# GOLDILOCKS & THE BIG BOND BEAR: DEFLATIONARY SPIKE RISK INTO 4%

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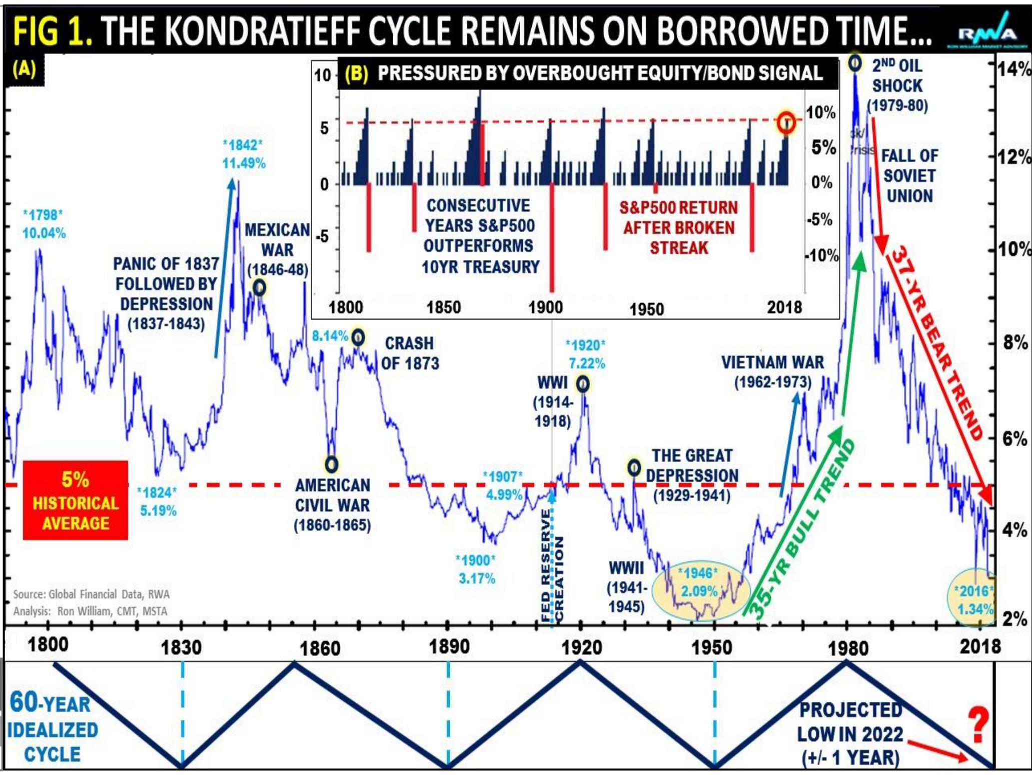


Fig 1. – The Kondratieff cycle as reflected on US 10-year bond yields. Source: Global Financial Data; RW Advisory LTD.



**People often forget the Goldilocks story is a fairy-tale.** In the real-world things do not normally balance perfectly; not too hot, and not too cold. As mainstream experts continue to bet on the so-called Goldilocks economy phenomena, we should be careful about choosing what to learn from children's stories. Remember that in the archetypal story authored by British writer and poet Robert Southey; Goldilocks had to contend with three bears. The baby and middle-sized bear was not too scary, but the big bad [bond] daddy bear caused her to run for her life. **Fairy-tales elevate us to magical kingdoms, far away from our crystalized ivory towers;** but alas, this is not a story that ends with, "and they all lived happily ever after".

The long-term chart of the US 10-year Treasury yield, spanning over 200-years, shows **clear evidence for the Kondratieff wave, marked by an idealized 60-year cycle average** (Fig 1-A). Even so, today's economists would rather believe in the fairy-tale of Goldilocks, than benefit from historical lessons of cycles. Be warned that once markets hit their tipping point, even a trusted linear trend, will no longer be your friend. **A cyclical roadmap is key during volatile and uncertain times.** Harvard professor Dr. Joseph Schumpeter wrote in the 1930s, "The Kondratieff Wave is the single-most important tool in economic forecasting". Veteran Halkin members will also recall the late Teddy Butler-Henderson, as a supporter of this long-cycle.

Looking back at the most recent secular bull and bear trends; interest rates started to rise just after WWII and peaked in 1981. The duration was 35-years. Thereafter, yields fell all the way down again, weighing into a **new record low at 1.34% in 2012/16, surpassing the lows set in 1940-50.** On the way up, Bonds and Gilts went from being the safest asset class, to toxic waste, and the only better place to be invested was equities. The cult of the equity was born. They were promoted in the UK as being the best investment for pension funds by Mr Ross Goobey. Ever since 1981, as rates have fallen, Bonds have been great performers and other people have prospered from them. This is the period of the Bill Gross bull-market.

Following the record lows of 2012/16, **the big bond bear K-cycle remains on borrowed time. The bear trend has broken the historical average duration and lasted 37-years.** A sharp mean-reversion higher is long overdue, but it serves to wait for Mr. Market to sound the alarm loud and clear. Too early, and we fall into the trap of one too many that have prematurely cried wolf. A breakout of the downtrend will not likely signal the imminent start of a bull market, but rather a slow-paced change in trend regime, which according to our work **will likely bottom and reverse in 2022 (+/-1 year).** Until then, we remain alert for growing risk of a spike, especially with mounting pressure from our equity/bond signal (Fig 1-Chart B).


Fig 2. – UST with 30-year regression band. B: CAPE, UST & SP500 yield. C: K-model. Source: Optuma, Market Anthropology, Seymour Pierce; RW Advisory LTD.

**A 30-year regression analysis of UST 10-year yields trend exhibits most of the fluctuations within bands 1-standard deviation** (STD), either side of the historical mean. Short-term changes in the direction of trend were made each time when these parallels were hit. These always resulted in significant trades in the opposite direction. One of them took place in 2003. It fooled both Mr Gross and me onto thinking it was the end of the long down wave in rates. This looked like a good market call until 2007, but then ultimately went wrong. **History teaches us that normalization is a gradual process** (Fig 2B).

The reason why we thought that was an important low has to do with what had occurred in a period that has now been dubbed by Mr Gross as the 'Old Normal'. We have since 2007 been in a 'New Normal', which is of course by historic standards is extremely abnormal. Historically interest rates have been driven by the rate of growth of the economy, with a little extra, to adjust for inflation. Over very long periods of time they have been **stable in the range between 3.5% and 5.5%.** Large economies have tended to grow at between 2% and 4%. Even in the rapid growth Industrial Revolution this range was not exceeded. Inflation has usually not been high.

In the 'New Normal', which has resulted from a policy brought in by Mr Greenspan at the US Fed, and continued by Mr Bernanke, and Mrs Yellen, we find **rates at the lowest levels ever seen in history.** In that nothing went wrong on the watch of those Fed chairpersons, their easing policy can be seen to have worked. Fig 3. illustrates a humorous lesson of how correlation can serendipitously coincide with a random causation; in this case, between the height of each Fed chairperson and their related policy. Interestingly, Mr Powell's taller height breaks the downtrend from 1987. **Could this signal a policy shift akin to Mr Volcker's days?** 😊

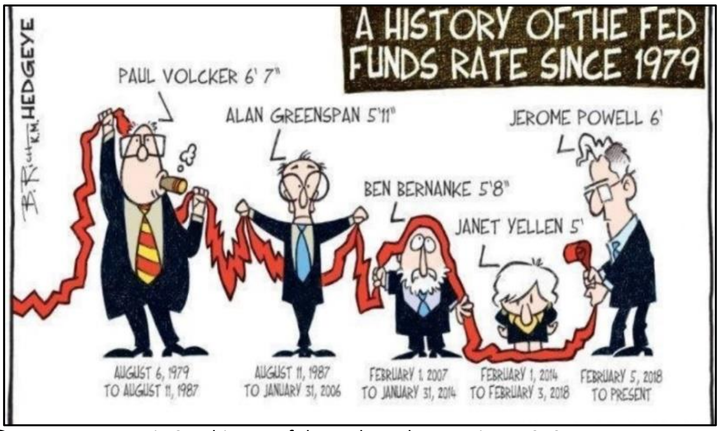


Fig 3. A history of the Fed Funds Rate since 1979.
Source: The Economist; RW Advisory LTD.

The mispricing of the safest base asset such as bonds, caused huge mispricing in many other asset classes. It has led to credit bubbles of astronomic proportions. The policy originally was used to head off a recession, that many feared might become a depression. **Not only is the US economy now doing quite well, but the recovery has spread out across the world, which overall is doing splendidly.** Further encouraged by President Trump's stimulus, growth in the USA is likely to accelerate. To simultaneously do the three things that have always created growth; notably deregulation, tax cuts, and infrastructure projects, is bound to have a long-term positive effect. **Subpar growth is not the way to bet for the remaining year ahead.** This gives the Fed a chance to raise rates whilst the going is good. They want to get back to levels of the old normal whilst they can, otherwise they will have no scope to help the next time the economy cools down. **Our idealized K-wave model signals that we are likely amidst the late-stage of the economic cycle, otherwise known as the 'autumn' season** (Fig 2C). We are mindful this is only an approximate proxy, with certain exceptions, but remain alert as the cycle matures.

Technically speaking, the correct patterns have formed. **The lows in 2012 and 2016 completed a large double bottom.** The record 2016 low itself is made up of an inverse head and shoulders. These are both classic reversal patterns. They do indicate the long-term downtrend in rates is likely to reverse by enough to breakout of the regression downtrend channel. The neck-line of the latest reversal pattern is at 3%. This is right on the +1 STD regression line. If the neck-line is broken, then the **prediction is a rise to at least 4%, with risk of a spike. This would serve as a potential "kiss of death" for the equity market.**


Fig 4. – US Treasury yields testing its 10-year regression, pressured by a reversal signal into 4%. Source: Optuma; RW Advisory LTD.

However, as previously stated, **it would not necessarily mean that the absolute low for rates was in place.** A comparative study of what happened during a similar downtrend, post-1929 wall-street crash (Fig 5-below), exhibits a double bottom pattern that led to a spectacular deflationary spike in 1931 to 5.5%. This was only to be followed later by new lows, as the depression got deeper. We do not know if this sort of event can replay, but if it did then this would be the scenario. It's interesting to note that **hedge fund manager, Mr Ray Dalio, is betting on a potential 1937 default-led spike.**

We share a similar concern, but for now **believe that rates rise strongly whilst the economy is hot.** This continues until central banks take the punch bowl away from the party, in late-2019, or early-2020. Then we get a recession, and the debt mountain unwinds, which in turn leads to a structural equity bear market. This would mark the 'winter season' of our K-model (Fig 2C). **Expect a hotter cold-war, and an explosion in the Middle-East.** This would result in a big daddy bear scare. Until then, don't worry about it. Any bears for now are only a baby one. Keep mindfully eating your tasty porridge.

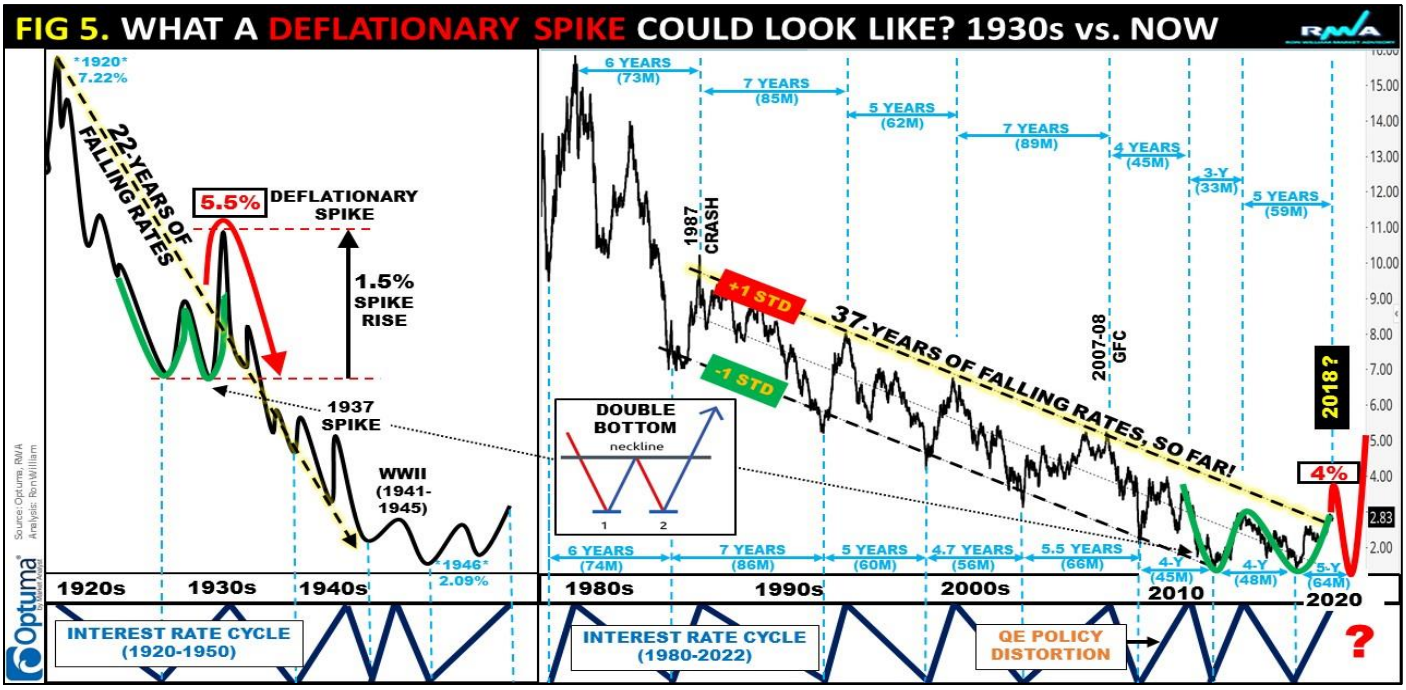


Fig 5. – Deflationary spike analogue between 1930s and now. Source: Optuma; RW Advisory LTD.