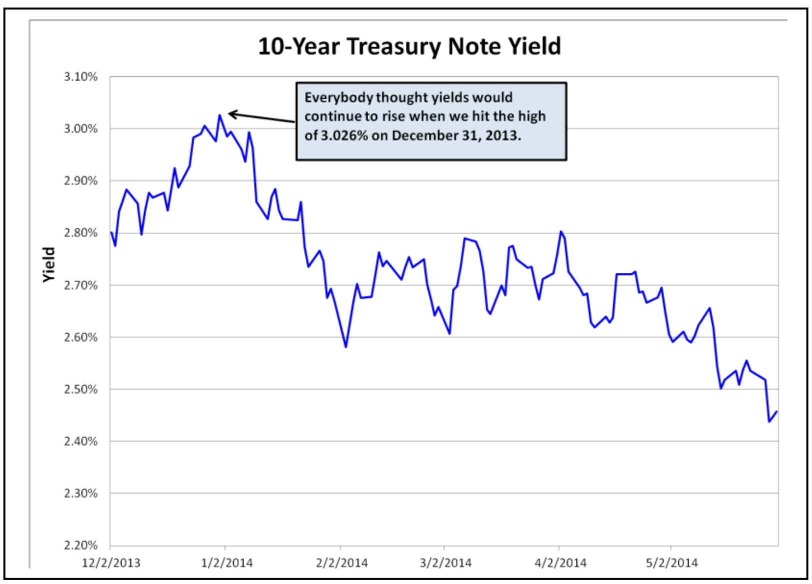
BUTLER, LANZ & WAGLER

June Newsletter 2014

On the last trading day of 2013, the yield on the 10-year Treasury note reached 3.026% - a yield last reached in July of 2011. Since then, the yield on the Treasury has really done nothing but go down, despite a record number of speculators betting against that move.



Keep in mind, and this will be critical in understanding this month's newsletter, when interest rates go down, bond prices go up. Conversely, when interest rates go up, bond prices go down. So, since the beginning of 2014, yields have gone down and bond prices have gone up. Throughout it all, conviction has been that bond prices would go down. We've covered this *ad nauseum* for months. At the end of 2013, investors were convinced that stocks would go up, bonds would go down, gold would go down and the dollar would go up. It took until mid-May for stocks to break positive on the year. Bonds are still way up on the year. Gold has gone down, but only after being the best performing asset class in the first three months of the year. The dollar, after flirting with long-term lows in the first five months of the year, finally has shown a little strength only recently on comments Mario Draghi made - not the US economy, which was the supposed source of all the bullishness in the dollar at the end of 2013.

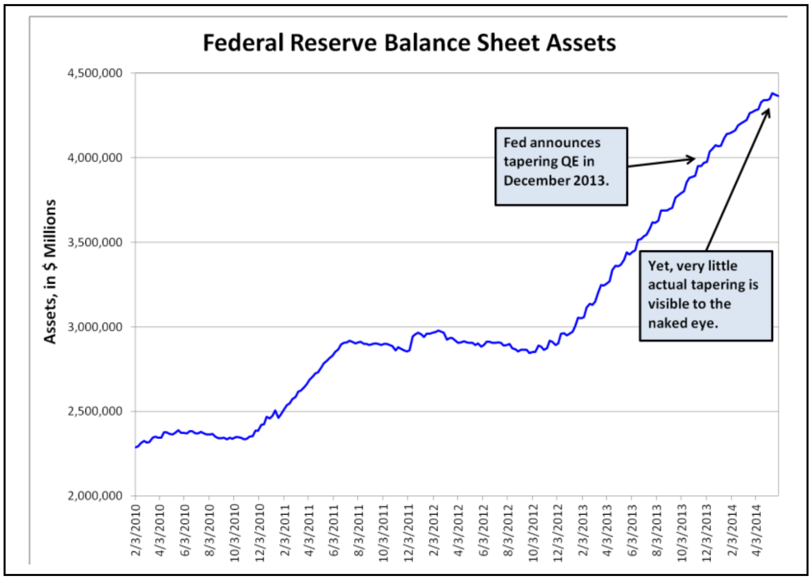
There is widespread confusion as to why the Treasury yield is going down. After all, we're starting to see signs of inflation - the nemesis of the bond investor, and major cause of yields rising. Also, the Fed is tapering its bond-buying program, called quantitative easing. It seems logical enough to conclude that once the Fed stops buying bonds, yields should rise. Why? Because the Fed's demand is forcing bond prices up and yields down. Absent that demand, bond prices should fall and yields should rise.

The strange fall-off in interest rates is of interest to bond investors. They simply want to know if the move down in interest rates is sustainable, or if they should expect yields to go back toward 3% or even higher. But interest rates are important to all investors, and frankly, everyone in the economy. Stocks cannot keep going up if the fall in Treasury yields is due to a failing economy. At some point, stocks will adjust to a reality that features lower earnings. Also, the economy itself is tied to interest rates. If they rise, expect there to be additional pain in the very important housing sector. If interest rates fall, or even stabilize around where they're at now, it's more likely that people can afford to buy homes. For these reasons, the recent drop in interest rates affect everyone in the economy - investors and otherwise. And it's the reason we're addressing that issue in this month's newsletter.

Reasons Why Interest Rates Should Be Going Up

Reason # 1 - Quantitative Easing (QE) is Ending

As noted above, many think interest rates should be going up because the Fed is slowly ending its QE program. We should be able to see this in the "assets" category of the Fed's balance sheet, released every week, because QE is the Fed's purchase of bonds from banks in exchange for money created out of thin air. We should expect to see bank's cash levels go up as the Fed's assets - bonds and mortgage securities - increase. The chart below should show the Fed assets decreasing.

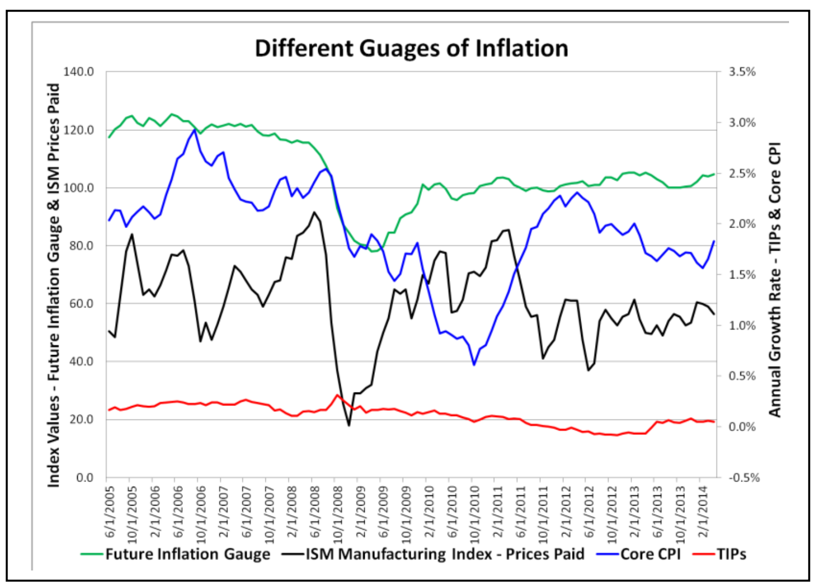


But we don't yet see this. Even though the Fed has now reduced its monthly purchase of bonds by $40 billion, it's hardly visible on the Fed's balance sheet. For now, the reduction in asset purchases has been almost imperceptible. So, yields are not going up because the Fed's asset level has not yet been meaningfully impacted. If the Fed keeps tapering, as they've done at every meeting since December 2013, this blue line should start to become horizontal. And by November of this year, it should be fully horizontal. Stocks and bonds both are more likely to react to the reduction in liquidity being provided by the Fed late summer or early fall of 2014 when the tapering has a more meaningful impact on liquidity in the system. The chart to the left shows that this has yet to occur. Bottom line - we should not expect yields to have any upward pressure due to tapering until the tapering has a material impact on liquidity.

Reason # 2 - Inflation is Heating Up

There are many ways to gauge inflation, but the Fed looks at Core CPI. That's inflation ex food and energy. But there are many ways to see if inflation is building in the economy. Aside from Core CPI, there's the Future Inflation Gauge (FIG), a leading indicator of inflation, the "Prices Paid" sub-index from the ISM Manufacturing Survey and the yield on Treasury Inflation Protected Securities, or TIPs for short.

As can be seen, two of these show absolutely no signs of a pickup in inflation and two do actually show inflation may be heating up a little. The strongest indicator is Core CPI, but the rest are not telling the same story. At best, we have mixed signals. If anything, we can say that we should not fear *de*flation. But actual run-away inflation is tied to the consumer. The consumer's ability to consume is constrained by his/her wage.

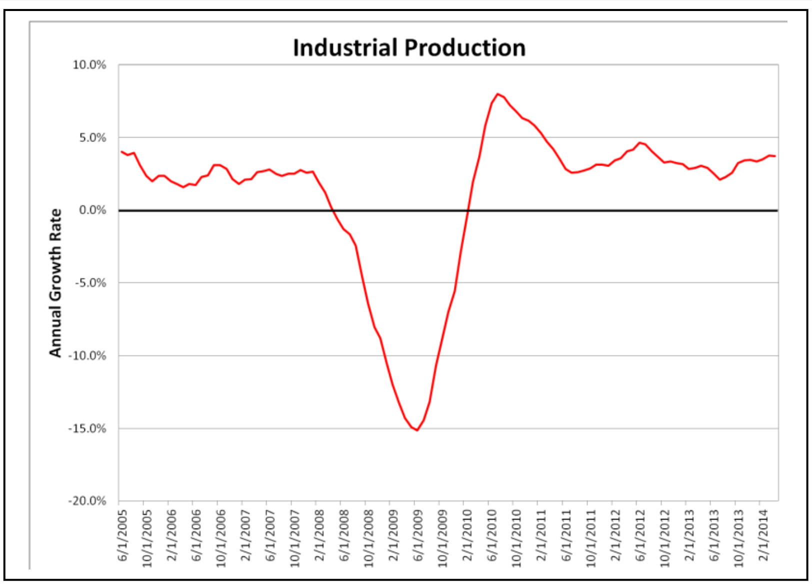


The chart to the right show that wages are growing at their average rate since 2000 - about 3.6% annually. To have anything more than a cyclical blip up in inflation, there needs to be upward pressure on wages. We're not getting that and we suspect the bond market understands this. Bonds have not bought into the "inflation is heating up" story. Not yet, anyway.

Most of you know that you can hear Butler, Lanz & Wagler's Chris Butler every Saturday morning at 8:00 on KCMO AM and 103.7 FM on *The Capitalist Pigs* radio show. But you can also hear Chris every Friday morning at 8:35 on Greg Knapp's KCMO Morning Show on the same stations.

Reason # 3 - The Economy is Heating Up

There is a feeling that since the economy is accelerating, bond yields should be rising, as they typically do when bond investors fear that strong economic growth will lead to inflation. But first quarter 2014 Gross Domestic Product showed that our economy "grew" at an annualized pace of -1%, the first negative quarter in over two years. Market participants understand that this is in part due to an unusually cold and snowy winter. Still, participants are disappointed. If a $17 trillion economy can be brought to its knees because half of the country experienced an unusually harsh winter, it's not as robust an economy as one might expect. Further, participants are rightly confused by the "it's the weather" story. Research indicates that we've not had a weather-induced recession since the 1800s. That's not to say that we have not had a negative GDP quarter due to weather, just not a recession.



Market participants are smart enough to know that harsh weather can also *add to* economic numbers. That's the story that industrial production is telling us. We barely saw a blip in this statistic this winter because what was lost in manufacturing was offset by increased utility usage.

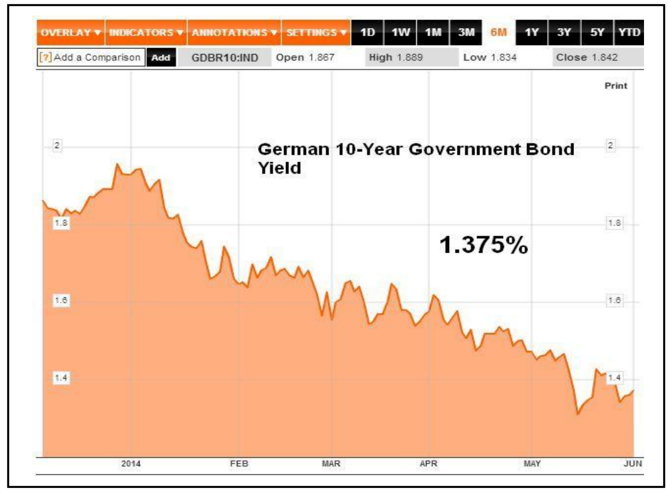
The bottom line is that GDP has been weak in 2014 and we're not setting records in industrial production. Our economy is probably not imploding as GDP might indicate, but we're not going gangbusters either and the growth rate in industrial production confirms slow, but positive, economic growth. The bond market knows the economy has not lit the world on fire. Until economic growth shows sustainable gains, we cannot legitimately expect bond yields to go up out of fear that such growth is a threat to our current low-inflation environment.

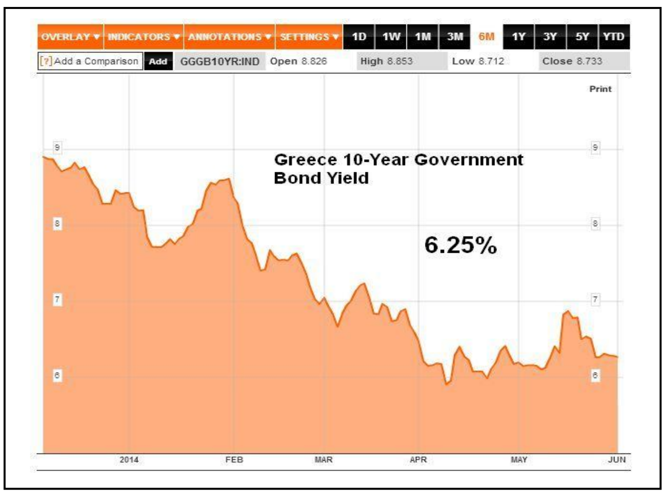
For more detail on both global and US economic releases, subscribe to *The Capitalist Pigs Podcast*. You can do this by going to www.thecapitalistpigs.com and hit the "Podcast" tab. Or you can find us on Apple iTunes. Either way, you'll get a detailed analysis of what releases came out for the week and what it means to investors. To be fully informed as to what's going on in the markets, you've got to know what's going on in the economy.

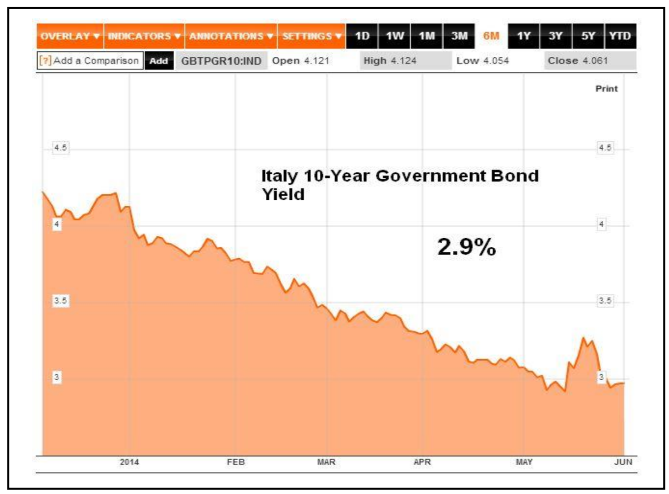
The Most Sound Explanation

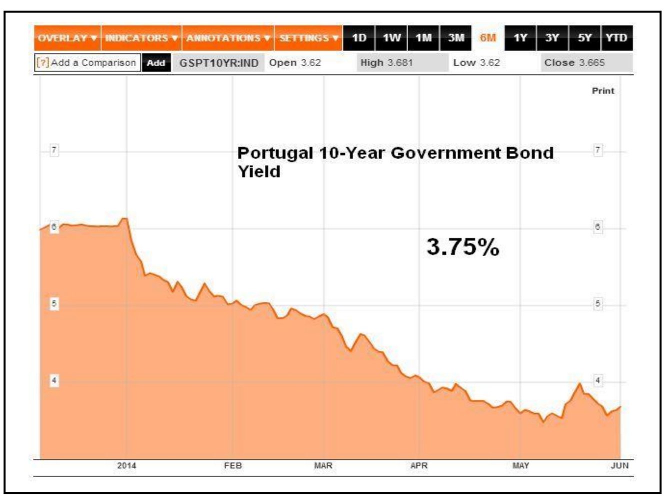
US bonds are not issued in a vacuum. They have competition. Not only do US corporate bonds compete for investor dollars against each other, they also compete against Treasury bonds. And, both US corporate bonds and US Treasury securities compete against similar bonds issued in foreign countries.

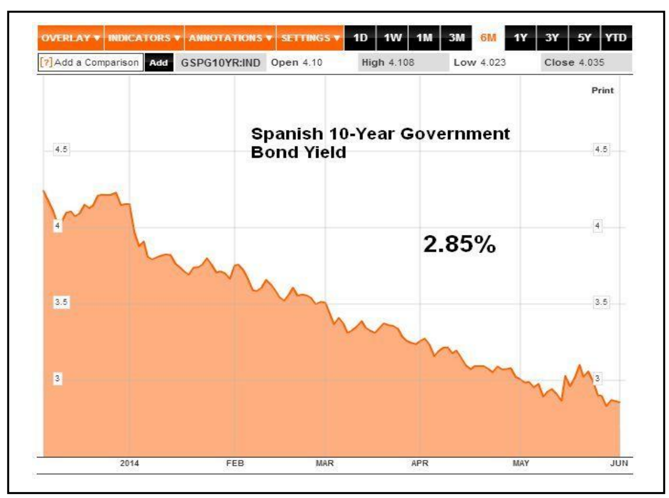
It pays to understand what's going on with European bonds if we hope to understand what's going on in the US bond market. Deflation has been a serious concern for the European Central Bank (ECB) for months. You may be thinking, "I thought things were great in Europe. If their economies are growing, shouldn't they be seeing inflation - not deflation?" And that would be a good question. The answer is that the whole "Europe-is-improving" story is a little old. It reflects the first three quarters of 2013 and not so much the last eight months. So, that means that European bonds are reflecting the weakness in their economies. Consider the following charts of European government 10-year bonds.





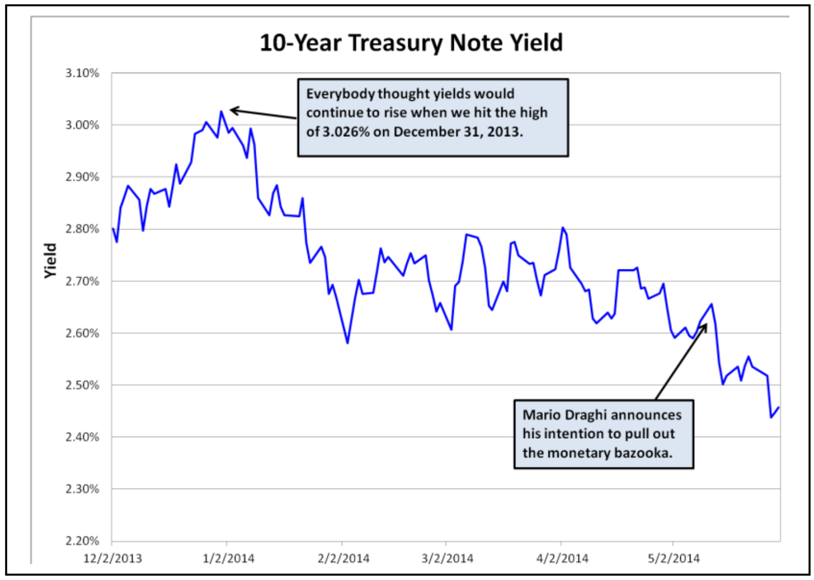






On May 8, Mario Draghi, the head of the ECB, essentially promised to announce a quantitative easing program for Europe at the bank's June meeting in an effort to spark inflation. Just like the US central bank, the ECB erroneous associates inflation with economic growth. They want inflation. Immediately after Draghi's promise of lower interest rates and QE, European yields dropped even more.

If Spain's 10-year bond is yielding 2.85%, should US Treasury bonds yield 3%? That would imply the US is a worse credit risk than Spain. Even though the US fiscal position is not as sound as it once was, it's still better than Spain's. To see US yields higher than Spain's would be absurd. Therefore, US yields, soon after Draghi's statement, appeared to be a value and they were bought, bringing yields down below the lower end of their recent range, as the chart to the right indicates. US government bonds compete against European bonds. US bonds were bought as Spanish and Portuguese bonds were sold to get the relative yields to better reflect relative credit risks.



What to Expect

Much has been written on what to expect from Draghi in June. If he fails to deliver on his promise, or more accurately, if that's the perception, yields can reverse and go back up. This seems to be the most likely scenario. It would simply be too difficult to cobble together a meaningfully loose monetary plan in such a short period of time. In fact, the last 7 or 8 trading days have seen a firming of interest rates based on a growing suspicion that Draghi will not utilize a monetary bazooka, but will instead stick to a more conservative approach. Incidentally, if Draghi fails to deliver a massive QE plan, we may see a little weakness in global stocks as well.

US investors and consumers should be concerned with inflation. That is the most sustainable and effective source of rising interest rates. We should watch the Future Inflation Gauge, which is firming up, but not a serious concern. And we should watch wages and salaries in the US. If and when we start to see gains being made in wages and salaries, it's time to watch very closely for signs of inflation. At that time, we can be more confident that yields rise, bond prices fall and interest rates economy-wide start bleeding upward.

One final caveat: we still haven't seen the impact of the Fed's tapering QE here in the US, as mentioned above. That's likely to change very soon. We could very easily see yields creep up in that scenario as a lack of liquidity starts to become visible to market participants. However, for that up-move to be sustainable, we'll need to see inflation rates increase in CPI and PPI. That will not likely occur with wage growth numbers where they're at today. If yields jump too much due to tapering QE, it will likely choke off economic growth. It's hard to imagine a scenario where yields on the 10-year Treasury hit 4% in 2014 without leading to a recession. Rising interest rates are the best way to reveal all the misallocated capital in the economy. Our guess is there's quite a bit of misallocated capital out there that needs to be revealed. Once misallocated capital is revealed to market participants, a recession ensues. We're not saying a recession is imminent. Our point is that it's paradoxical that if rates rise too much, revealing all the malinvestment that has occurred due to quantitative easing, a recession ensues, ***which then forces yields to plummet once again***.

If tapering starts to meaningfully impact liquidity, and Draghi's monetary policy disappoints, yields will almost certainly rise. But it will not likely be sustainable. If anything, we run the risk of having yields jump so much, it chokes off economic growth resulting in lower yields. If Draghi's monetary policy is actually a bazooka, it may offset the impact of the Fed tapering its QE program. In that case, we may see a muted reaction in yields, or even lower yields, in the US for the foreseeable future.

This is our new reality. Yields are reacting more to central bank action than economic fundamentals. Central bank intervention is likely here to stay, until it can be proven that such policies hurt more than help.

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