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September 2019

Economic Update, September 2019

Where are Long-Term Interest Rates Headed?

by Richard Morey

By mid-August, we had made a bit over 30% this year in our largest fund which owns exclusively long Treasury bonds. For a few days I pondered this, wondering if that meant we had already received much of the gains expected in government bonds from now until the bottom of the next recession.

Coming to no definitive conclusion, I was fortunate to receive reports from Albert Edwards and Lacy Hunt, who happen to have been the two best forecasters of long interest rates in the world for the last 20 years. They are still both saying the same thing, which is that yields will fall much further.

Albert Edwards

We'll begin with Albert Edwards' views. Over 20 years ago, Mr. Edwards described what was going to occur in the European and U.S. economies over the next 25 years. To date, our economies have followed what Edwards predicted to a remarkable extent. In fact, his predictions of 20 years ago are getting more and more accurate.

Albert Edwards said we were going to enter what he termed an economic "Ice Age." He said our central banks were creating a situation in which the economy would only be able to grow through ever-creasing debt. The continually increasing debt would lead to ever-decreasing economic growth and, therefore, lower and lower interest rates. Edwards said this over twenty years ago. He further said this would inevitably end in a deflationary debt crisis.

Since then we have had the two slowest economic expansions since World War II, and the lowest interest rates in human history. Having listened to Edwards for years, I really think it unwise to go against his predictions.

Knowing interest rates were going to be going down for over 20 years, culminating in a deflationary crisis driving rates far below any point seen in history, Edwards has been recommending long Treasuries for much of the last 20 years. From an investment standpoint, this has been a very lucrative thing to do.

Of course, now that long Treasuries have risen so much this year, we begin to hear the chorus chanting we have a Treasury bond bubble. Here is Edwards' response: "…this government bond rally is not a bubble but an appropriate reaction to the market discounting the next recession hitting the global economy from all overleveraged corners of the world (including China), with close to zero core inflation and precious few working tools left at policymakers' disposal… The bubbles are not in the government bond market in my view. They are in corporate equities and corporate bonds."

Edwards then gave technical reasons why yields will continue to fall. He has a 0.5% target on the 10-Year Treasury yield by the end of next year. This means they will drop another roughly 1%. In fact, he said "we are on autopilot until we get to 0.5%."

At this point a person might think a 1% drop in interest paid on 10-Year Treasuries hardly sounds earth-shattering. From one perspective it isn't, though it would likely give long Treasury investors another roughly 60% in price gains. Edwards considers this a given at this point. In fact, he expects rates to fall much further than one-half of one percent, and to stay low until we are through this business super-cycle.

How, you may wonder, can rates go even lower? To discover the answer, we only need to look overseas, to Europe and Japan, to see their $17 trillion of negative-yielding bonds. For many years, Albert Edwards has been pointing, first to Japan and then to Europe, as the path the United States is also following.

Dr. Lacy Hunt

Like Albert Edwards, Lacy Hunt has been correct in his assessment as to the direction of long rates for over 20 years. Whereas Mr. Edwards focuses upon macroeconomics, Dr. Hunt comes to the same conclusion through interest rate theory.

In his most recent quarterly report, Dr. Hunt uses theory and data to show why long interest rates in the U.S. will be going much lower. Dr. Hunt uses accounting identities, proven theorems, and official data to come as close as is humanly possible to proving what will happen in the future.

While his theories and their applications can be difficult to understand, I'll give you the core of his proof and conclusion. (Please note I have changed it a bit from Dr. Hunt's presentation, which is completely acceptable when you have equivalent variables in an equation.) Here is a synopsis of the proof long rates will be going down further:

1. It is a proven fact that economic growth slows whenever total debt in an economy exceeds certain levels. At this time, we are far beyond those levels in every type of debt. Combined, we are now more heavily-indebted than anytime in history. Keep in mind the two previous highs included 1928 and 2008.

   This is a case of proof based primarily on an overwhelming abundance of historical examples. Dr. Carmen Reinhart, in the book *This Time is Different*, specifically studied every case in history in which a nation responded to a debt crisis like we did in 2008-9. It wasn't hard to find examples, since over 80% of all countries that have a debt crisis do the same thing. Instead of letting their insolvent banks go under, they bail them out. This inevitably leads to an explosion of government debt.

   Every country that has taken this path, in 700 years, has found their economic growth debilitated thereafter – on average for the next 22 years. In addition, at the end of that 22-year time period, long-term interest rates were at or near their lowest in the nation's history. This is exactly what we have done, and the results thus far have been the same.

   There are many reasons the economy can **never** grow strongly under the debt load our nation faces today. When you have a massive amount of 'nonproductive' debt in your economy, the interest payments are a continual drag on growth. When that nonproductive debt (which includes most government debt, nearly all credit card debt, and a huge amount of corporate debt including every penny borrowed to buy back stocks) continues to grow unchecked, so much money is diverted from the productive parts of your economy that growth becomes impossible.

2. This brings us to our next proven fact explaining why long interest rates will be going much lower. It is now nearly an established fact that long interest rates fall when economic activity falls.

   Since we can prove economic activity falls when the nation is overindebted and continues to increase debt, and we can prove long interest rates go down when economic activity falls, we can therefore prove long rates will be going down if debt continues to rise.

The following quote from Dr. Hunt's Second Quarter 2019 report, summarizes his thoughts:

The Past Ten Years

As widely celebrated in numerous articles, the current expansion reached its tenth anniversary in July 2019, thus making it the longest running expansion on record. This accomplishment is a hollow victory since real per capita GDP rose only 1.4% per annum in this expansion, the poorest growth rate for an expansion since 1950.

The possibility of underperformance in the current expansion was presaged by the expansion from 2001 to 2007. In this first expansion of the high debt era, real per capita GDP growth was 1.9% per annuum. Prior to the 2001 expansion the average growth in real per capita GDP during expansions since 1952 was 3.0%. Thus, the real per capita GDP growth was 36.6% and 53.3%, respectively, less than in the prior and current expansion, when compared to the base period. As debt levels, on average, moved higher, real growth retreated. This indicates once again the deleterious effects of high debt levels, as well as reflecting the nonlinear relationship as diminishing returns set in with higher debt levels. Thus, even if larger Federal debt accelerations are enacted in the future, the growth rate will slide further, resulting in even lower long-term Treasury yields.

The Federal Reserve Board

There is one final piece to our picture showing long rates falling much further. This involves our good old Fed. If we had a Fed dedicated to seeing debt of all kinds reduced throughout the economy, then we would say rates will be going way up. But for as long as debt continues to rise, long rates will continue their long-term path down.

In order to attempt to anticipate how low rates will likely go, we need to examine what occurs during an economic downturn. First, the Fed will do anything they can dream up to attempt to get interest rates lower and lower and lower. I read ex-Chair Janet Yellen's report she gave at Davos a few years ago in which she wrote that, according to current Fed theory, in the next recession they could envision the natural rate of interest going as low as a negative 7%!

Do I believe she meant the Fed would consider setting the Fed funds rate that low? Surely not. Instead, I've always thought she was just trying to get the markets ready for negative rates. To see where rates are likely to land, we can look to Europe, and to the nature of investors when they are scared to death. Looking at Europe, we can see the Fed would have no trouble going to a negative 1. Then if we are correct and the coming economic and markets downturns are unusually severe, we could see them going perhaps 1-2% further into the negative. Long Treasury prices would gain another 100% or so in price.

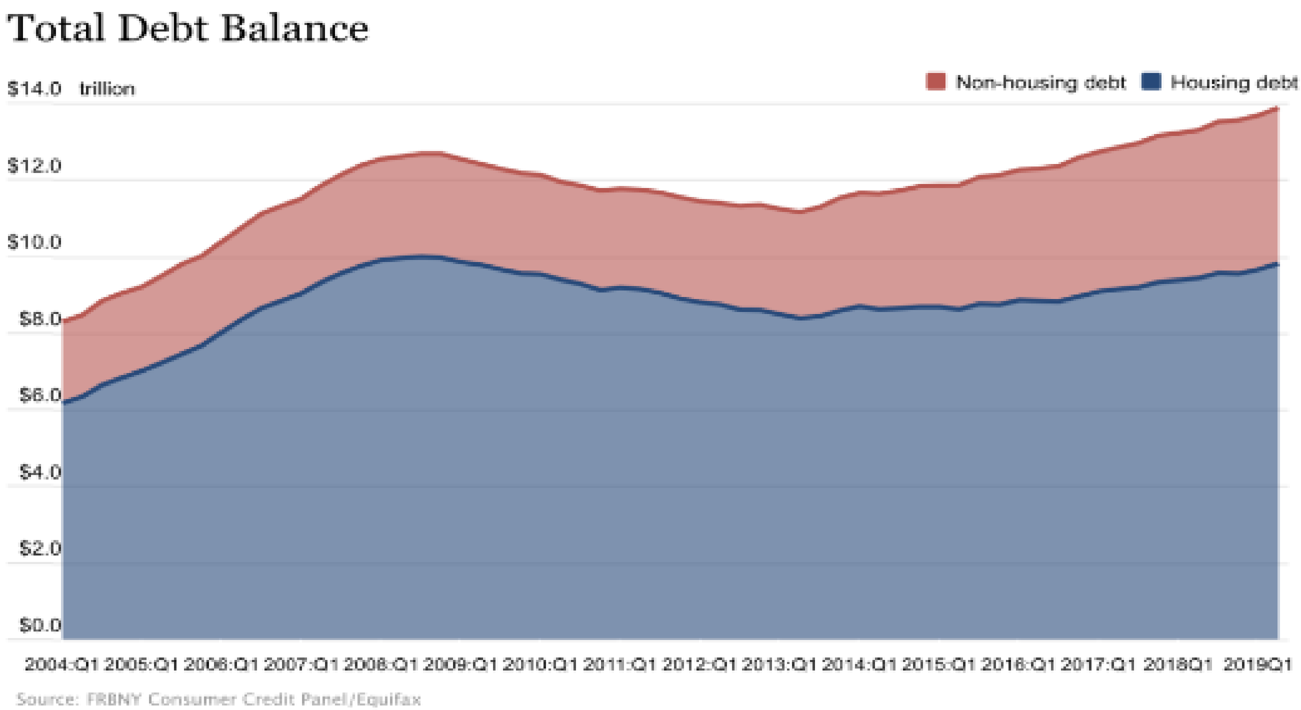
When will we have a confirmed recession?

We have a good idea as to where the economy is headed, but do we know when the next recession will be confirmed to have arrived? 'No' would still be the honest answer to that question at this time. There are an increasingly large number of signs, from real disposable income falling below where it was 16 months ago, the savings rate plunging to 2.4% in the first quarter of this year (versus an average of 6.4% since 1929), manufacturing actually already in recession, business spending falling over the last year, corporate earnings in recession, corporate profit margins falling for several years, an inverted yield curve, etc., etc. Then we have the geopolitical concerns, from the trade war, to Europe quietly collapsing before our very eyes, to numerous emerging market economies on the brink of crisis. Stir in 2

¼% in interest rate increases over the last two years, with the reduction in the money supply through the reversal of Quantitative Easing, and you've got a recipe perfectly designed to lead the economy to go bump in the night.

But we still have a strong consumer!

Last month stocks had unusually large losses on a number of days. On those days I tuned into Bloomberg and the other financial channels to see how they were spinning all the negative news. Their spin consisted of exactly one sentence, with no context. In just two days I heard the same statement perhaps 50 times. Their mantra was "but the consumer is strong." Not just strong, but rip-roaring strong. Since over two-thirds of the economy is, supposedly, predicated on consumer spending, the economy must be in great shape.



(This originally appeared on The Basis Point: Household Debt—How Much Money Does Everybody Owe? Q2 2019 Edition)

Two facts show why the consumer is not only not strong but in serious trouble. One fact is that disposable income has been falling for the last 16 months. How can the consumer be 'strong' if the amount of money they have to spend is falling?

The second fact easily answers this question, and it is illustrated in the chart above showing total consumer debt. All the alleged strength in consumer spending can be found in that chart.

Conclusion

Total U.S. credit market debt now stands at over $73 trillion, giving us a debt-to-gross-domestic-product ratio of approximately 350% This is far, far beyond the level beyond which economies have always had a debt crisis. Unfortunately, the entire world is in a similar, or worse, situation.

When I listen to the financial media these days, I am continually stunned by the absurd, outrageous, dangerous statements presented as serious thoughts. Last night I was watching Bloomberg and heard the head of an investment firm saying this is a great time to buy more stocks because "stocks do well at the end of a business cycle." Yes, right up until they crash.