INVESTMENT UPDATE NEWSLETTER

ALLEN TRUST COMPANY

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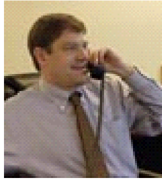


William A. Harris, CFA
Portfolio Manager

On Milestones and Grindstones

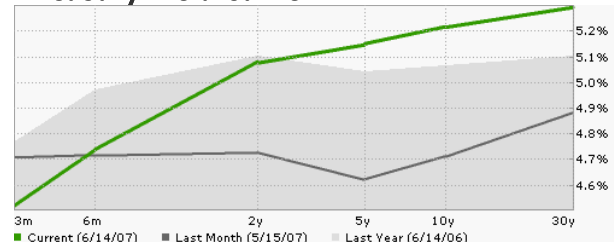
You may have heard trumpets last month when the S&P 500 joined the Dow Industrials in record territory, finally surpassing the all-time high it set back in March 2000. There was cheering aplenty, though the occasion points up a sobering reality as well: shorn of its dividends, the popular stock market benchmark returned *less than zero* over a seven year period, and even now the tech-heavy NASDAQ retains but the husk of its bubble era majesty.

All of which just goes to show a few things: 1) though U.S. equity investors have on average and over very long periods been handsomely rewarded for risking their capital (earning a 5% annualized premium to government bonds from 1926-2006), there can be long periods when share prices deliver them nothing; 2) while the stock market gains of recent years have been episodically breathtaking, they represent ground lost and recaptured rather than won anew; and 3) dividends should NOT be regarded as mere ornamentation, stodgy and purposeless to all but cantankerous fuddy-duddies (e.g. yours truly).

Just as 1,527.46 on the S&P 500 served last month as a milestone for the financial press to hang their headlines on, so too has a 5.00% 10-year Treasury yield served this month as a threshold for similar melodramatization.

The graph at the top of the right column shows a 50bp jump in the benchmark 10-year Treasury yield in just a month (and a month absent Fed action, no less). When it punched through 5.00%, media commentators hollered, the stock market shuddered, and on an overnight basis it quickly shot as high as 5.32%. Perhaps more interesting than the 10-year's crossing an arbitrary demarcation line (which indeed it had already crossed a year ago, albeit temporarily) is how the yield curve's shape across maturities has changed. It has normalized to an upward slope, and more distant maturities again offer higher coupons.

Treasury Yield Curve



Source: TD Ameritrade Institutional

This makes a difference in part because it reintroduces the potential for a temporal carry trade (the interest margin earned between shorter and longer rates), a primary profit motivation for lenders traditionally and thus part of the bedrock of capitalism. It also serves as a signaling device blinking out the message that the economy is proving stronger than had been expected and inflation ain't dead (we never thought it was!). More to the point – and on the practical level, for us – it makes buying longer dated maturities less uncomfortable than it was a few months ago.

If the curve continues to steepen, however, and longer rates keep rising, the bond market throws down a gauntlet to stock investors. Obviously, higher bond coupons will vie for dollars which might otherwise be invested to equities, but there are two additional and potentially undermining factors to consider, on Wall Street and Main Street alike. Higher interest rates could throw cold water on M&A activity already underwritten by schlocky loan structures (a phenomenon to which I believe we can attribute a goodly part of this year's stock market gains); and higher rates will compound the challenge to U.S. consumers who have been helping drive recent all-time record profit margins.

On this last point, a final milestone bears noting. The Mortgage Bankers Association reports that the rate at which loans are entering foreclosure has hit new records for the last two quarters. Maybe that will prove to be just an especially bad vintage of subprime unwinding. But to the U.S. workers on whose indefatigable spending hangs the fate of so much stock market capitalization, it won't be the milestones that matter so much as how close they can keep to the grindstone.

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