October 4, 2022

Dear Clients and Friends:

The term "bond vigilantes" was coined in July 1983 by Ed Yardeni, then the chief economist at Prudential-Bache Securities. Bond investors were on edge about the prospect of high inflation returning, after the Paul Volcker-led Federal Reserve (Fed) had so recently vanquished it. In hindsight, these fears likely indicated a fair amount of PTSD, but there were also legitimate concerns. The effective federal funds rate had fallen precipitously from 20% in mid-1981 to 8.5% by early 1983 (yes, somehow an 8.5% policy rate seemed loose in those heady days). Federal budget deficits were also on the rise due to the adoption of supply-side Reaganomics, with the deficit-to-GDP ratio hitting 5.7% in 1983 after averaging 2.4% during the previous 10-year period. Mr. Yardeni summed things up nicely: "So if the fiscal and monetary authorities won't regulate the economy, the bond investors will. The economy will be run by vigilantes in the credit markets."

Thus began the era of the bond vigilantes, who policed sovereign debt markets and kept countries from pursuing profligate policies, lest they face the consequences of higher yields and escalating debt-servicing costs. The bond vigilantes exerted their influence over the balance of the 1980s and the 1990s, perhaps reaching a zenith in 1993-94. U.S. federal deficits had begun to creep higher again in the early 1990s, which, among other factors, led to a nearly 300 bps increase in the 10-year U.S. Treasury yield from October 1993 to November 1994. Political gadfly James Carville, at the time an advisor to President Clinton, quipped: "I used to think that if there was reincarnation, I wanted to come back as the President or the Pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."

The Clinton administration and Congress subsequently reduced the federal deficit and, aided by a period of strong growth, managed to achieve federal budget surpluses in 1998-2001. By October 1998, the 10-year U.S. Treasury yield had fallen to 4.2%, down from the 8% peak in the 1994 "bond market massacre." The fiscal situation in the U.S. had become so rosy, in fact, that then-Chair Alan Greenspan made the following statement to the Senate Budget Committee on January 25, 2001: "The most recent [Congressional Budget Office] projections, granted their tentativeness, nonetheless make clear that the highly desirable goal of paying off the federal debt is in reach before the end of the decade." Those projections proved tentative indeed, as U.S. federal debt held by the public eclipsed $9 trillion by the end of 2010 and currently stands at $24 trillion. Notwithstanding this explosion in federal debt outstanding, the bond vigilantes went into hibernation, stultified into a two-decade long torpor by persistently low inflation, zero interest rate policy, and quantitative easing (QE).

They seem to have finally awakened, however, as evidenced by the recent moves in the U.K. rates market. In early September, Liz Truss, the new prime minister and leader of the Conservative Party, introduced a plan to cap gas and electricity rates for two years. More recently, Chancellor of the Exchequer Kwasi Kwarteng proposed a plan to boost growth by cutting taxes, without any offsetting reduction in outlays. As Mark Twain is often reputed to have said, "History doesn't repeat itself, but it often rhymes." These two policy measures will require tens of billions, if not hundreds, in additional deficit spending and debt issuance over the next several years. All of this while the Bank of England (BOE) is hiking rates and set to begin quantitative tightening in order to rein in domestic inflation that has hit 10%. The Gilts market and the British pound reacted quite rationally, selling off sharply as investors punished the U.K. for pursuing a set of fiscal policies that are – being as neutral as possible here – very unfriendly to bond investors.

The move higher in rates was exacerbated by a doom loop of margin calls, rumored to be U.K. pension plans implementing highly levered LDI programs. This final destabilizing component ultimately prompted the BOE to intervene and pledge to purchase an unlimited quantity of long-dated Gilts until market order had been restored. This strange brew of shifting fiscal and monetary policies caused what can only be described as breathtaking volatility in U.K. rates. The 30-year Gilt yield, for example, rose 140 basis points (bps) from September 21 to September 27 and declined 106 bps the day the BOE intervened, which is something like a 16 standard deviation event. So James Carville got it *almost* right. Central banks with an unlimited QE checkbook can intimidate everybody. Just ask the bond vigilantes who were short Gilts the morning of September 28.

At all times, but particularly in turbulent times like these, we strive to apply the principle of Occam's razor to our decision-making process. This principle is attributed to the 14th century logician and Franciscan friar William of Ockham, who wrote "Numquam ponenda est pluralitas sine necessitate," or "Plurality must never be posited without necessity." In plain English, when confronted with competing explanations for the same phenomenon, the simplest explanation, the one that makes the fewest assumptions, is likely the correct one. In even plainer English, we like to Keep It Simple Stupid.

Why is inflation problematically high? The Fed and other central banks waited too long to begin tightening monetary policy and, in the U.S. at least, this loose monetary policy was combined with excess fiscal stimulus. *What is the Fed's solution to high inflation?* Keep raising rates and shrinking the balance sheet until enough aggregate demand has been destroyed, but try not to crush the economy in the process. *Will the Fed go too far?* Quite possibly. The Fed governors have been pining for their own Volcker moment the same way that baseball players dream of hitting a game-winning home run in the World Series. *How should investors respond?* Focus on as few variables as possible. Take advantage of elevated risk premia by increasing exposure to cheap assets that have an exceedingly low probability of suffering permanent impairment.

This is precisely what we have been doing on behalf of clients this year, and over the past quarter. Real rates are nearly 300 bps higher than they were at the end of 2021, and are now at levels last seen in early 2010. A majority of the yield curve is inverted, but it will not remain so indefinitely. Credit spreads, in particular high yield spreads, are reasonably attractive on a risk-adjusted basis. Valuations of select non-U.S. dollar assets also appear cheap, although "King Dollar" may not be ready to abdicate the throne just yet. The positioning is therefore straightforward. The specific timing is less certain, although the dénouement of this particular saga appears closer at hand. If heightened volatility persists, however, we retain ample portfolio liquidity and flexibility that we stand ready to deploy on your behalf.

Sincerely,

Mark M. Egan, CFA
Managing Director