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Bonds Are Not Protecting You From Inflation

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We're all familiar with the phrase "this time is different." This generally describes a case being made that something has changed which makes the current or future environment noticeably different than the past. The notion is scoffed at as a foolish belief that causes investors to make the same mistakes time and time again. Legendary investor John Templeton notably described the phrase as "*the four most costly words in the annals of investing*."

We would counter this argument with another phrase: "*something is always different*." Every economic and market cycle will have numerous similarities to past cycles. At the same time, no two cycles will be identical and *something will always be different*.

This economic cycle is coming from a prolonged period of extraordinary Federal Reserve interest rate intervention, both on the short and long end of the treasury curve. The markets are focused on a huge increase in the Fed Funds Rate from zero to 5.5% in a relatively short timeframe. Yet, with core CPI running at 4.7% (12-month rate for July), Fed Funds are yielding less than 100 basis points over core inflation. This is not extraordinarily restrictive. It is in fact close to where it should be.

Longer term treasury yields have moved up from the intervention-driven lows of recent years, but the 10-Year treasury yield of 4.25% (as of 8/25) is still below the current core rate of inflation. The "normal" inflation-adjusted yield of longer treasuries should be around 2%. It may be there now if inflation comes down relatively soon to approximately 2%. If that outlook proves too optimistic, the 2% real yield will not be achieved.

With real treasury yields only modestly positive on the short end and below current core inflation on the longer end, along with fiscal policy running huge deficits, the economy is growing. The GDPNow model from the Atlanta Fed currently projects current quarter real growth of 5.9% (as of 8/24). This contrasts with the forecasts of business economists for the third quarter averaging around 1.9%, with some still projecting economic contraction for the quarter. The tempo of the economy is strong.

While "disinflation" seems fairly well established, it may take years to achieve a 2% inflation goal. This suggests short term rates remaining higher for longer, investors in floating rate debt instruments doing better than investors in longer term fixed securities, and equity investors doing better than bond investors.

Convertible Bonds are particularly attractive for investors seeking returns greater than inflation with protection of principal. The equity optionality of convertible bonds provides investors with the inflation pass-through power that companies have through pricing flexibility. For investors seeking the benefits of convertible bonds with less volatility, convertible arbitrage is a strategy to consider. In addition to convertibles, alternative strategies functioning as bond substitutes deserve serious consideration.

We recognize the potential for a wide range of outcomes going forward, including economic contraction induced by central bank policy. At this juncture, however, we suggest investors position portfolios for higher rates of inflation lasting longer and focus on investments able to provide a meaningful real rate of return after inflation.

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