. Besides the inverted yield curve, which we wrote about in detail in our Q1 letter, other signals are also suggesting that the U.S. economy is, at the very least, slowing down if not approaching a recession. With growth slowing and the increasing possibility of a recession ahead, investors might be increasing their allocation to U.S. Treasuries, driving bond prices up and yields down.

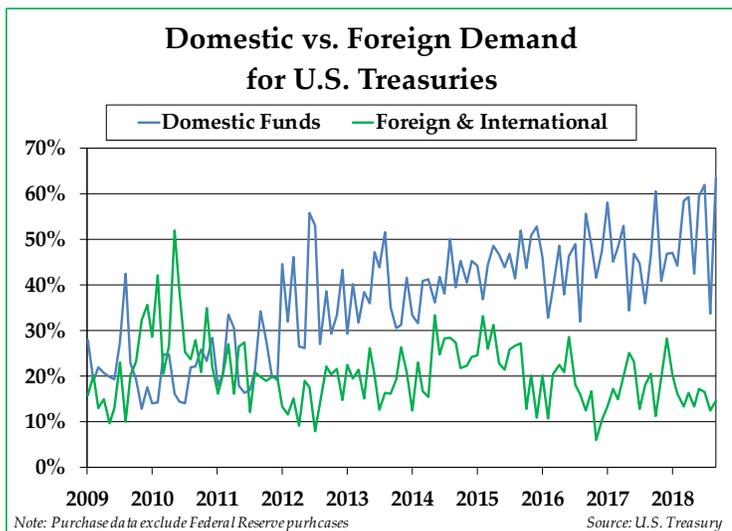


- **Increasing Pool of Retiree Investors**

As the U.S. population ages and 10,000 new baby boomers enter retirement daily, investor demand for safety and yield should continue to increase. Retiree investors are less inclined to own an oversized allocation to risk assets like stocks, opting instead for U.S. Treasuries and other less volatile assets. As demonstrated in the chart below, domestic investors have been purchasing an increasing share of U.S. Treasury auctions. It is possible that the strength in bonds recently is partly attributable to increasing demand by domestic investors who are aging and seeking a safe haven, although it is difficult to understand why domestic demand for Treasuries would be discernably different today than it was eight months ago.

- **Federal Reserve as a Treasury Buyer**

Last year, the Federal Reserve reduced the size of its balance sheet by selling its U.S. Treasury holdings. This incremental supply increase pushed down Treasury bond prices and pushed up Treasury yields. However, with the stock market correction that took place in Q4 2018 and with economic numbers weakening, the Federal Reserve is signaling that it will soon cease its sale of U.S. Treasury bonds and begin to buy U.S. Treasury bonds once again. Whether it is to fund the U.S.



budget deficit or to push investors back into riskier investments, the Federal Reserve is communicating to investors that large-scale asset purchases of U.S. Treasuries may soon resume. Investors may be buying U.S. Treasuries now to front-run the Federal Reserve and enjoy the price appreciation that could take place once the Federal Reserve becomes a buyer again.

- **Negative Yielding Foreign Bonds**

As crazy as it may sound, a huge share of government debt across the world pays a *negative* yield, which means that investors in such bonds are paying government issuers to hold their money for them. A record \$12.5 trillion of foreign bonds are now generating a negative yield, and that yield is becoming increasingly more negative as the global economy continues to weaken and as central banks communicate their willingness to do whatever it takes to provide additional monetary stimulus. While U.S. Treasury yields might appear to be low relative to what investors could earn 20 years ago, Treasury yields are high compared to most other sovereign debt in the developed world such as the debt of Japan, Switzerland, Germany, and Sweden.

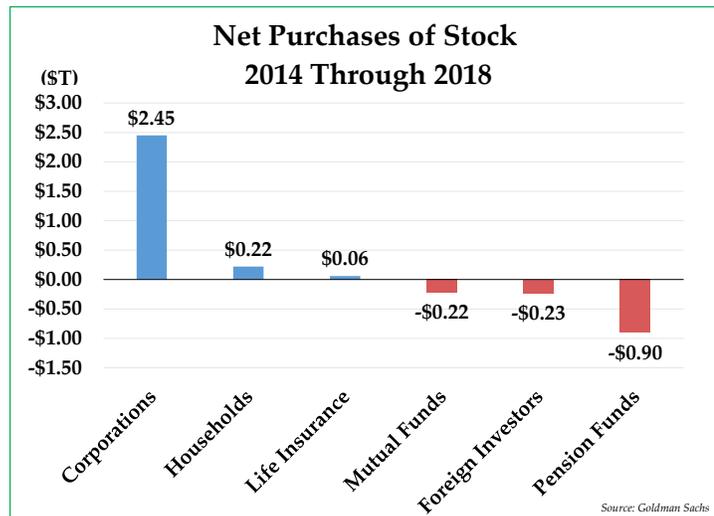
Perhaps, then, the bond market is making sense. With the economy slowing, baby boomers aging, and the Federal Reserve increasingly inclined to become a Treasury buyer, many investors are finding Treasury bonds to be attractive.

The Stock Market

However, if all of the above is true, why is the S&P 500 Index testing all-time highs right now?

- **Corporate Buybacks**

With bond yields so low, it remains inexpensive for companies to issue bonds and use those bond proceeds to buy back their own stock. While corporate buybacks create weaker corporate balance sheets and amplify long-term stock market risk, they nevertheless create incremental short-term demand for shares and boost share prices. This trend has been driving the U.S. stock market for the past five years. Also, with corporate bond yields pitifully low, private equity funds can more easily finance the acquisition of publicly traded companies with cheap debt. While baby boomers might be reallocating their investments towards bonds, other investors, namely corporations and private equity firms, are using leverage to buy stocks.



- **The Fed "Put"**

The U.S. stock market, in many respects, has become a significant driver of the U.S. economy over the past 20 years. Pension plans depend on a rising stock market. So, too, do retirees. Employees with 401(k) plans, while not yet retired, have to increase their savings rate if the U.S. stock market does not continue to deliver attractive returns. The Federal Reserve knows this, and Federal Reserve monetary policy has evolved since the Financial Crisis to focus increasingly on preventing the stock market from correcting. After the correction in December 2018, the Federal Reserve immediately stopped tightening and communicated a far more dovish monetary policy stance. Investors may be buying stocks because they expect the Federal Reserve will do whatever it takes to keep the stock market party going and it simply may be that *"There Is No Alternative"* to buying U.S. stocks (also known as the "TINA" effect).

- **Inflation Hedge**

The U.S. budget deficit is worsening due to increasing military expenditures, growing medical and

retirement entitlements, recently enacted tax cuts, and rising debt service obligations, with no end in sight. At the same time, an emerging consensus is developing that the dollar is too strong relative to other currencies, making it difficult for U.S. manufacturers to compete. President Donald Trump and Senator Elizabeth Warren have both remarked recently that a weaker dollar is a critical factor to America's future economic competitiveness, and economists like Harvard's Carmen Reinhart advocate that the Federal Reserve should keep bonds yields well below the inflation rate to reflate the economy. While seemingly overvalued, stocks may be an attractive hedge for those investors looking for inflation protection.

- **Interest Rate Manipulation**

Because the Federal Reserve has enacted policies in recent years to influence not only the interest rate of short-term bonds but also the interest rate of long-term bonds, some investors do not believe that the yield curve provides a useful signal for upcoming recessions and are therefore less concerned about an imminent recession.

Unlike 2008, when the Federal Reserve appeared to be asleep at the switch, central banks around the world appear to be on alert today, for better or for worse, and stand ready to provide markets with liquidity to avoid another crisis. Ultimately, whether the rising stock market or falling bond yields are correct depends in no small part on whether the U.S. economy is entering a recession or just another soft patch.

If a recession is coming or has already arrived, corporate earnings are likely to fall, credit spreads should widen out, and corporations will find it more expensive to issue bonds to buy back their own shares, all of which should result in a challenging market for stocks and bonds with high levels of credit risk. Under this scenario, we will be glad to be net short stocks and long gold.

On the other hand, if the economy is just going through a soft patch rather than a recession, the Federal Reserve's monetary easing efforts during the second half of the year should reflate the economy and allow the stock market to continue rising, driven by corporate buybacks. Under this scenario, inflation expectations should increase once again along with economic growth as the soft patch recedes. Today, many of the more attractively priced stocks available are cyclical companies, with already pessimistic discounts due to increasing concerns about slowing growth, declining global trade, and growing geopolitical concerns. Should growth re-accelerate, cyclical stocks and the stocks of companies that are exposed to global trade should perform well, similar to what happened in 2017 as economic expectations improved.

Should you have any questions about this letter or anything else, please do not hesitate to reach out to Colin Rennich at colin@appleseedcapital.com or at 312.896.9660.

Sincerely,
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Portfolio Managers, Appleseed Capital

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