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Alert: Fed Tapering Is Coming

Avoid Zero Cash-Flow Stocks and Bonds

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Currently, investors face several potential near-term risks, including:

- Lofty equity valuations paired with low bond yields
- Supply chain bottlenecks leading to downward earnings revisions
- "Transitory" inflation concerns
- Simmering US-China tensions

But these are all "known unknowns" - recognized threats whose true likelihood of materializing is unclear (much less their actual consequences). While important, there's a practical limit to how much attention and concern they require.

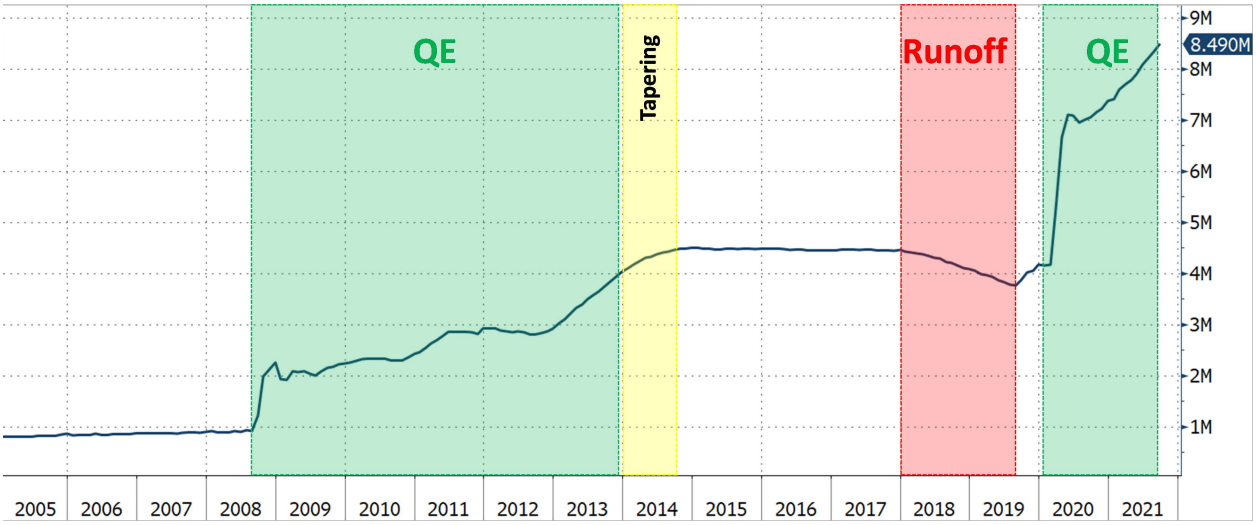
Instead, we're focused on the implications of a significant "known known", an event we're highly confident will come to pass: Fed tapering.

Quantitative Easing: A Brief Reminder

Since the Great Financial Crisis of 2008, after cutting the Fed Funds rate to zero, the Federal Reserve has largely relied on a tool of monetary policy called Quantitative Easing ("QE"). When the Fed judges further monetary stimulus is needed, QE allows it to print dollars and directly purchase existing bonds in the open market. Purchased bonds are kept on the Fed's balance sheet, out of circulation (likely to their maturity).

The Fed has been purchasing $120 billion of bonds every month since March 2020. This has massively swelled the liquidity in the system and arguably, driven all asset prices higher.

Fed Balance Sheet ($ Trillions)

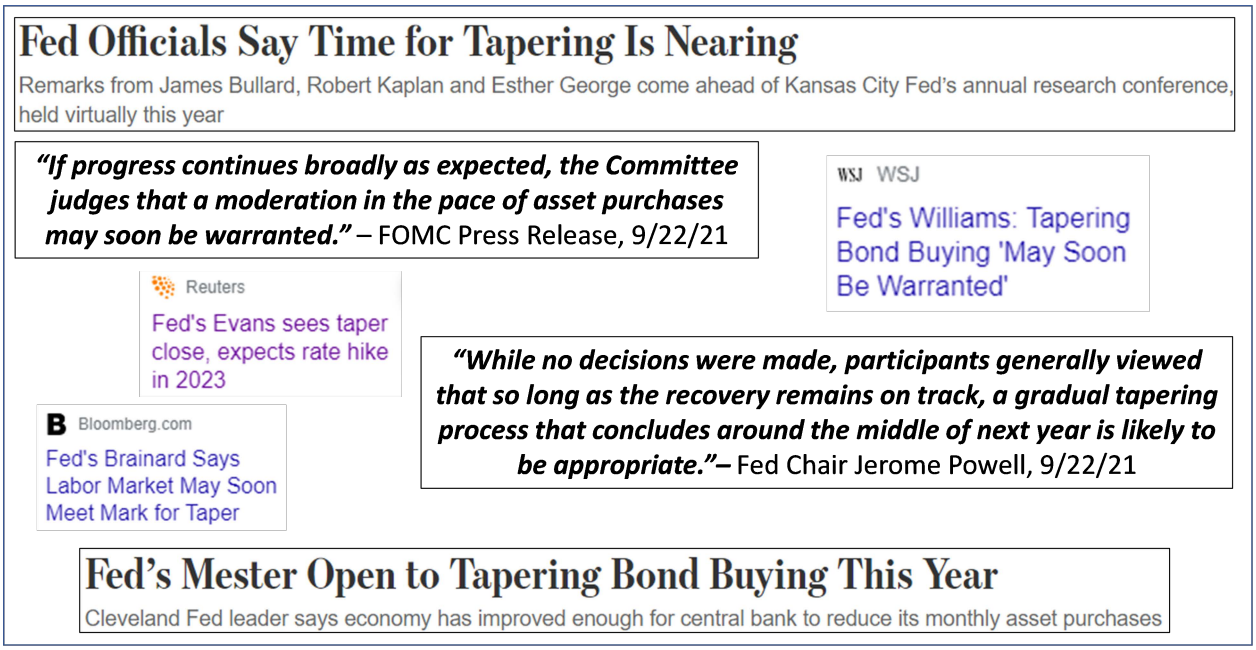


Source: Bloomberg

But every tide makes a high-water mark before it turns, and the US is about to reach that point.

Tapering Is Imminent

While timing and the pace of tapering is uncertain (November, December or January?), it's generally accepted that the Fed will soon begin tapering the pace of its asset purchases.



Importantly, tapering doesn't mean an end to QE – it's merely the process of gradually reducing the pace of *new* purchases until stopping altogether. But it is undoubtedly the first (small) step in the monetary tightening process, marking a notable change in the tide of liquidity. As with any paradigm shift, this has implications for those assets which benefitted most from the prior regime: low-cash flow stocks and bonds.

The Perils of Low Cash-Flow Stocks and Bonds

Despite all the terminology and technical complexity, the core principle behind loose monetary policy is simple; ensure ample access to cash at a low cost. Interest rates are essentially the price of renting money today that's returned sometime tomorrow, an "exchange rate" for capital between present and future. Low rates (or a low exchange rate) mean money today is plentiful and can be rented at a low cost that encourages capital investment.

Within this analogy, low cash-flow stocks and bonds are the largest 'money-renters' of them all.

Low Cash-Flow Stocks

As ownership stakes, stock prices reflect the market's valuation of a business' current and assumed future cashflows. Typically, higher cashflows lead to a higher valuation, but there's a difference between present and future earnings. Whether distributed to shareholders (via dividends or buybacks) or reinvested in the company, current earnings are proof positive that a business is viable as profits are already achieved.

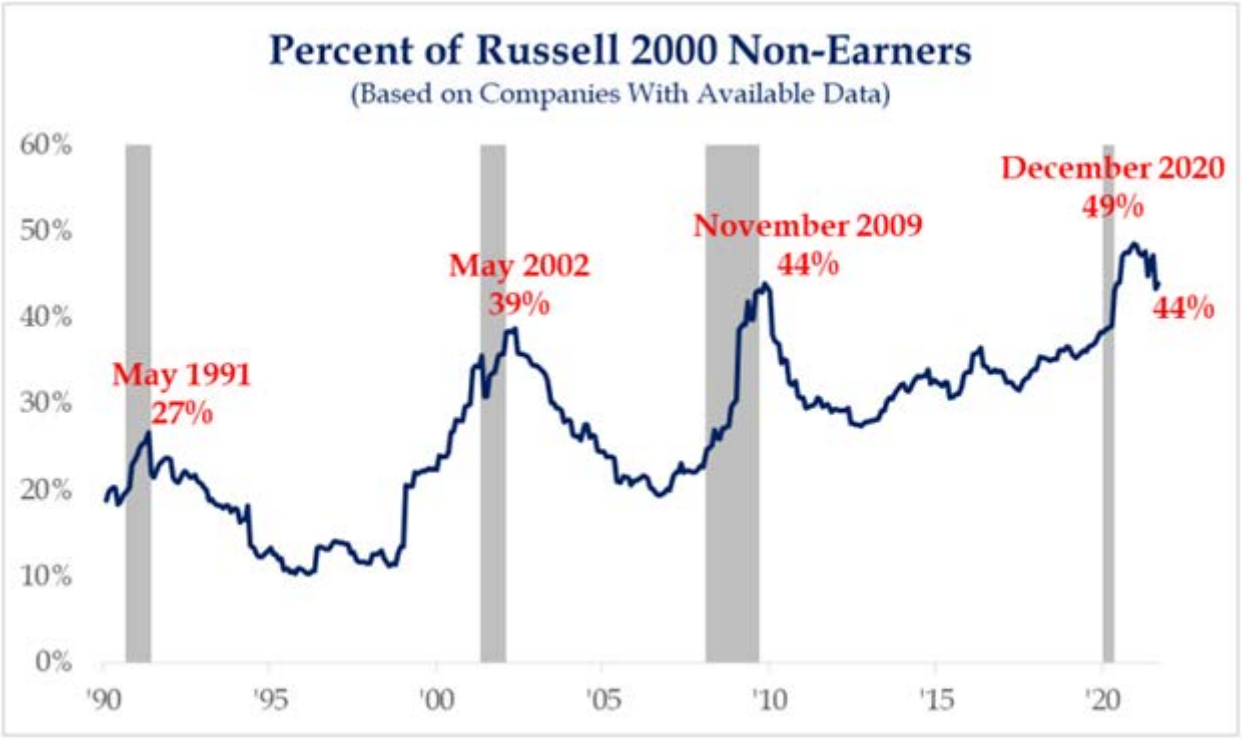
Future earnings are a different animal; no matter how "rigorously" they're modeled or forecasted, the future is inherently *un*certain. Future earnings must be *discounted* to account for the possibility things go wrong; the greater the uncertainty, the greater the discount necessary to determine a fair present value. The size of the discount is directly related to interest rates – lower rates translate into a lower discount, and vice versa.

Accordingly, QE and ultra-low rates have greatly benefitted the stock prices of those companies with little-to-no current earnings but plenty of future optimism. But now that rates - and therefore discount factors - could potentially start rising, those assumed future earnings are about to become less valuable.

Interest Rate Used to Discount Cashflow	Discounted Value of $1,000,000 Lump Sum Received in...		
	10 Years	20 Years	30 Years
1.0%	$905,287	$819,544	$741,923
1.5%	$861,667	$742,470	$639,762
2.0%	$820,348	$672,971	$552,071
2.5%	$781,198	$610,271	$476,743
3.0%	$744,094	$553,676	$411,987

Source: Treasury Partners calculations

This is a problem for more equities than commonly realized. The proportion of public companies with no current positive earnings – and therefore valued solely on the basis of hoped-for future earnings – has ticked notably higher over the past 15 years.



Source: Strategas

Low Cash-Flow Bonds

A bond is simply a defined stream of cashflows (interest payments) received according to a predetermined schedule until maturity, when the much larger principal/face value that the borrower "rented" from the lender is returned. As is commonly known, bonds are sensitive to changes in interest rates, and the lower the coupon and the longer the final maturity, the more sensitive the bond's price becomes to even small fluctuations in current interest rates. This makes intuitive sense; low (or even zero!) coupon bonds which won't return their principal for many years are similar to low cashflow stocks whose hoped-for earnings are concentrated in the distant and uncertain future.

As we've discussed many times in previous white papers, this factors into a bond's "duration," a measure of price sensitivity to changes in market rates. As a result, it's normal for high duration bonds to have greater price volatility than low duration bonds.

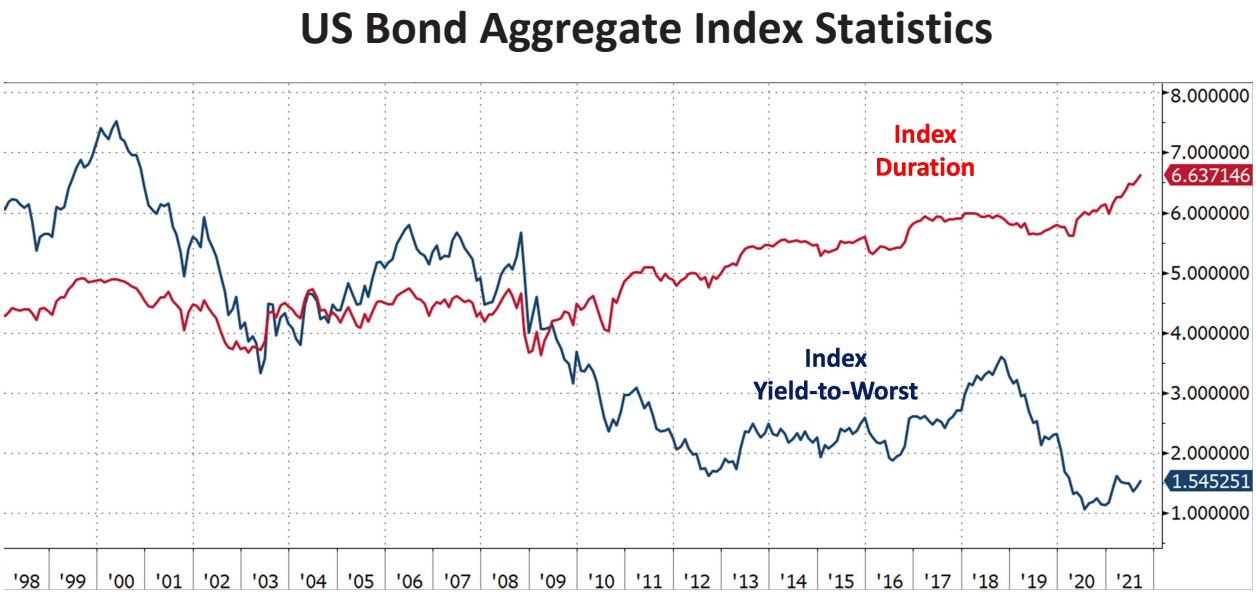
The problem is that current yields don't come anywhere close to sufficiently offsetting the price risk. Consider the 10-year Treasury, whose current yield and coupon are both approximately 1.50%; it's undeniably a low coupon, long final maturity, high duration bond. Take a look at this bond's price change if rates rise or fall within a narrow 0.00-3.00% band. As you can see, if rates rise 1%, the bond's value declines by nearly 9%, certainly not an appropriate tradeoff for a "safe" investment.

Current Treasury Yield = 1.50%					
Scenario	Price Change	10 Yr Yields Previously at This Level	Scenario	Price Change	10 Yr Yields Previously at This Level
Rates Fall 0.50% (1.00%)	+4.7%	Jan 2021	Rates Rise 0.50% (2.00%)	-4.5%	Jul 2019
Rates Fall 1.00% (0.50%)	+9.7%	Aug 2020	Rates Rise 1.00% (2.50%)	-8.8%	May 2019
Rates Fall 1.50% (0.00%)	+15.0%	Never	Rates Rise 1.50% (3.00%)	-12.9%	Nov 2018

Source: Treasury Partners calculations as of 9/28/21

Important Point

Like low cashflow stocks, low cashflow/high duration bonds are a more common problem than they used to be. Ideally, investors are looking to maximize the amount of yield they are paid for each unit of duration risk they must accept; as the chart below shows, the yield/duration ratio is the lowest in a generation. This makes fixed income investing potentially risky in the current environment.



Source: Bloomberg Barclays US Bond Aggregate Index

Treasury Partners View

An interesting piece of trivia is that the 10-year Treasury yield hit its absolute peak (15.84%) exactly 40 years ago on September 30, 1981. Despite plenty of fluctuations along the way, it's been a long journey lower since.