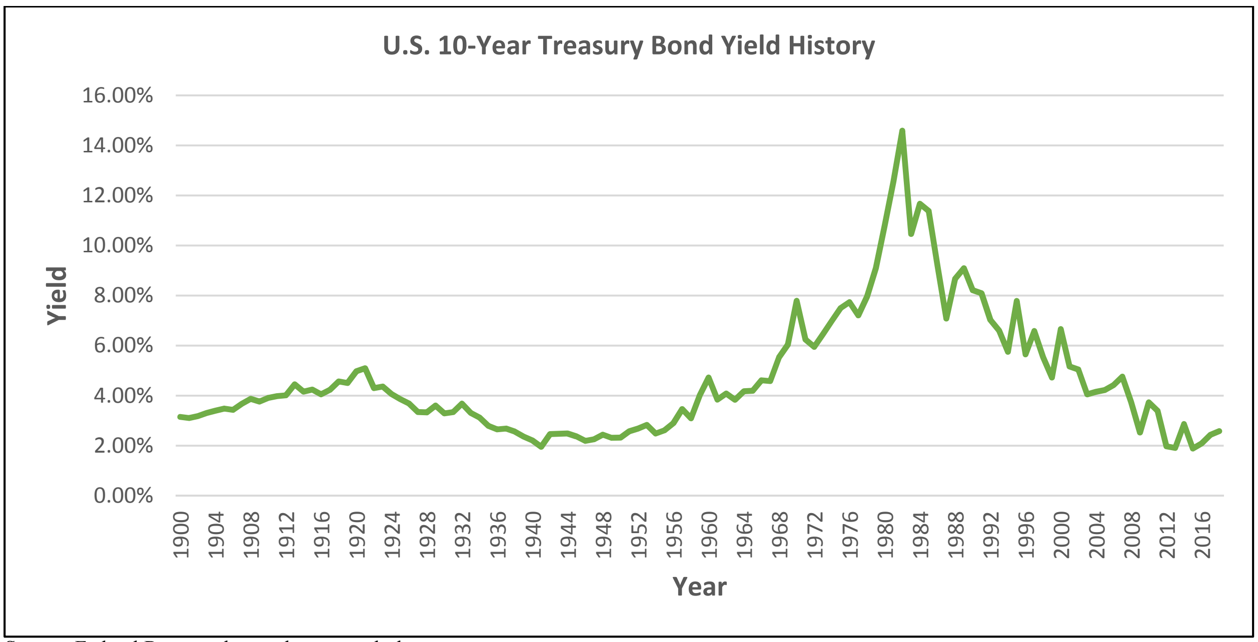
Alley Company Quarterly Letter
Stocks, Bonds, and Interest Rates

October 12, 2018

The level of interest rates is always an important factor in the investment equation and the direction of interest rate movements can be equally important. The Federal Reserve just raised the Federal Funds rate by 25 basis points to 2.25%, continuing a string of gradual increases over the past three years. Meanwhile, the yield on the ten-year U.S. Treasury bond recently ticked above 3% after trading between 1.50% and 3.0% for the past eight years. Investors are currently grappling with the perceived negative impact of rising interest rates offset by the positive implication of the yield curve in the U.S. still being near the lowest levels in recorded history.

In the second quarter of 2015, we wrote a quarterly letter entitled Déjà Vu?, where we discussed the notion of interest rates staying "lower for longer." In looking at the graph below that charts the ten-year U.S. Treasury bond yield since 1900, the average yield has been about 4.7%. During the high inflation periods of the late 1970s and early 1980s interest rates were significantly above average, and conversely, during periods of disinflation as in the 1940s and 1950s, interest rates were significantly below average, and stayed that way for over twenty years. Interest rate normalization could be a gradual process as we move forward, similar to cycles in the past.



Source: Federal Reserve data and www.multpl.com

Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

Today, stealth-like productivity caused by quickening technological innovation – e.g., information flow on hand-held devices, cloud computing, online retailing (Amazon effect), hydraulic fracking, and healthcare innovation – is a disinflationary force and contributor to lower interest rates in the U.S. and abroad. The underlying trend of globalization, which has been in place for decades, also continues to play a role in the overall containment of inflation and interest rates. And rock-bottom levels of interest rates in other developed economies such as Germany and Japan, where the ten-year government bond yields are 0.53% and 0.15%, respectively, have created an ongoing bid for U.S. Treasury bonds.

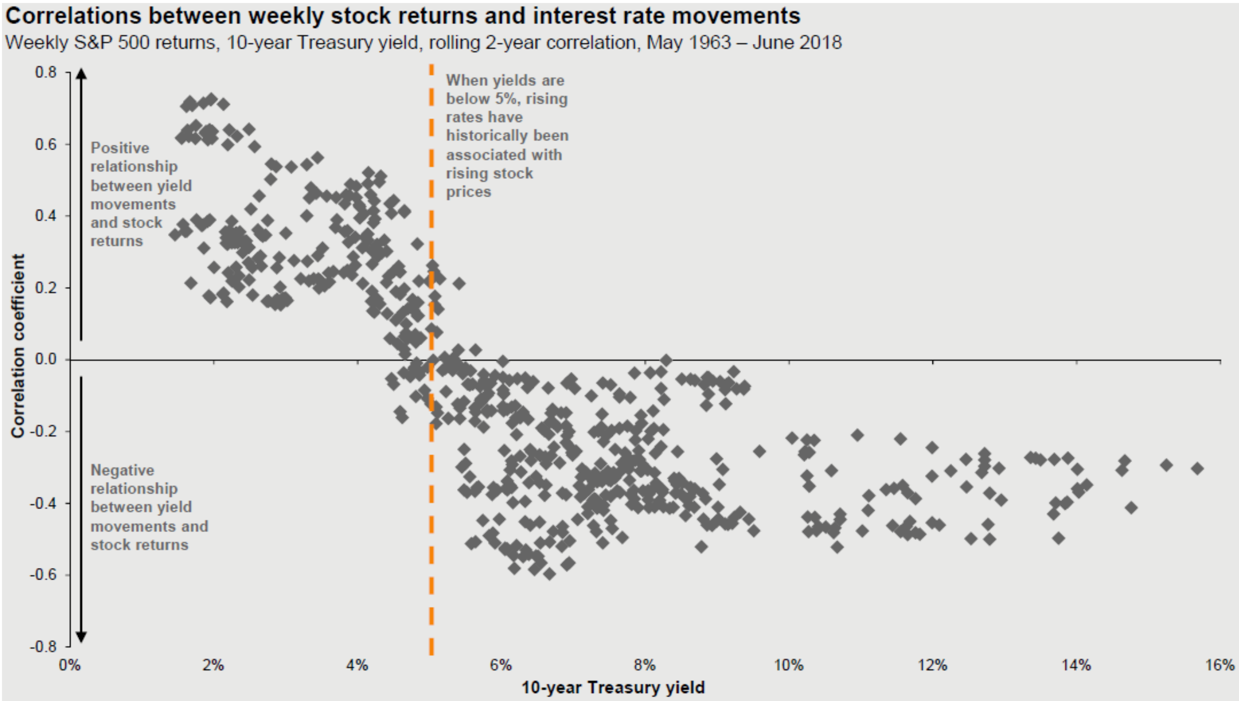
Meanwhile, there are countervailing factors in the United States economy that are causing upward pressure on interest rates against the backdrop of the aforementioned disinflationary forces. Since 2016, when the price of oil convincingly recovered from its collapse in 2014-2015, the energy and manufacturing sectors have responded favorably in leading the economy to stronger growth. In addition, corporate tax reform has been "icing on the cake," further bolstering economic activity. A new wild card, the prospect for inflation being stoked by the recent trade war activity, bears close scrutiny. While neither the economy nor inflation are increasing at levels that are considered "too hot," these factors have given the Federal Reserve a license to continue raising the Federal Funds rate to what they view as a more normal level.

So what does this all mean for stocks and bonds?

For fixed income investors, we view gradually rising interest rates as a net positive. First, earning 3.15% in the ten-year U.S. Treasury bond is an unsatisfactory return when consideration is given to the real return after taxes and inflation. Second, elderly savers have been hurt badly over the past decade, earning ultra-low levels of interest income in money market funds and CDs and will welcome higher yields in this lower risk area of the fixed income market. Third, for long-term investors in bonds, being able to reinvest at higher yields over time will be a good thing as the current income component, or cash flow, for coupon clippers will be increasing. And fourth, while "on paper" the total return on fixed income investments may be somewhat negative during a time of rising interest rates, reinvesting at higher yields will offset near-term paper losses over time.

For equity investors, rising interest rates can "theoretically" have a negative effect on stock prices as a higher discount rate suppresses equity valuations. However, when interest rates are low, e.g., the ten-year Treasury bond below 5%, stock returns and interest rate movements tend to be positively correlated, meaning when interest rates rise stock prices rise. The following exhibit illustrates this correlation and infers a couple of points. First, rising interest rates suggest a strengthening economy and thus improving earnings which is good for stocks. Second, when interest rates are below 5% as is the case today where the ten-year U.S. Treasury is at 3.15%, fixed income investments are not very competitive with stocks. History shows that when interest rates reach the 5% level they become more competitive with stocks which makes intuitive sense as well.

Interest Rate Movements and Stock Returns



Source: JP Morgan "Guide to the Markets" Q4 2018

Recent market volatility reflects investor concerns about the prospect of rising interest rates and the implications of ongoing trade disputes, particularly with China. If interest rates are starting at a low level and rising "for the right reason" – i.e., a strengthening economy – then the investment backdrop for equity investors can remain positive. And gradually rising interest rates can be a positive for fixed income investors as well, allowing them to re-invest at higher yields over time.

The Alley Company Quarterly Letter discusses general developments, financial events in the news and investment principles. It is provided for information purposes only. It does not provide investment advice and is not an offer to sell a security or a solicitation of an offer, or a recommendation, to buy a security. The statements and opinions contained herein are solely those of Alley Company LLC and are based upon sources and data believed to be accurate and reliable. Additional information regarding Alley Company, LLC can be found by accessing the SEC's website at *[www.adviserinfo.sec.gov.](http://www.adviserinfo.sec.gov)*