

Quarterly Point of View *Inflation & Duration*

April 8, 2021

For 40 years, one of the most enduring trends in finance has been the secular decline in interest rates. After peaking near 16% in the fall of 1981 following years of spiraling inflation, the 10-Year United States Treasury Note embarked on a multi-decade decline, reaching a recent low of 0.51% this past summer during the heart of the pandemic. Given the extraordinary time span of the interest rate decline, it's easy to see how a generation of investors has been lulled into a sense that rising rates don't pose much of a risk, because they never seem to materialize.



Though interest rates remain extraordinarily low in historical context (six-decade chart of the 10-Year Note above) and shouldn't in their own right cause major concern at these levels, they have started to climb higher over the past nine months. The 10-Year Note moved sharply from its August lows to close 2020 with a yield of 0.92%, and the new year has seen an acceleration in the trend higher closing the quarter at 1.74%.

One of the primary reasons is accumulating evidence indicates inflation may be taking root. An important measure of market-based inflation expectations is the 10-year “break-even rate,” which is measured as the spread between the yields on nominal U.S. government bonds (10-year Treasury Note discussed above) and those on Treasury Inflation-Protected Securities, or TIPS. In March, this spread hit 2.36%, the highest level in eight years, and almost 2% higher than a year ago.

Commodities such as crude oil, lumber, copper and aluminum have all surged in recent months, and according to Federal Reserve regional bank surveys, manufacturers are budgeting for large commodity price increases over the next two quarters¹. Add this to expectations for U.S. GDP growth reaching 6-7% this year due to post-pandemic pent up demand, and further imbalances between that demand, and constrained supply, could drive prices even higher. Federal Reserve chair Jerome Powell has appeared somewhat dismissive of those concerns to this point, telling Congress last month that policymakers saw the resulting impact on inflation as “neither particularly large nor persistent.”¹ The markets seem to indicate, however, they are not taking his words at face value.

Additionally, we have the backdrop of massive monetary and fiscal stimulus, the likes we’ve never seen. The federal budget deficit exceeded \$3 trillion last year, and Congress just passed another \$1.9 trillion stimulus bill several weeks ago. On top of all that, an infrastructure bill has been proposed and will likely head to President Biden’s desk - with an estimated price tag of more than \$2 trillion. That is a total of roughly \$4 trillion in 2021 alone, which for historical perspective is what the United States spent fighting all of World War II, adjusted to today’s dollars². A trillion here, a trillion there, with no sign of stopping and the debasement of the U.S. Dollar becomes more than a looming threat for the next generation, but instead a potential incendiary element of inflation risk in the not-too-distant future.

Time will tell if these signals coalesce to produce persistent inflation, or if it’s just another ‘transitory’ scare, but investors, both in the bond and equity markets alike, have started to take notice. For bond holders these factors have hit with blunt force this year. The ETF representing long-dated treasury securities of 20 years or more, TLT, declined over 14% through March, something to which bond investors are unaccustomed. For equity investors the reaction has been more nuanced, but internal action may be indicating a change in long-standing market leadership is at hand.

These interest rate developments obviously have implications for investors, and if they persist it’s likely we will be weighing the contrasting ramifications with regularity.

Equity Duration

There is a concept discussed predominantly in bond markets called duration. Duration, which is used to measure a bond’s sensitivity to interest rate volatility, considers the present value of all coupon and principal payments to be received in the future. Expressed in years, it is the weighted average time until cash flows are received. The longer the duration, the greater the interest rate risk for the security. This has been evident clearly for bond investors with long-dated maturities recently, as discussed above.

Equities are considered long-duration assets and do not share the fixed payment schedules and principal maturities of bonds, so measuring equity duration is less precise. Though opinions vary on the preferred method to calculate equity duration, a common approach is the inverse of the dividend yield - meaning a very low yielding stock would therefore have a long duration (extended time to receive cash flows) - versus a higher yielding stock where cash flows are received sooner. For example, the S&P500’s current yield is just under 1.5%, implying a duration of 67 years. For a portfolio of dividend focused stocks that yields say 3.5% on average, the duration of that group would equate to 29 years. In other words, with a significantly shorter duration, the dividend portfolio will theoretically exhibit less sensitivity to interest rate volatility. Though the concept may be less precise with equities, the notion is important and timely.

The dominance of U.S. growth stocks over value stocks has been a powerful and prevailing investment theme over the past decade. Recently however, value (which as a group contains a significantly larger portion of high dividend payers) has begun to outperform growth. Though there's more than one factor for this, the timing coincides neatly with the rise in interest rates, and since September, value stocks have outperformed their growth counterparts by more than 20%³.

The 1970's, and parts of surrounding decades, offers a thought-provoking illustration of the equity duration concept in action, as it was a period of aggressive inflation and spiking interest rates. A few revealing samples:

- Owning the top 20% of dividend yielders in the S&P500 rebalanced annually for the entire 1970's, as a proxy for short duration stocks, produced significant outperformance to the index itself. The high dividend / short duration basket of stocks rose 10.4% per annum, almost two times the return of the index, at 5.9%⁴.
- The span from January of 1977 to September of 1981 is informative as well. An acute rise in interest rates of over 8% was experienced, the sharpest part of the rate volatility that decade, as inflation spiraled higher. In that stretch, short duration equities defined as the highest dividend yielding decile of all stocks traded on the NYSE, AMEX and NASDAQ exchanges outperformed the S&P500 by 16.4%, or 3.3% annualized⁵.
- Finally, by extending our view out a bit wider from 1960 to the peak in rates in September of 1981, we can see how it played out over a longer cycle. As you can see in the Treasury chart on page one, the 10-Year Note yield was just under 5% at the start of 1960. By January of 1970 it had moved to 7.8%, and by the fall of 1981 it hit 15.8%. The rise was not in a linear fashion, but it is clear that two-decade period saw a persistent march higher in interest rates. Over that entire cycle, short duration stocks outperformed, and did so significantly. The top three deciles of dividend payers on all U.S. exchanges returned 10.3% per annum in that timeframe, beating the other, longer duration segments. Specifically, the outperformance against the bottom three deciles of yielders and the non-dividend payers (meaning the longest of all equity duration groups), was over 3% annualized, and produced that outperformance with much less volatility.

After four decades of decline in the cost of money, it's easy to feel it's simply an abiding feature of finance and markets. In the realm of behavioral finance, the concept of "availability" or "recency" bias suggests that freshly observed or experienced events strongly influence our decisions. Since investors have seen nothing but a decline in rates, this bias can inadvertently become deeply engrained, particularly because it's not only "recent" but has been reinforced for such a long period of time.

Time will tell if inflation takes hold or interest rates rise materially, but it will serve investors well to prepare for a day where it's more than just theory.

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Respectfully,



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1. US Companies Sound Inflation Alarm. Financial Times, 3/29/2021.
2. Costs of Major U.S. Wars, Congressional Research Service, 6/29/2010.
3. Russell 1000 Value Index & Russell 1000 Growth Index, provided by Factset.
4. GreenRock Research, Kevin Malone, 2018.
5. High Dividend Stocks in Rising Rate Environments, Global X, August 2017.

Statistical and analytical data provided by Factset.

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