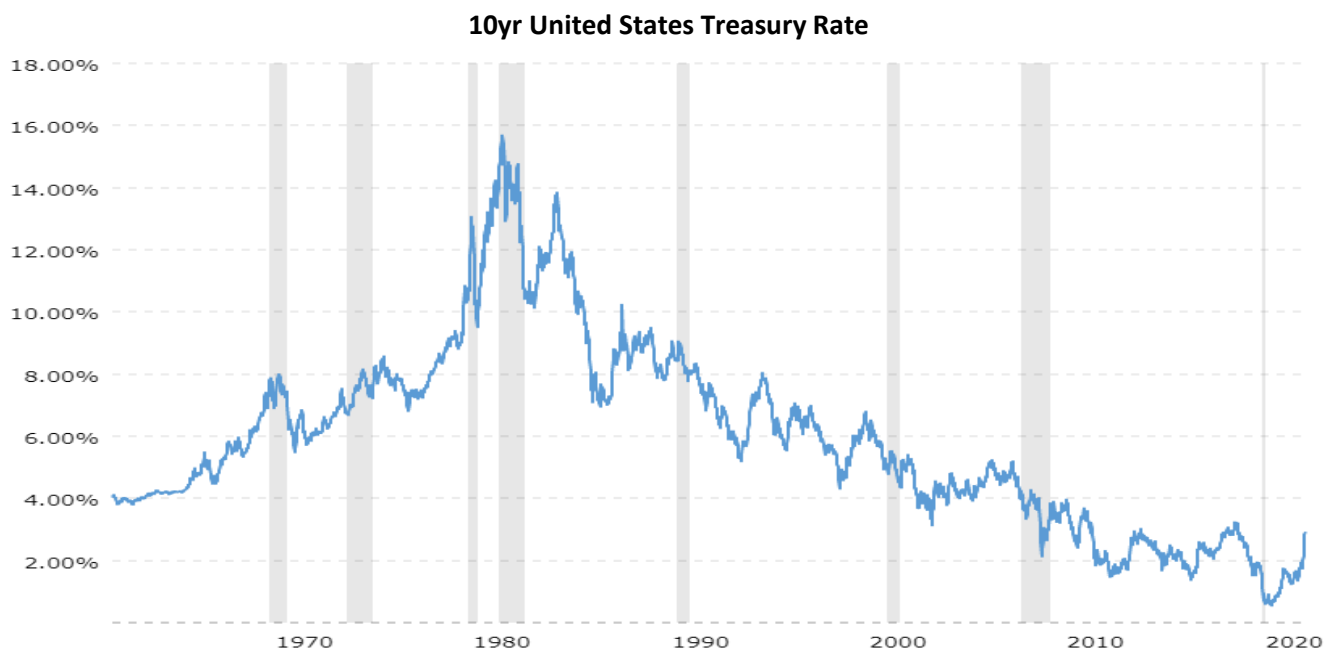


Is Interest FINALLY Interesting??

The price of money, more commonly referred to as the interest rate, has experienced a significant amount of volatility recently. This bout of volatility comes on the heels of 40yrs of falling interest rates. In fact, most investors today have spent their entire investing career operating against the backdrop of falling rates. That backdrop is shifting as the price of money appears to be making a trend-change that, if sustained, will have a meaningful impact on the performance of risk assets globally. One question we hear frequently from investors is at what point will interest-bearing assets provide an attractive level of current income? Frankly, it's a question we contemplate regularly and wanted to address in more detail to provide a framework we hope you will find helpful.



Source: <https://www.Macrotrends.net>

What is money 'worth'?

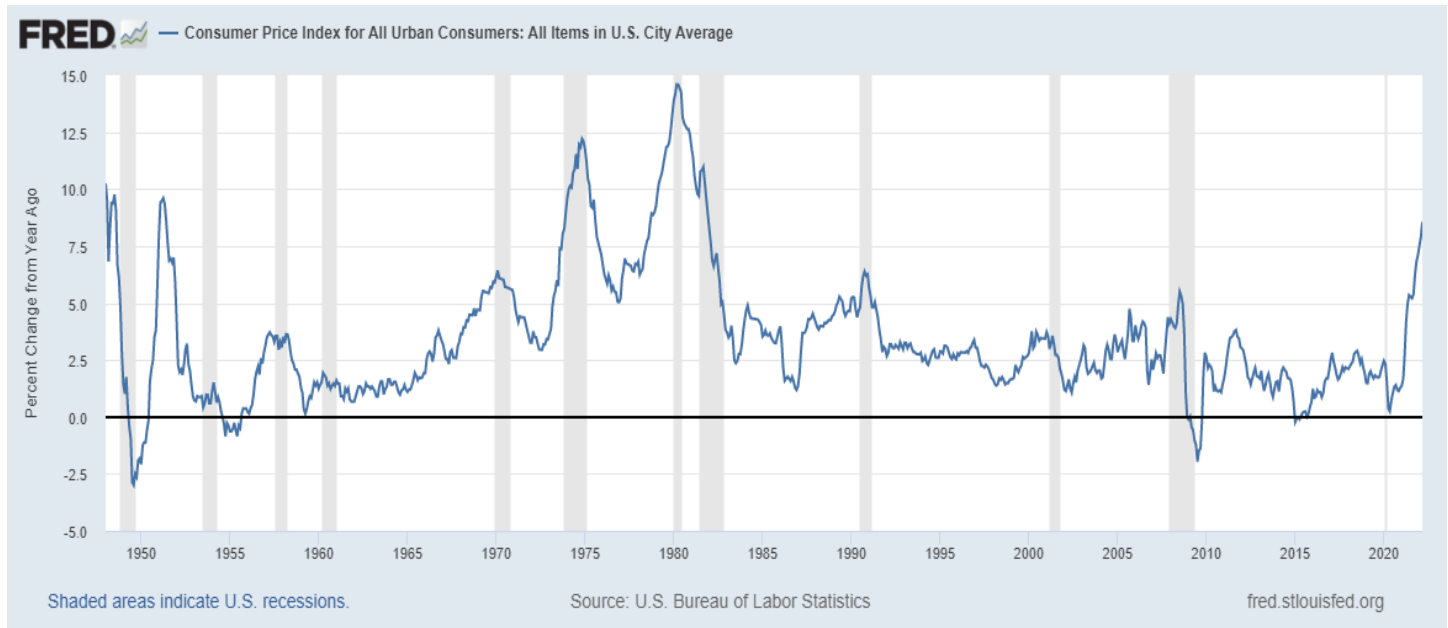
"The chief value of money lies in the fact that one lives in a world in which it is overestimated." H.L. Mencken

For such a seemingly simple concept, the value of money has become something of a curiosity. In 1999, the Bank of Japan moved to a zero interest rate policy to combat deflation, effectively ushering in an era of 'free money'. Not to be outdone, in response to the eurozone crisis, the European Central Bank adopted a negative interest rate policy in 2014, upending the basic understanding of what it meant to be a lender of capital. Imagine being a borrower from Jyske Bank, Denmark's third-largest lender, and being offered a 10yr loan with a -0.50% annual rate¹. You read that right; the borrower was PAID to borrow money for ten years.

As the last decade came to a close, in part as a response to the low level of interest rates, unorthodox monetary theories previously relegated to harmless debate in academic circles began to circulate among political elites. One of the more

popular concepts came to be known as Modern Monetary Theory (MMT) which espoused a belief that governments that issue fiat currency could spend in excess of receipts (taxes or debt issuance) with the only limitation being inflation. Of course, at the time, there was very little inflation which emboldened proponents of the theory to support very liberal fiscal spending policies. In June of 2020, “The Deficit Myth” written by Stephanie Kelton became a New York Times bestseller as MMT went ‘mainstream’.

Proponents of orthodox macroeconomic theory and those with a modicum of common sense are likely unsurprised by what has ensued since. As shown below, due in part to a prodigious amount of monetary and fiscal stimulusⁱⁱ offered in response to the COVID-19 pandemic, inflation has accelerated dramatically.



As the chart above from the St. Louis Federal Reserve shows, inflation is at levels not seen since the 1970’s. In response, the United States Central Bank has begun the process of ‘making money valuable again’ by raising the Fed Funds rate twice to-date to a current range of 0.75% - 1.00%. Current consensus expectations (median) are for two more 50 basis point (bp) increases this summer and several additional 25bp increases in the Fall and Winter resulting in a Fed Funds rate of 2.25% - 2.50% by years endⁱⁱⁱ. These policy adjustments to combat high inflation and ‘normalize’ interest rate policy are significant contributors to the pervasive volatility experienced by risk assets in 2022.

How much is enough?

“The four most expensive words in the English language are, ‘This time it’s different’.” Sir John Templeton

As you are probably well aware, investors in bonds have had a rude awakening to the punitive impact of rising interest rates on fixed income securities. Coming into this year, the taxable bond market had produced a positive total return in 42 of the previous 46 years (1976 through 2021). However, year-to-date (through May 5th), the taxable bond market is down 10.1%, which puts it on track for its worst return in history^{iv}. Rising interest rates, inflation and widening credit spreads are deadly for real returns in fixed income securities.

However, as interest rates rise, the yield on fixed income instruments becomes more enticing for investors looking for current income. At what point are yields ‘high enough’ to allocate more assets toward fixed income instruments? While the answer to that question is heavily influenced by your personal financial situation, some historical perspective is helpful in providing a framework to discern the difference between ‘better’ and ‘enough’ as it relates to yields. As you contemplate your allocation strategy, we want to offer a few historical datapoints to inform your analysis.

Last September, Deutsche Bank published a report^v that highlighted the nominal and real returns of a variety of asset classes over the last 100 years through July 31, 2021. The following data was pulled from their research.

	Annualized Nominal Return	Annualized Real Return
Equity	10.7%	7.7%
Corporate Bonds	6.2%	3.3%
10yr United States Treasury	5.1%	2.3%

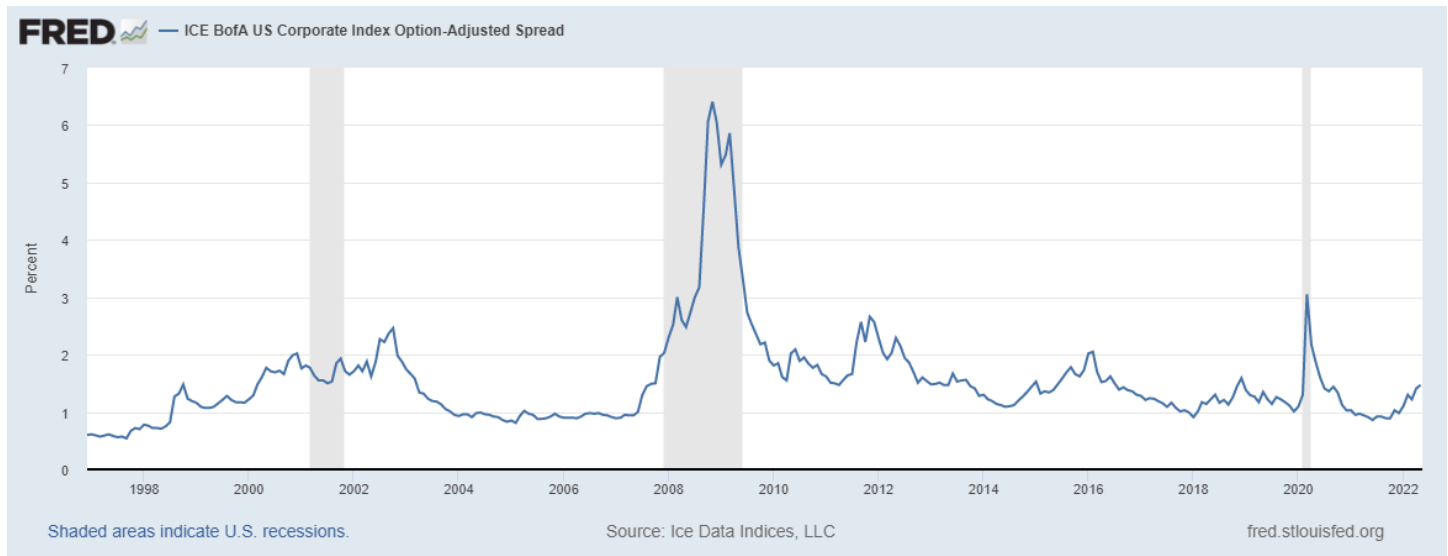
This data is helpful in establishing a baseline for ‘how much is enough’. As previously discussed, consensus expectations call for the Federal Reserve to increase the Fed Funds rate to a level of 2.50% by the end of the current calendar year. Over the last 40 years, the ‘spread relationship’ of Fed Funds to the 10yr United States Treasury has averaged approximately 200bp’s (equivalent to 2.0%) as shown in the chart below.



To discern the attractiveness of lending money to the United States government for ten years, if the current consensus is accurate, a 10yr Treasury bond would be considered fairly valued if it paid a 4.5% coupon (2.5% Fed funds rate plus 200 basis points of curve premium). As a secondary ‘sanity check’, if the Fed is successful in managing inflation down to its long-term target of 2.0%, in order to produce a real return that is in line with the 100yr average, nominal yields on 10yr Treasury bonds need to be in excess of 4.3% (2.3% annualized real return plus 2.0% inflation). The coupon on a 10yr Treasury Bond has ranged from a yield of ~2.80% to ~3.20% in the month of May to-date.

Secondarily, as investors consider the attractiveness of investing in corporate credit, we use the same logic and historical precedents. Over the last 40 years, investment grade corporate credit spreads have averaged approximately 120bps as

shown in the chart below. Using the previous ‘target’ yield on a 10yr Treasury bond, we can calculate the corresponding required coupon to incent investors to lend money to an Investment Grade rated corporation.



To discern the attractiveness of lending money to investment grade corporate borrowers for ten years, taking the ‘fair value’ of the 10yr Treasury coupon calculated earlier and adding the average ‘credit spread’ would give you a target coupon of 5.7% (4.5% 10yr United States Treasury coupon plus 120bps of credit spread). As a secondary ‘sanity check’, if the Fed is successful in managing inflation down to its long-term target of 2.0%, in order to produce a real return that is in line with the 100yr average, nominal yields on investment grade rated corporate bonds with a 10 year maturity would need to be in excess of 5.3% (3.3% annualized real return plus 2.0% inflation). As of this writing, BBB-rated, 10yr bonds on average yield ~4.80%^{vi}.

Asset Allocation implications

“The function of economic forecasting is to make astrology look respectable.” John Kenneth Galbraith

As Galbraith humorously points out, the future is inherently unknown and unknowable. However, history is a helpful tool as we survey the investment landscape to find attractive opportunities to protect and grow the assets we manage. Based on the analysis in this paper, the risk/reward offered by fixed income securities today looks fair by historical standards. Interestingly, the fixed income markets appear to price in the inherent assumption that the Federal Reserve will be successful in engineering a decline in inflation to their long-term target of 2.0%. While we find the current yields of fixed income instruments to be at levels that finally merit some interest, they are not yet at a level that would inspire us to make a wholesale shift in allocation.

Matthew A. Hekman, Portfolio Manager
Waterfront Balanced & Waterfront Equity strategies

Definitions:

Fiat currency: a government-issued currency that is not backed by a physical commodity but rather by the issuing government.

Nominal Interest Rate: The interest rate before taking inflation into account.

Real Interest Rate: An interest rate adjusted for inflation, reflecting the inflation-adjusted yield to the lender.

Disclosures:

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^{i i} Smith, K.A. (2020). Negative Interest Rates Explained: How They Could Affect You. Forbes, May 18, 2020.

<https://www.forbes.com/sites/advisor/2020/05/18/negative-interest-rates-explained-how-could-they-affect-you/?sh=1e9092de7b46>

ⁱⁱ Jordá, Liu, Nechio & Rivera-Reyes (2022). Why Is U.S. Inflation Higher than in Other Countries?. Federal Reserve Bank of San Francisco, 2022-07. <https://www.frbsf.org/economic-research/publications/economic-letter/2022/march/why-is-us-inflation-higher-than-in-other-countries>

ⁱⁱⁱ Bloomberg. Survey of 48 economists conducted April 22, 2022 – April 27, 2022

^{iv} Bloomberg. Bloomberg US Aggregate Bond Index

^v Reid, Allen & Templeman (2021). Long Term Asset Return Study. Deutsche Bank, September 13, 2021.

^{vi} Bloomberg. Bloomberg USD US Corporate IG-rated 10yr tenor using Mid Yield to Convention