MEDALLION WEALTH MANAGEMENT

September 2021 Market Commentary

For What It's Worth

"There's somethin' happenin' here
But what it is ain't exactly clear"

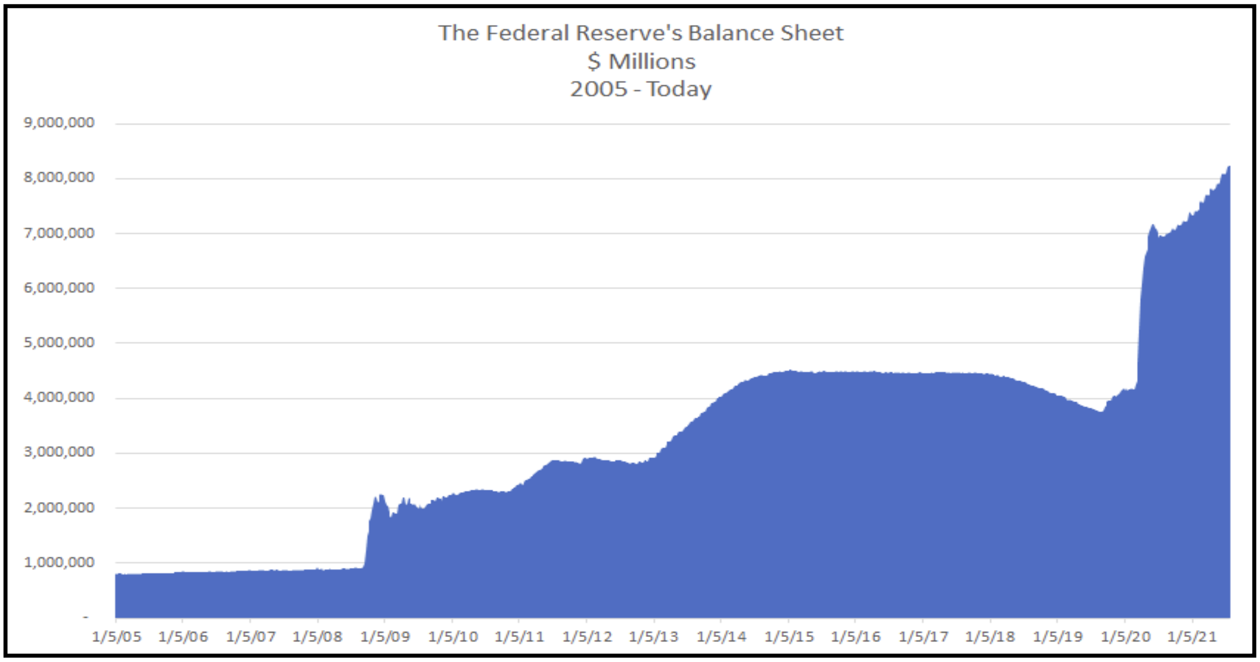
For What It's Worth - by Buffalo Springfield
https://www.youtube.com/watch?v=xWQeaYOhR5I

Every now and then, amid all the noise and confusion, *"I think it's time we stop children, what's that sound? Everybody look what's going down."* Yeah, this is one of those times.

With last week's much anticipated Jackson Hole speech by Fed Chairman Powell now in our rearview mirror, we should pause a minute and take a hard look at interest rates. More importantly, what it means for the average investor's asset allocation. Namely, does a 60/40 or 70/30 stock/bond allocation continue to make sense? Or does any allocation to bonds make sense?

First, let's take a quick look at what the Fed has been up to since the 2008-09 Great Financial Crisis, and of course our current Covid-19 Pandemic crisis. One of the first things the Fed did back in 2008, when financial markets began to freeze up, was slash short-term interest rates to zero. They also began a program called quantitative easing which allowed the Fed to buy all manner of financial assets to inject liquidity into the financial system. After the success of those programs in keeping us out of financial ruin, the Fed didn't hesitate in doubling down when the Covid-19 Pandemic hit. Interest rates were again slashed to zero, and the Fed ramped up bond and mortgage purchases to unprecedented levels.

The chart below shows how the Fed's balance sheet averaged under $1 trillion prior to 2008, then jumped to nearly $3 trillion, and now sits at an eye opening $8 trillion.



The Fed is currently buying $80 billion a month in Treasury bonds and $40 billion a month in mortgage-backed securities. During his Jackson Hole speech, Chairman Powell stated that the Fed is very near a point where they will begin tapering these purchases, but he firmly reiterated that does not mean they are anywhere close to raising interest rates.

The immediate question for investors is will the tapering of bond purchases cause interest rates to rise? Initially the answer would be an obvious yes. If the Fed buys fewer Treasuries and mortgages, then there will be less demand and rates would rise. Basic supply and demand. But, on the other hand, if the Fed's tapering signals tightening monetary policy, then tightening means less growth and inflation in the long-run, therefore rates go down.

The truth is we really don't know what rates will do. With the Fed, and other global central banks, continually intervening in the capital markets, historical free-market relationships between supply and demand have become irrelevant.

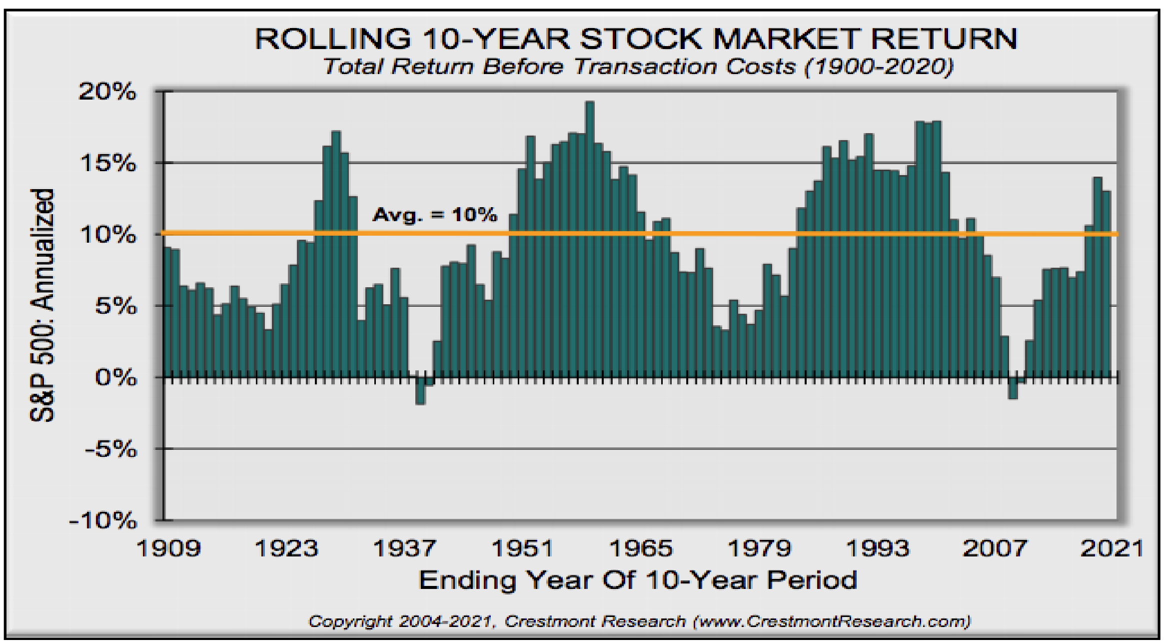
Another critical question is can the Fed and other central banks ever allow rates to rise much? The obvious answer here is **NO**. With government debt at unprecedented levels, and absolutely no sign of it reversing, there is no way the government can afford to pay the interest on the debt if rates rise. If rates on longer-term Treasuries begin to rise, the Fed will be forced to intervene by buying up all longer dated Treasuries. (See Japan for a roadmap of exactly how this works.)

This doesn't mean that inflation can't rise, as we have seen this year, it simple means that the link between inflation and higher interest rates may be broken. It's perverse, but it's exactly what has been going on for several years. Inflation, especially real world inflation, has been running hot but rates have barley ticked higher.

<u>Is the 60/40 asset allocation dead?</u>

For the last 40 years interest rates have generally fallen from the mid-teens to our current level of 1% and change. During that 40-year period many pension plans and individuals have adopted a balanced asset allocation of 60% stocks and 40% bonds. During that period a 60/40 portfolio returned over 9% annually, while also lowering volatility. Sounds great right?

But today, with the 10-year treasury yielding about 1.30%, your equity portfolio would have to return at least 14.3% annually over the next ten years to get you to a 9% return. Of course that could happen, as of today the S&P 500 has returned 16.59% annually over the last ten years.



The real question should be, why anchor our portfolio to a large bond allocation if we know our 10-year return will only be in the very low single digits? Sure, historically, bonds have acted as a buffer for stock volatility; if stocks fell because of a slowing economy, bonds would do relatively well as interest rates also fell. The problem with this thesis is that at current interest rate levels your absolute return is just so low, and in a manipulated bond market, there is no guarantee that bond yields will offer that same buffer from stock market volatility as they did historically.

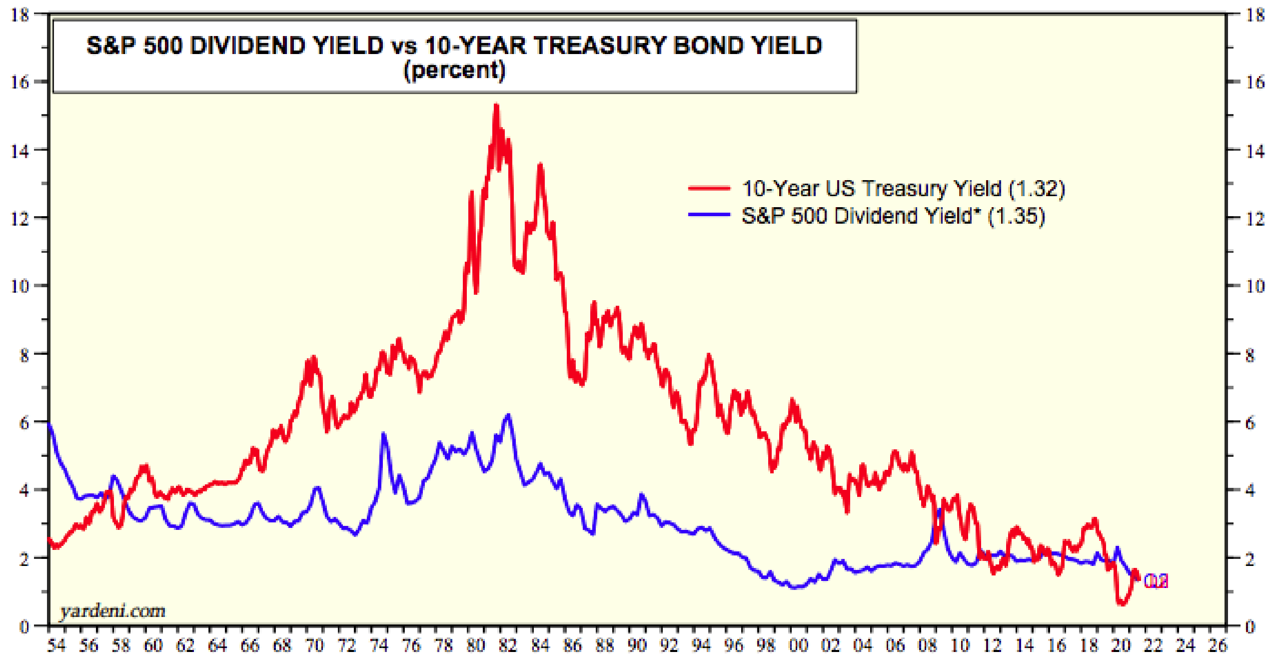
If bonds aren't offering enough in the form of absolute yield, and if it appears true that the Fed may try to engineer permanently lower yields to fund our ballooning deficits, is there an alternative to the classic 60% stock/40% bond allocation?

Maybe. **Maybe there is a better alternative for total return that can still offer some of the same risk/reward characteristics as the classic 60/40 portfolio. I'm thinking of a combination of equity income and cash. A healthy dose of dividend paying, dividend growing, common stocks mixed with cash equivalents to mute volatility.**

Historically, stocks yielded more than bonds because stocks were viewed as more risky than bonds, therefore they had to compensate investors upfront with a higher dividend yield. That relationship worked up until about 1959, when bonds began yielding more than stocks.

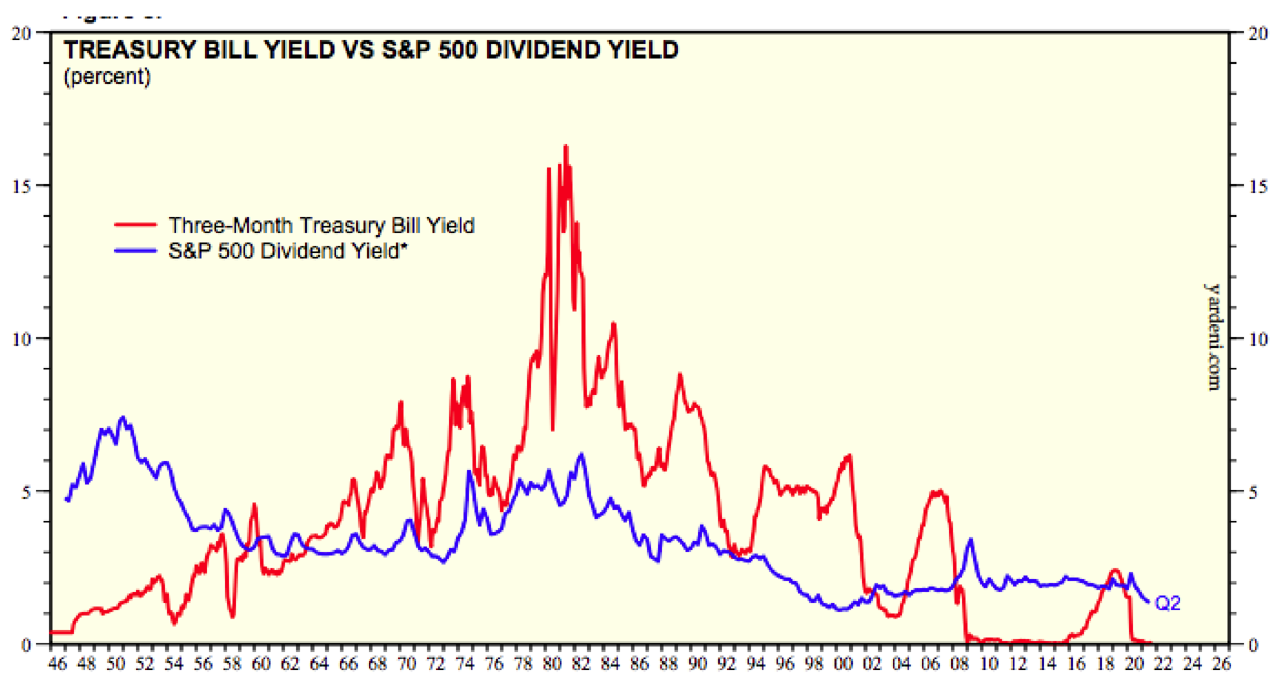
As Peter Bernstein tells it in his classic book ***Against the Gods: The Remarkable Story of Risk,*** when interest rates first rose above stock dividend yields, "My partners, veterans of the Great Crash, kept assuring me that the seeming trend was nothing but an aberration. They promised me that matters would revert to normal in just a few months, that stock prices would fall and bond prices would rally.
I am still waiting. **The fact that something so unthinkable could occur has had a lasting impact on my view of life and on investing in particular. It continues to color my attitude toward the future and has left me skeptical about the wisdom of extrapolating from the past**."

For 50 years bonds yielded more than stocks, and shortly before Bernstein's death in 2009 that relationship reversed and stocks again yielded more than bonds. This higher dividend yield on stocks wasn't because stock investors demanded a higher current yield on stocks because of their riskiness; no, it was because the Fed forced interest rates on bonds lower. Today the yields on 10-year Treasuries and on the S&P 500 are nearly identical at about 1.30%.



* S&P 500 four-quarter trailing dividends per share divided by quarterly closing value of the S&P 500 index.
Source: Standard & Poor's and Board of Governors of the Federal Reserve System.

We can also see that the yield on cash equivalents is still nearly zero, and that stocks yield about 1.30% more.



* S&P 500 four-quarter trailing dividends per share divided by quarterly closing value of the S&P 500 index.
Source: Standard & Poor's and Federal Reserve Board.

Of course this 1.30% dividend yield is for the broad market as a whole; there are plenty of dividend paying stocks that yield more. In fact our Equity-Income portfolio is designed with the goal of yielding at least 50% more than the yield on the S&P 500. So if the S&P 500 is yielding 1.30%, we want to yield at least 1.95% (1.30% x 1.5). On top of that current yield, many dividend paying stocks grow their dividends near the rate of earnings growth. Over the last 15 years the S&P 500 has grown earnings at 7.5% annually and has also grown dividends at 6% annually.

If the S&P 500 continued to grow dividends over the next 15 years at a 6% annual rate, your yield on cost would have risen from 1.30% to 3.17%. Growing yield—something you don't get from bonds.

"There's certainly somethin' happen' here, and what it is ain't exactly clear." But what if, like that seminal period in 1959 when bonds went on a 50-year run of yielding more than stocks, what if bond yields stay very low for a very long period of time and stocks yield more than bonds? Does it make sense to allocate less of your portfolio to bonds and more of your portfolio to dividend paying stocks and cash? I'd like to think so, but like Peter Bernstein I have grown very skeptical at my, or anyone's, ability to look into the future. I know this is what I'm doing with my own portfolio, I don't know if it will be right, or right for everyone, but it makes sense to me.

Be careful out there,

Chris Wiles, CFA

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