Alley Company Quarterly Letter
Two Percent

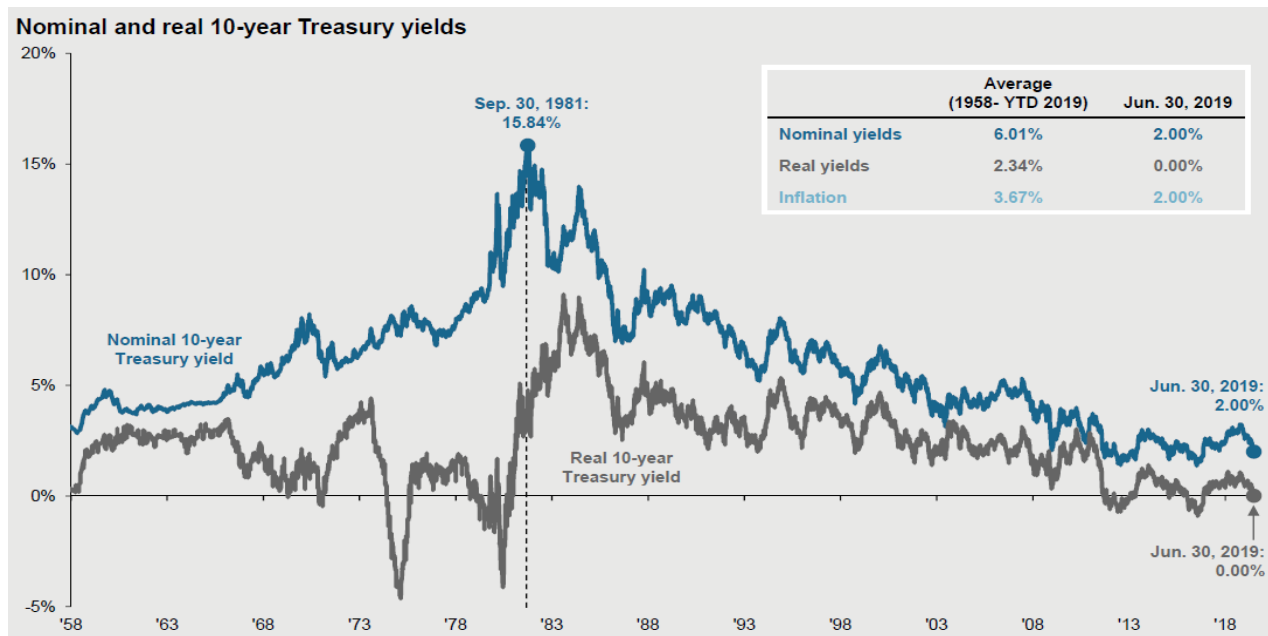
July 11, 2019

It is remarkable that the ten-year U.S. Treasury bond is now yielding 2%, back to near the lowest levels in recorded history. We have long posited that interest rates could stay "*lower for longer*," but ten years into a solid economic expansion and with the unemployment rate near record lows, "two percent" is indeed noteworthy.

Inflation, which has been in the range of 1.5 to 2.0% for most of the past decade, is technically the most important determinant of the level of long-term interest rates (see exhibit below[1]) and has been a major contributor to the lower for longer interest rate regime we are experiencing. There are a number of reasons why inflation has remained so low during the past ten years, all of which have served to keep interest rates low. The following are a few examples:

- Technological innovation that has increased competition for goods and services globally
- Slowing population growth in the U.S.
- Anemic growth in developed economies outside the U.S., where some major economies such as Germany and Japan have long-term interest rates that are actually *negative*
- Consumers living within their means post the Great Recession
- Increased regulation of the U.S. financial and banking system which has helped to rein in risky lending practices

Interest Rates and Inflation



	Average (1958- YTD 2019)	Jun. 30, 2019
Nominal yields	6.01%	2.00%
Real yields	2.34%	0.00%
Inflation	3.67%	2.00%

Source: JP Morgan Guide to the Markets

Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

Today, with the ten-year Treasury bond yielding 2% and down from a recent high of 3.25%, the bond market is signaling an economic slowdown and continued low inflation. Meanwhile, the stock market, having recovered all of the 20% correction that occurred in the fourth quarter of 2018, is feeling content with a supportive Federal Reserve and is betting that the trade war with China will end in the not-too-distant future in part due to the upcoming election in the U.S. Whatever the outcome of this dichotomy, "two percent" has important investment implications.

In the world of fixed income, investors should think of themselves as lenders. For the lender/fixed income investor, two percent represents a challenging level in which to earn a satisfactory return, especially after consideration of inflation and taxes. In fact, as the prior exhibit depicts, at the current inflation rate of 2%, the "real rate" on the ten-year U.S. Treasury bond is 0%. As a result, investing in fixed-income securities at current yields is more about managing one's overall risk profile and protecting capital than it is about generating returns that will grow wealth or even maintain purchasing power for the long haul.

In the world of equities, investors should think of themselves as business owners. For the business owner/equity investor, two percent represents an attractive financing environment and a historically low discount rate. Businesses are theoretically more valuable when future cash flows are discounted back to the present at a lower interest rate. However, it is critical that the economy or company in question is fundamentally sound and growing over time. Interest rates in Japan, for example, have been trading between zero and two percent for over twenty years, but given a stagnant economy, equity returns have underperformed for most of this time period. So assuming that the U.S. economy continues on sound footing and companies continue to have attractive growth prospects, two percent is likely to be good for equities.

Another way to look at the investment landscape is through the lens of valuation. The S&P 500 is currently trading at about 16.5x forward earnings (an average valuation historically) while the ten-year U.S. Treasury bond is trading at 50x "earnings" if the analysis is done taking the reciprocal of the 2% yield. This relationship underscores a distinct valuation gap favoring equities over bonds, which is particularly noteworthy if the U.S. economy continues to grow.

"Two percent" is indeed remarkable in an economy that seems to be chugging along steadily. Economic expansions and bull markets generally do not die of old age. They are almost always sabotaged by restrictive monetary policy. The Federal Reserve is unquestionably in an accommodative mode to support further economic growth. The bond market could be signaling a slowdown in the economy and ten percent corrections in the stock market come and go regularly, but our feeling is that "two percent" will end up favoring stocks for the long pull.

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[1] The graph plots the nominal ten-year Treasury yield and the real ten-year Treasury yield. The difference between the two is the rate of inflation. During the past decade, real yields have come down significantly and have hovered around 0% for the past seven years.