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Equity Duration

When Stocks Act Like Bonds

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We are in unchartered territory for interest rates, with the cost of borrowing lower than the inflation rate. There have been other times in U.S. history when rates have been this low, but inflation was never this high during those periods. The same holds true overseas. Low rates have always corresponded with periods of subdued inflation.

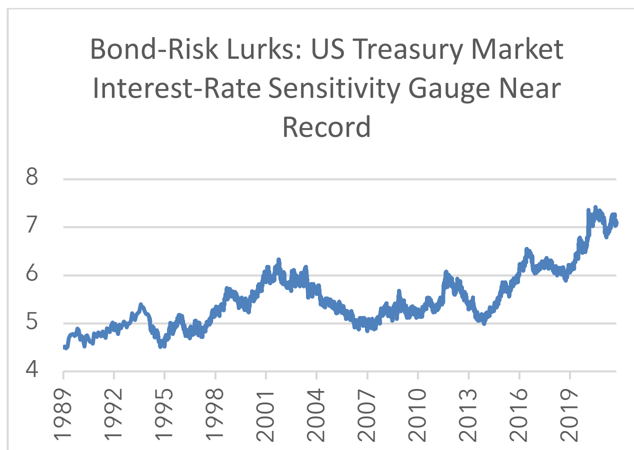
Unprecedented negative real interest rates have led to some sharp distortions in equity prices that may be reversed should the historic relationship between the cost of borrowing and the rate of inflation hold once again. This potential unwind should favor sectors and stocks with low duration and whose earnings are geared towards higher rates.

In 1938, a little-known researcher at the National Bureau of Economic Research named Frederick Macaulay was studying the behavior of the bond prices of railroads. He reached an insight that was a breakthrough at the time but seems intuitively obvious today: changes in bond prices are a function of not only changes in interest rates and the size of the coupon, but also the time elapsed until the coupon payments are received. For example, a ten-year U.S Treasury that pays coupons annually will be less sensitive to changes in interest rates than a similar yielding bond that pays all the interest at the end of ten years (a zero-coupon bond).

When "duration" was conceived, the U.S. was still in the midst of the Great Depression. Inflation was an astounding -2%, yet government bond yields were 3%, providing a generous 5% real interest rate. Contrast that era with today when current inflation is 5% and 10-year bond yields are 1.5%; an unheard of -3.5% real interest rate. For those who believe inflation is transitory, the Treasury Inflation Protected Securities (TIPS) market provides a longer-term real interest rate. The current real interest rate on 10-year TIPS is roughly -1.0%, about as low as it has ever been and especially low during a period of economic growth, highlighting the disconnect between rates and expected inflation.

I have been concerned about mounting inflation, which was featured in *Global Foresight* last January. At that time, the consensus forecast for 2021 U.S. Consumer Price Index (CPI) was only 2.0%. Since then, economists have steadily raised CPI forecasts and the consensus is currently 4.4%. Forecasts for 2022 are now 3.3%, up from the 2.2% consensus from January. Rather than relying on economists' forecasts, TIPS provide a market-implied inflation forecast. This is now at 2.57%, just shy of its all-time high of 2.71% reached in March 2005 (It's worth noting that TIPS have only been traded since the late 1990s, which has captured a relatively benign period for inflation).

The bond market is clearly signaling that inflation is not merely transitory, although it is also not close to the rampant levels of the 1970s. While I am not suggesting rates will approach anywhere close to their peak 40 years ago, of 15.8% on 10-year U.S. Treasuries, I believe they should move directionally higher. With rates roughly 1.5% as of 11/04/2021, a 100-basis point increase has far more impact on bond prices than does a 100-basis point move when rates are closer to 4.0% because of the concept of duration.



Source: Bloomberg as of 11/03/2021

As shown in the chart above, duration in the U.S. Treasury market (interest-rate sensitivity) is near an all-time high because of low rates. This heightened sensitivity to rate changes should also impact equities.

One important distinction is that while duration can be precisely calculated for a bond, one needs to estimate the timing and size of future dividend payments when calculating it for a stock. Since this is merely an estimate, calculating equity duration is somewhat of academic exercise, not a precise forecast. However, it lends insight on sectors and stocks that should perform better in different rate environments.

Mature companies with very low economic cyclicality, coupled with a reliable dividend policy, often called "dividend aristocrats" seem like an obvious beneficiary of low rates. Their dividends so rarely get cut that they often serve as bond substitutes for yield-hungry investors.

As an example, a stock of a hypothetical consumer goods company that trades to yield 100 basis points (bps) above U.S Treasuries, would decline 16% if yields on ten-year Treasuries rose 50-bps from 1.6% to 2.1%, holding all-else constant. A 100-bps increase in 10-year Treasuries to 2.6% would result in a 28% decline on that same stock if it sold off to maintain its yield premium of 100 bps above Treasuries. Keep in mind, a 2.6% interest rate would still be below implied 10-year breakeven inflation. This would merely take us back to the nominal rate environment of 2018, despite much lower inflation then. We do not need 1970s-style inflation or rates to create a massive impact on bond proxies whose P/E (price-to-earnings) ratios bear little resemblance to their growth prospects, but whose reliable dividends entice investors to use them as bond substitutes.

Unlike the dividend aristocrats, companies generating little free cash flow today for the promise of long-term cash flow growth on balance have much higher duration and would arguably (if not intuitively) be more vulnerable to higher rates should all else be equal. Many earlier-stage technology companies would fit this description.

The relative winners in a rising rate environment should be companies whose earnings are positively geared to higher rates or companies with pricing power to offset higher rates and inflation. Financials, some industrials, and materials companies could potentially benefit from modestly higher rates and lingering inflation.

Inflation has been so low for so long that many are convinced it is transitory. However, there are shifts in labor since the start of the pandemic that are taking longer to unwind. In 1930, John Maynard Keynes famously predicted his grandchildren would only need to work 15 hours a week thanks to technological innovation.

Given the record number of both unfilled jobs and people quitting jobs as measured by the Bureau of Labor Statistics (BLS), it seems many workers have become acclimated to a 0-hour workweek. Keynes vision of the 15-hour workweek relied on massive productivity gains reducing the demands for labor. However, the current macro environment cannot accommodate so many opting out of the workforce. The pandemic caused a plunge in workforce participation and less than half of those who left in early 2020 have returned to work or are looking for work according to the BLS. This helps explain why with the global economy rapidly escaping the clutches of the pandemic, demand for goods and services is far outstripping supply. This imbalance has led to inflation that is likely to persist until workforce participation increases.

Also consider the relative "free lunch" low rates have provided for all the pandemic-related spending that has supported the U.S. economy. The Build Back Better Plan and the Bipartisan Infrastructure bill equal 13% of annual U.S. GDP. Already during the pandemic, 23% of GDP has been spent, with little associated interest expense because of low rates. By contrast the New Deal that was passed during the Great Depression equaled 12% of GDP, while the American Recovery and Reinvestment Act adopted during the Global Financial Crisis equaled 6% of GDP.

Coupled with all this fiscal stimulus, the U.S. Federal Reserve has been incredibly accommodative with rates and growing the supply of money. An adjustment by the Fed to begin tightening sooner rather than later should help support a base case of rates moving up modestly. If the Fed remains exceptionally accommodative, inflationary pressure may last longer and ultimately result in even higher rates.

Conclusion

While I do not expect a massive surge in interest rates, they have stayed surprisingly subdued despite lingering inflation that has spiked this year and looks to be persistent in the future given labor shortages. The historic disconnect between inflation and rates has arguably been the biggest surprise driving markets this year as higher inflation supported higher nominal revenues and earnings, while low rates have helped keep P/E multiples elevated. If rates merely retreat to 2.5% - 3.0%, levels seen in 2017-2018, technology and consumer staples should underperform while financials whose earnings would be positively impacted and could see some multiple appreciation. Select materials and industrial companies could also be poised to do well as their pricing power should offset the impact of modest inflation and higher rates.

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