Alley Company Quarterly Letter
Déjà Vu?

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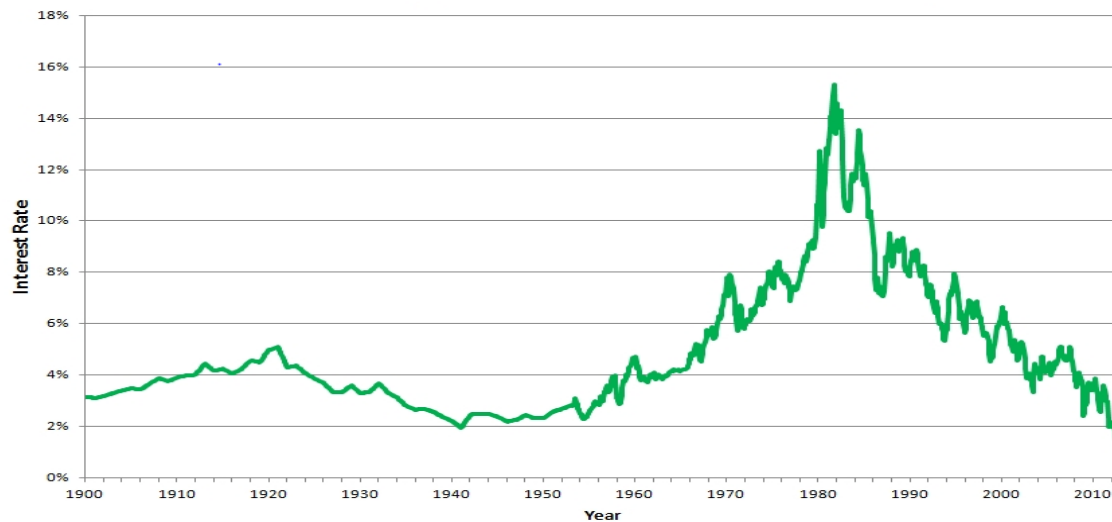
"History does not repeat itself, but it often rhymes"- attributed to Mark Twain

Today's low interest rate environment in the US is seemingly spoken about as if it were a complete anomaly in America's financial history. A closer examination of historical interest rates suggests that we have been here before. Between 1935 and 1955, the yield on the ten year US Treasury bond stayed consistently under 3.00%. In fact, in the early 1940s US policymakers put interest rate "controls" into place in order to allow the US economy to recover from the Great Depression and to manage the debt that was taken on to fight World War II.[1] These interest rate controls were not all that dissimilar to recent Federal Reserve policy of helping to keep interest rates low to foster a much needed economic healing process in the aftermath of the 2008-2009 financial crisis. A natural question during these periods of low interest rates is, "When will interest rates trend back to more normal levels and won't this adjustment be negative for stocks?"

US 10 Year Treasury Bond Interest Rate History



Source: www.observationsandnotes.blogspot.com and U.S. Department of the Treasury

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In looking at the chart on the preceding page, it is hard to readily conclude what is normal, but since 1900 the average ten year bond yield has been 4.7%.[2] The high inflation periods, specifically the late 1970s to early 1980s, offered interest rates that were significantly above average. Conversely, during periods where inflation was benign to outright deflationary, interest rates were substantially below average as seen during the 1940s and 1950s as well as the recent time period.

From the low point in interest rates of the early 1940s, it took nearly twenty years for the ten year US Treasury bond to reach the long-term average interest rate level of 4.7%. We have long argued that given the severity of the Great Recession, a muted but sustainable recovery was the most likely economic course in the ensuing years. In that context and the aforementioned historical experience, it is conceivable that interest rates could be *lower for longer* than most investors are anticipating.

A widely held view is that interest rates are on the verge of rising back to what might be considered more normal levels and that stocks will be negatively impacted. Intuitively, higher interest rates would be a competing force for investment capital and make the proposition of owning bonds more appealing relative to stocks. However, when we look back at the interest rate normalization process that occurred during 1941-1960, the annualized total return of the S&P 500 was a very attractive 14.50%. The annualized return for the ten year U. S. Treasury bond was just 1.93% during the same period.[3]

One could argue that this previous period of strong equity returns was driven by favorable fundamentals, including the "Suburbanization of America," as well as significant infrastructure projects in the US that enabled solid GDP growth. Today, we are in the midst of a high technology renaissance period for America that could be equally powerful in its long-term impact for our economy.

The advances that are being made in technology are improving productivity and the flow of information for individuals and companies in unprecedented fashion. What's more, the pace of innovation is quickening. From virtually any location in the world, one can access a multitude of information from a Google search on a mobile phone. Cloud computing is allowing us to store data more efficiently and our ability to parse that data and make intelligent business decisions appears to be growing every day. Hydraulic fracking technology is driving energy prices lower and leading us to energy independence. On the health technology front, we have made enormous strides in treating many cancers in recent years and we seem to be on the cusp of advances in the treatment of Alzheimer's, multiple sclerosis, and heart disease. Recent economic statistics suggest that productivity growth has been sluggish, but these computations appear to be outdated as the benefits of information technology may be difficult to measure in traditional ways.

History does not repeat itself exactly, but it can provide an excellent guidepost for what the future might hold. Fixed income investments are generally not priced for significant returns, but this asset class does play an important role for its ability to dampen overall market volatility. In time, interest rates will likely rise as the US economy continues to heal, but the process of interest rate normalization, as history shows, can be lengthy and should not be feared by equity investors. A sustainably improving economy coupled with low and modestly rising interest rates can be a powerful backdrop for positive equity returns.

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[1] Mark Toma, "Interest Rate Controls: The United States in the 1940s", The Journal of Economic History, Vol. 52, No. 3, September 1992, pp. 631-650.

[2] Average 10 Year US Bond Interest Rate was calculated by taking the January 1st Interest Rate for each year and then calculating the average from those figures.

[3] Annual return figures were taken from Aswath Damodaran's "Historical Returns of Stocks, Treasury Bonds, and T-Bills: 1928-2014", New York University.

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