LEDYARD
FINANCIAL ADVISORS
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INVESTMENT THOUGHTS

MAY 2018

GETTING PAID FOR RISK

One long standing principal of investing is not to take an uncompensated risk. Before a prospective investment can pass the test, one has to calculate its upside potential versus its downside. This principal seems straightforward and uncontroversial. Of course, why would this not always be part of the process? One of the factors that complicate the exercise is finding something against which to measure the risk. There should be a natural hierarchy where certain types of financial assets need to be compensated with reference to the specific risk being taken on. The investor’s task is to sort out where the level of risk in that asset stands at a given point in time. It should be clear that the risks attending to a certain financial asset do not remain constant over all time periods. By illustration, driving the same highway in dry, wet or snow conditions changes the risks even if always on the same road. Another element in measuring risk is to attempt to establish the rate of return on an asset presumed to be *risk free*. If one can establish a reasonable estimate of this number, one has to presume all other asset choices will have more risk. The question then becomes what rate of return (risk premium) is required to compensate the investor for those expected risks?

In finance, our industry has viewed the return on the 90 day U.S. Treasury Bill, a full faith and credit obligation of the U.S. Government, as “risk free”. Presently, the rate on this instrument is about 1.8%. This rate is the starting point for the pricing of risk in other financial assets like stocks and bonds. Dramatic changes in this rate can set in motion rapid changes in the prices of other financial assets like stocks and bonds.

Measuring risk for **bonds** broadly means estimating credit quality and expected inflation, both of which can be influenced by Federal Reserve monetary policy. Consequently, bond investors look at the risk free rate and apply a premium, additional required yield compensation to offset inflation over the term of the bond’s maturity. Generally, bond investors want more yield for longer duration.

Since the time of the credit crisis in 2008, interest yields have been suppressed by Fed monetary policy and, as a consequence, the inflation premium bond investors have required has been close to zero. This is an unusual circumstance and is, today, changing emphatically in response to rate hikes envisioned for the Federal Reserve policy. The 10 year US Treasury Note is another yield that is used to measure longer term risks in the stock and bond markets. After years of slow growth and deflation concerns, the US economy is finally rebounding . The Federal Reserve is keen to see positive inflation reflective of a stronger economy evidenced in bond yields. Its current inflation goal is a range around **2%**.

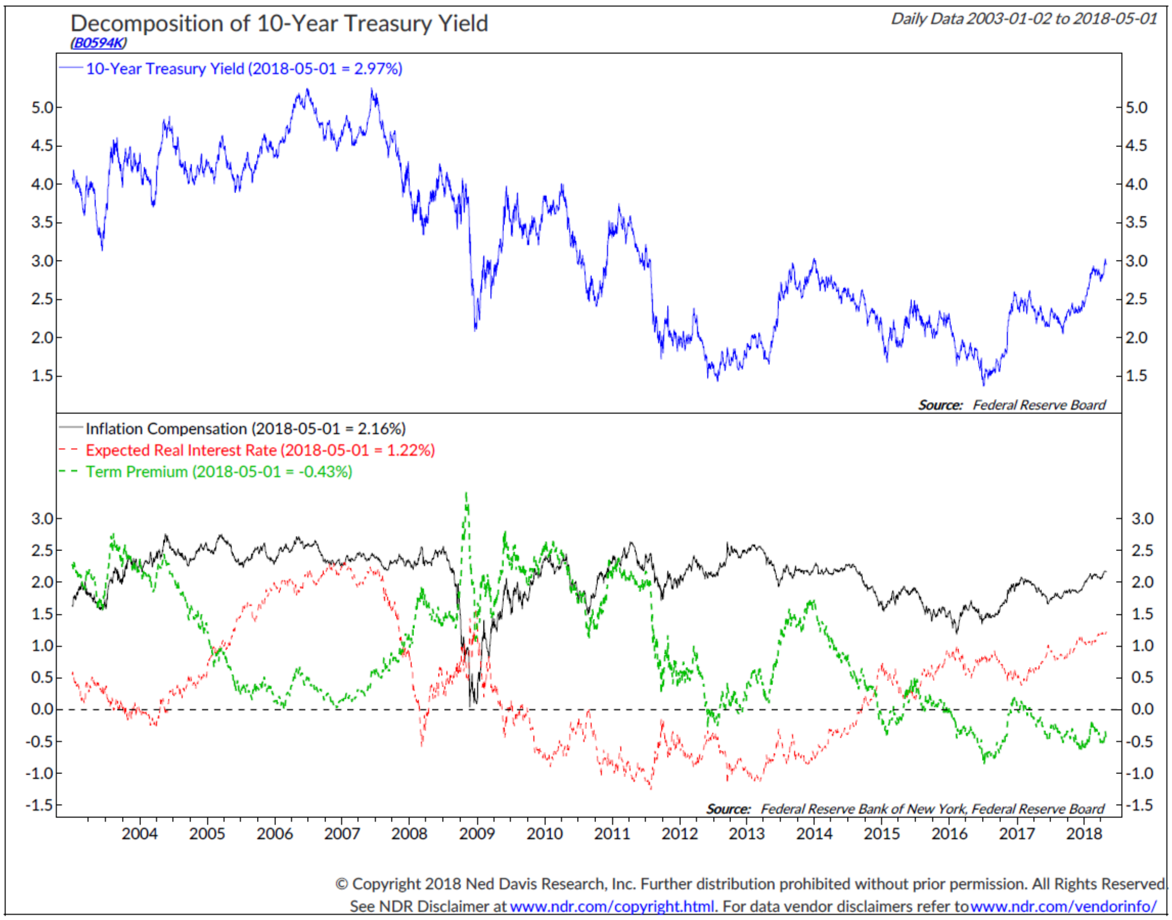
In chart #1, we see the decline in 10 year bond yields from the late 1980's. The Federal Funds rate can be viewed as the wholesale cost of money and is the interest rate at which banks lend reserve balances to other depository institutions overnight. The Federal Reserve uses the Fed Funds rate as a tool to control U.S. economic growth. Raising this wholesale rate translates higher rates to all other interest rates. The Fed wants to keep inflation under control and uses this rate to increase or decrease the cost of credit in the economy. 10 year yields are rising and how far they move up is shaped by the real growth of the economy and inflation expectations. Ultimately, it should track the growth rate of GDP. Bond investors will assess risk from the level that the Fed allows inflation to attain. They will want to be compensated an amount above the risk free rate that offsets inflation. The focus of investors today is how high the Fed will raise the Fed Funds rate to keep inflation from going above its 2% target.

Chart #1

Source: Legg Mason

The chart below shows the makeup of the 10 year bond yield; the nominal yield of 2.97% wherein is embedded an inflation estimate plus something for the duration aspect. If inflation estimates move up, the yield will need to rise, which means bond prices would fall to provide a bigger risk premium.

Chart #2



A factor that makes guessing where interest rates will go more difficult is the fact that Central banks are still suppressing yields as a method of stimulating growth. Both in the US and in Europe and Japan, Central banks are in various stages of monetary easing. The US is beginning a tightening phase, but is limited by the rates existing in other G10 countries. There is a large gap, for instance, between the 10 year bond yield in the US compared to Germany, Europe's strongest economy. The US bond is close to 3% and the German bond at ½ of 1%. This spread matters, as the US wants to be competitive with Germany and wider differentials tend to strengthen the Dollar, making our exports more expensive.

Ledyard Financial Advisors believes we should expect our 10 year bond yield to move up further in 2018 to a range of 3.25%-3.6%. If we refer back to the yield on the “risk free” 90 day US Treasury Bill of 1.8%, adding 2% inflation risk to it suggests these levels are achievable. The next question is whether the higher rates become a debilitating headwind for the economy and stocks, or whether the Fed calibrates its moves deftly in keeping with underlying fundamentals. Longer term, growth of Government debt will offset to some extent the fiscal spending impulse. In the short run, however, rising prices paid by US corporations for materials and wages point to inflation pressure. These short term pressures support the Fed raising rates that could be a problem for stocks and bonds.

In our risk exercise we have looked at how to judge bond risks. Now we move on to stocks. If bonds need to be compensated for inflation risks, it follows that an even higher return would be required for a riskier asset like stocks. Unsurprisingly, stockholders want an *equity risk premium* above the return that can be earned on bonds. In this case we use the yield of the 10 year bond (3%) as the starting point. As a historical measure, the equity risk premium has been about 4%. The unusual circumstance of artificially low yields as a result of Fed policy however has corrupted the relationship between bond returns and stocks. This is reflected by the fact that low rates allow the market to trade higher as expressed by the price to earnings ratio. It implies that the value of future earnings will not be degraded by much inflation. Low cost money has flowed into stocks driving up prices to where the risk premium to be received is rather skimpy (3% ten year minus 1.8% risk free rate =1.20%). This is a long way from 4%. Bond yields are *suppressed* and these low yields *support* corporate earnings via a lower cost of capital. *The risk to stock prices rises as yields rise.* Reestablishing an equity risk premium at or near 4% would mean stocks would have to be cheaper than they are today, or earnings would need to grow very rapidly. Since the *median* S&P 500 P/E ratio today is 24, against a 50-year average of 17, we know the market is not cheap and is not offering much of a risk premium to compensate for it. This does not mean imminent peril but corporate earnings growth will need to match the Fed’s rate hikes. For now we interpret rising rates as a reflection of stronger growth. The stock market’s test will come in the next economic slowdown when lowering rates, as was done after 2008, will not be a remedy with the same power.

Investment Implications:

The primary risk to both stocks and bonds as asset classes is the direction and level of interest rates. More than any other factor, a change in the cost of money and inflation will affect valuation. Today both stock and bond markets offer small risk premiums. In the coming ten years, will inflation stay at 2% or less? As money moves from financial assets out into the real economy can asset prices hold up? For the next two years we believe the strong global macro economy will support good US growth aided by supportive financial conditions and the one-off tax cut and increased fiscal spending. A slow steady withdrawal of the Fed's monetary stimulus, in coordination with other central banks, can be accommodated. New government bond issuance to cover fiscal spending will, ultimately, pressure yields to move higher.

Uncertainty brings about a shortening of investor time horizons and we should expect more volatility of asset prices. Some of the price moves will just be changes in mood rather than fundamentals. There is still more time left in this expansion even though the fastest growth may have already been reached. When a cycle is normalizing, i.e. as in coming back to a more natural level of interest rates, one should stay invested while earnings are rising. In equity markets, avoid pockets of vulnerability that have high interest rate sensitivity and take shorter maturities for bonds or those with inflation adjustment features. In any case, aggressiveness will not be well rewarded. Don't take uncompensated risk.

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