

We're now in the dog days of summer, and it was another relatively quiet week for markets. The S&P 500 finished up slightly on the week as the second quarter earnings season officially kicked off, highlighted by reports from the large banks as well as Netflix on Thursday afternoon. Overall, recent earnings suggest that credit conditions remain relatively healthy. The four money center banks, in aggregate, reported a sequential decline for both loan loss provisions and net charge-offs across their loan portfolios.

The economic resilience and robust corporate earnings growth hasn't stopped the "nattering nabobs of negativity"<sup>1</sup> from voicing their concerns. Their latest target – the bond market. Many pundits have been lamenting over the poor returns earned by bond investors in recent years. The chart below (which has been circulating across the financial press) sums it up:

**Bond Market (Treasuries) Annualized Real Return (Inflation-Adjusted) By Decade**

Decade	5 Year Treasuries	10 Year Treasuries	Long-Term Treasuries
1930s	6.6%	6.0%	6.9%
1940s	-3.5%	-2.9%	-2.1%
1950s	-0.9%	-1.4%	-2.3%
1960s	1.0%	-0.1%	-1.1%
1970s	-0.4%	-1.9%	-1.8%
1980s	6.8%	6.9%	7.5%
1990s	4.3%	4.4%	5.9%
2000s	3.6%	3.7%	5.2%
2010s	1.4%	2.4%	4.9%
2020s	-3.5%	-5.1%	-8.3%

Source: *A Wealth of Common Sense*

Some of the more humorous and extreme views getting traction lately:

- *Bond investors seem to be fleeing away from Treasuries, and exploding deficits could trigger a fiscal crisis on the not-to-distant horizon*
- *Large foreign buyers aren't purchasing U.S. bonds anymore, and there will be a severe lack of demand to absorb future issuance*

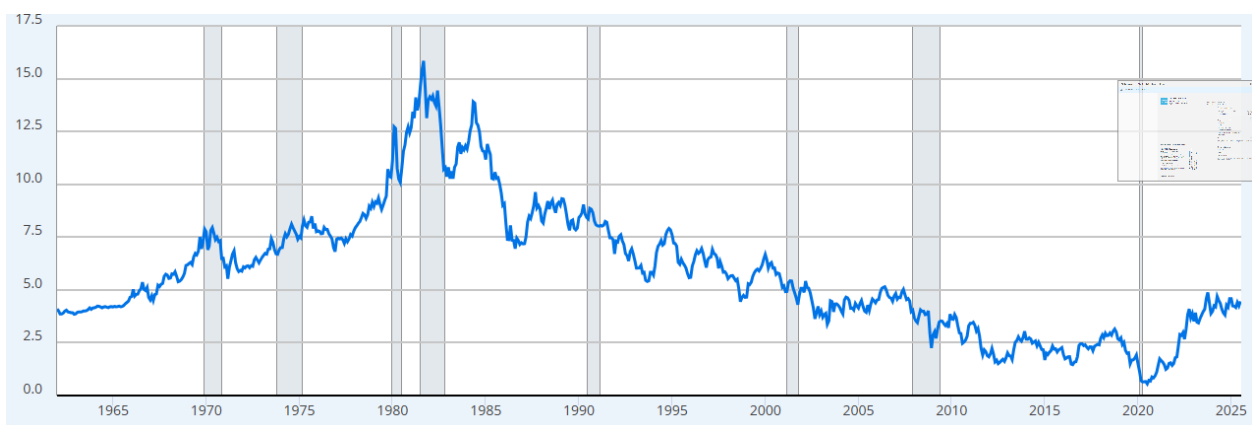
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<sup>1</sup> "Nattering nabobs of negativity" is a phrase coined by Spiro Agnew, U.S. Vice President under Richard Nixon, to describe those perceived as excessively critical or pessimistic, particularly in the media. He first used the term during a speech in September 1970.

- *Higher yields represent an eroding faith regarding the country's creditworthiness and pose a significant threat to U.S. exceptionalism*

First and foremost, the recent negative bond returns reflect normalization after the zero-interest rate policy (which was turbo-charged during COVID) in effect post-2008 ended when the Fed started hiking rates in 2022. Unlike stocks, bond returns are capped. Bond prices and yields move in opposite directions (as yields rise, prices fall and vice versa). Yields can only fall to zero (I don't believe persistent negative rates in the U.S. are a realistic possibility); therefore, as rates approach this lower bound, it increasingly caps future returns. Thus, the recent negative performance (following a four-decade bond rally as rates fell from the early 80s peak) we've witnessed is solely due to this simple mathematical reality. Coming into the decade, the 10-year Treasury was sitting at 1.9%, near an all-time low, declining even further in early 2020 during the depths of COVID. This left virtually no room for further price appreciation and set the stage for negatively skewed go-forward returns as rates would inevitably rise at some point.

### **U.S. 10 Year Treasury Yield (%)**



Source: U.S. Federal Reserve

In addition, the fear regarding a lack of future demand for Treasury bonds is highly exaggerated in my view. Even excluding foreign buyers (who, on the whole, continue to roll into new purchases), the many trillions of investment capital sitting on the balance sheets of banks and insurance companies, as well as bond funds, can comfortably absorb any reasonable demand shortfall. Banks and insurers are incentivized to hold Treasury assets given their preferential capital treatment, which is highly unlikely to change anytime soon. In addition, should major disruptions across the bond market occur, the Fed can step in and buy paper to shore up liquidity, parking the securities on the Treasury's ample balance sheet.

Perhaps the larger question is why equity investors seem to care so much regarding Treasury yields. As you can see from the above chart, there's virtually no long-term correlation between stock and bond returns, certainly not the latter driving the former. The 1930s, for example, were great for bondholders but a nightmare for stock investors suffering through the Great Depression. Conversely, the 1950s was a golden decade for stocks as the S&P posted annualized gains of 19%, while bonds were well in the red. Nevertheless, the market's obsession with the Federal Reserve (which only sets short term rates anyway) has become highly ingrained over many years, which doesn't seem to make a lot of sense from my seat.

Furthermore, the claim that American dominance is waning certainly doesn't square with the performance across our largest technology companies, which are leading the AI revolution at unprecedented levels of scale. Claiming that rising Treasury yields are a threat to U.S. exceptionalism is akin to trashing a beautiful steak dinner because the paltry garnish is supposedly not up to par. Fluctuations across bond yields have virtually no impact on the fundamental health of these exceptional companies, unparalleled outside of the United States, or their future growth.

As we've written about in prior letters, there's always reasons to be concerned as investors. Currently, elevated tariffs (especially if they climb further) still have the potential to somewhat erode corporate profit margins and/or cripple customer demand. Any disruption to planned capital spending across the AI landscape would threaten the secular trend powering this bull market. Thankfully, all signs point to a continued ramp across the ecosystem, including semiconductor orders, data center expansion, and software spend. Maintaining a keen focus on the key drivers impacting revenue growth across the largest companies is paramount. Obsessing over the Fed's next move, or every little wiggle across the bond market, is an unproductive exercise in my view.

In essence, while there are always risk factors, paying attention to what's truly significant while ignoring the noise is essential as an astute investor. I'm not suggesting interest rates don't matter at all, simply that the fervent obsession with bond yields and the Fed isn't warranted. There are much bigger fish to fry; the market's medium to longer term trajectory will most likely have virtually nothing to do with interest rates. Yield curve shifts and rate fluctuations simply aren't key drivers regarding the long-term health of the most consequential public companies.

The reality TV-worthy drama concerning Fed Chair Jay Powell's job security, questions about central bank independence, or pontifications regarding the government's fiscal sustainability, can provide entertaining dinner conversation. However, for long-term

focused equity investors, they should be assigned a factor of zero in portfolio management decisions.

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