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Thoughts From Our CIO

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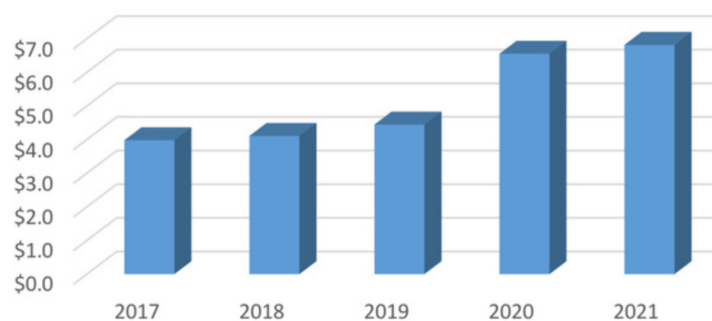
THE BOND BEAR MARKET HAS JUST BEGUN

2021 marked the beginning of what could become the worst bond bear market in 50 years. The Bloomberg Barclay's Aggregate Bond Index, representing $26 trillion in market value, generated a loss of -1.5%. When combined with the loss of purchasing power from inflation, the results are even worse. The CPI inflation rate for 2021 was 7.0%. Combining the loss in the bond index with the loss from inflation, the purchasing power loss, or real return, from an investment in the Aggregate Index was -7.9% in 2021*.

What drove these purchasing power losses for bond investors? The answer is not complicated and it was government policy. First, fiscal policy was the most inflationary in decades. The Covid-19 pandemic triggered a massive increase in Federal spending and the deficit, with Federal Government outlays of $6.8 trillion shown in Chart 1. The annual deficit expanded accordingly to nearly $3 trillion as shown in Chart 2.

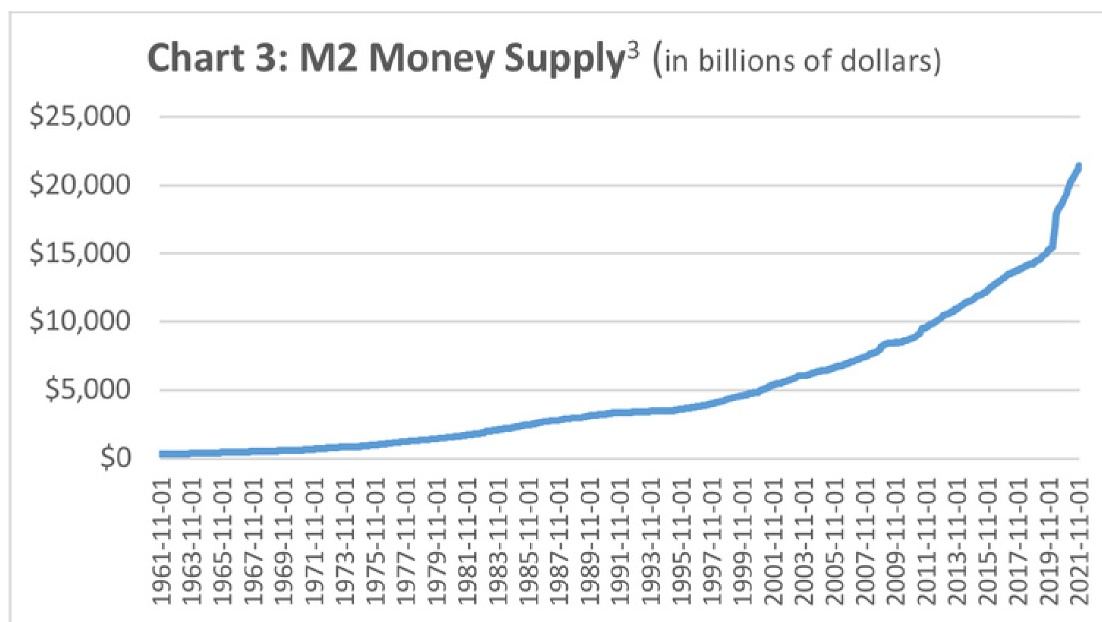


1. Annual periods shown in the graph represent the U.S. Federal Government's fiscal year ended Sept. 30. Source: Congressional Budget Office, U.S. Department of the Treasury

2. Data as of the U.S. Federal Government's fiscal year ended September 30, 2021. Source: Federal Reserve

Secondly, we are in the midst of the most inflationary monetary policy in decades. The media continues to use the word "accommodative" to describe Fed policy. This term can be mistakenly taken as meaning accommodative to economic growth. We argue that "accommodative" instead means policies accommodative to high inflation and can better be described as simply, inflationary. In the last two years the money supply as measured by M2 has expanded 41%, as shown in Chart 3 below:

**Return after inflation or real return is calculated as (1+Index return)/(1 + inflation rate)-1*
Sources: Bloomberg U.S. Aggregate Bond Index, U.S Bureau of Labor Statistics



3. Data through November 1, 2021. Source: Federal Reserve Bank of St. Louis

Third, the Fed's manipulation of interest rates to levels significantly below the prevailing rates of inflation means that considerable time will be required to bring interest rates to a "neutral" level, let alone a restrictive level. Based on current data it could take at least two years to reach "neutral" monetary policy. In our view, this translates into at least two more years of inflationary monetary policy.

Losses in real terms, adjusted for inflation, will build on the 8.2% loss for 2021. Over the next two years these losses could build to cumulative losses of 15-20% in real terms. Making this worse is that these losses are not the kind of "corrections" and pullbacks we typically see in equity markets that are often followed by cyclical recoveries of value. As we said in an earlier piece, purchasing power losses are permanent. Inflation is followed by disinflation, not deflation.

In our opinion, bringing this outlook to asset allocation, a 60/40 equity/bond allocation could be challenged to produce a positive return in real terms after inflation over the coming years. Portfolio structure can be modified to address this but will require sharply reduced allocation to investment grade debt. This in turn means taking on more risk, and the challenge will be to minimize the amount of additional risk taken on.

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