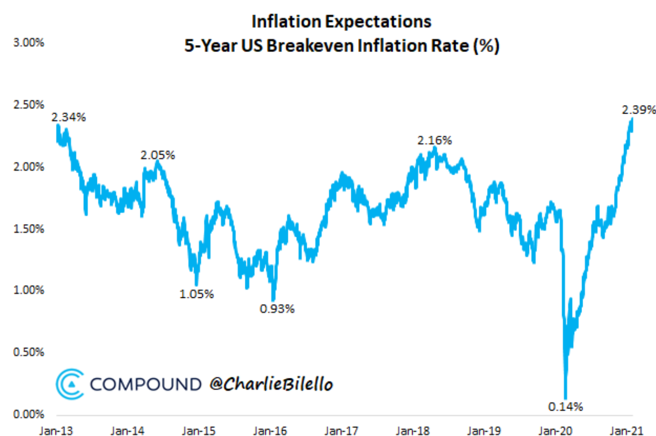
MARATHON INVESTMENTS Newsletter, February 28, 2021

The S&P 500 closed at 3,811.15 on Friday, down 2.5% for the week and up 1.5% year-to-date. Similar to the previous week, the main issue was a further rise in interest rates. Many investors had expected a rise in interest rates this year, but what spooked the stock market was the swiftness of the rise in rates.

When investors think about investing in bonds, losing money probably isn't the first thing that comes to mind. Bonds tend to be synonymous with safety and allowing you to sleep well at night. Risk in bonds primarily comes in two forms: 1) interest rate risk (risk of rising interest rates) and 2) credit risk (risk of default). For investors in government bonds (Treasuries), the risk resides entirely in the first category as we assume the US government will make good on its promise to pay us back. For investors in corporate bonds, the risk is often a combination of the two depending on the duration (years) and credit quality of the bonds.

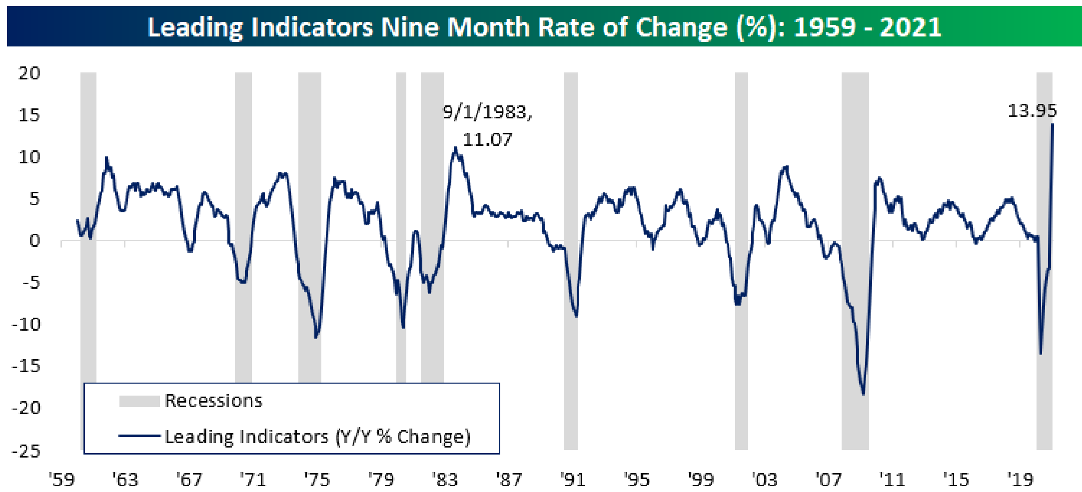
While this is often the case, often is not always. We're seeing that so far this year with the 30-year US bond Index down more than 10%. The value of bonds is inversely related to interest rates. 10-year (1.46%) and 30-year (2.15%) Treasury yields hit new 52-week highs during the week. On Thursday, after a disappointing 7-year Treasury auction, the 10-year rate briefly rose to 1.61%, but fell back to 1.46% at the end of the week. Driving the move higher in bond yields has been faster economic growth and the continued rise in inflation expectations.

Investors' inflation expectations can be seen in Treasury markets by looking at the difference between the yields on ordinary Treasuries, like the 5-year and the yields on inflation protected Treasuries, known as TIPS. This difference is called the breakeven rate and this has risen to nearly 2.4% in recent days, the highest level since May 2011.

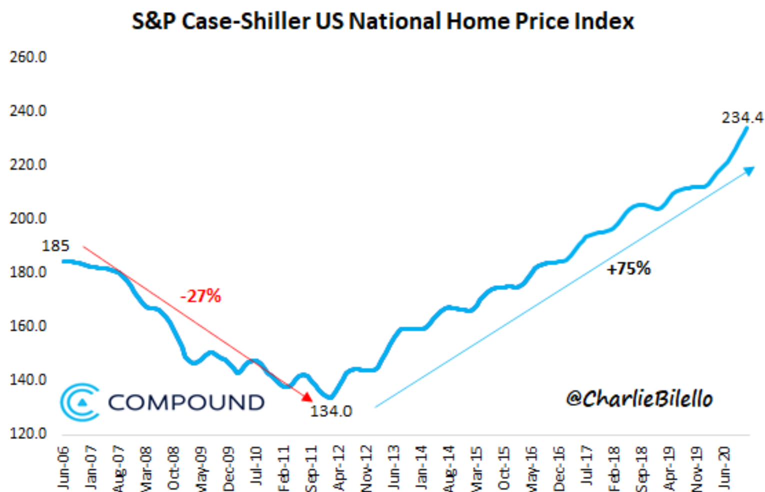


Interestingly, shorter-term breakeven rates are higher than longer-term ones, a very rare situation, known as the inversion of the breakeven curve. This forecasts a spike in inflation that then falls away. 10-year breakeven rates are 2.15% and 30-year breakeven rates are 2.1%. A possible explanation is that the $1.9 trillion coronavirus relief package will bring only short-term benefits and only a short-lived bump to inflation.

Treasuries are also weak because investors are forecasting a booming economy. Leading indicators have surged in recent months, and the nine-month rate of change is the highest in 60 years. Top leading indicators are the yield curve, durable goods orders, the stock market, manufacturing orders, and building permits – all at high levels.

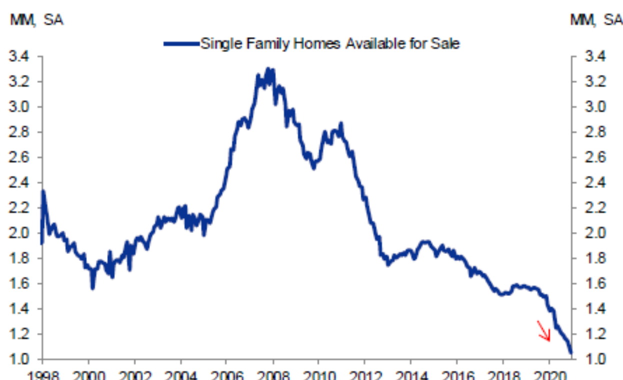


The US housing boom continues with US home prices hitting all-time highs again, up 10.4% over the last year. This trend is expected to continue. A Reuters poll of housing analysts forecasts growth of 5.7% in the Case-Shiller house price index this year, followed by 4.6% in 2022. These projections are also based on near record-low inventories of housing and mortgage rates that are still at low levels despite a rise in recent weeks.



Housing inventory in the US is at historically low levels.

Inventory of homes for sale



TINA and ERP

In the past few years, investors argued There Is No Alternative (TINA): you have to invest in the stock market because interest rates are low and you don't make any money on bonds. Now with rising interest rates, that argument is less valid as bonds are getting incrementally more attractive.

A simple way to look at it is the Equity Risk Premium (ERP), which is an excess return an investor earns by investing in the stock market over a risk-free rate (on a Treasury bond).

An easy calculation is the stock market's earnings yield (Earnings / Price) which is about 5%. This is the inverse of the P/E ratio. Compare that with the yield on the 30-year Treasury bond (2.1%) and the difference is 2.9%. The graph shows that this ratio has declined a lot in the past 12 months due to rising stock prices and rising Treasury yields. In other words, bonds are getting more attractive versus stocks. The US 10-year Treasury yield (1.4%) is now also closing in on the S&P 500 dividend yield (1.5%) and briefly surpassed it last week.

$1.9 trillion relief package

House Democrats passed their $1.9 trillion relief package early Saturday morning. With that hurdle cleared, Democrats in the Senate will seek to get a final version to President Joe Biden's desk before March 14, when expanded unemployment benefits expire for millions of Americans.

The massive bill includes an extension for expanded unemployment benefits, aid for states and local governments, and another round of direct stimulus checks. The bill also raises the minimum hourly wage to $15.

The government's $600 stimulus checks made a big splash in January, boosting disposable income by 11.4% at an annual rate, and leading to a 2.4% increase in consumer spending. Consumers mostly bought goods, which

picked up by 5.8%, and relatively few services, which rose only 0.7%. It is expected that a boom in services spending will follow later this year as the pandemic eases and consumers are able to spend on things like travel and dining out. In January, the personal saving rate – or saving as a share of after-tax income – rose to 20.5% from 13.4%.

Warren Buffett's annual letter: "The best results occur at companies that require minimal assets to conduct high-margin businesses – and offer goods or services that will expand their sales volume with only minor needs for additional capital."

*Building wealth in the stock market requires patience and discipline. Marathon Investments selects quality companies with strong balance sheets which generate above average cash flows and dividends. The company is expanding and interested in new clients and referrals. Portfolios are personalized, there are no investment minimums and costs are low to ensure that you benefit the most in the **long run.***

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Thank you for your interest, Hans

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