Third Quarter 2018 Commentary

The stock market continued to gain steam during the third quarter. The S&P 500 returned 7.7%, which was its strongest quarterly showing since 2013. The Dow Jones Industrial Average posted an even stronger return of 9.6%.

Despite the strong recent performance of stocks, the talk of Wall Street lately has been focused on the bond market and, more specifically, on the recent sharp increase in interest rates. The benchmark yield on the 10-year U.S. Treasury note has surged above 3% over the last few weeks. The 3% level is one that the 10-year flirted with briefly earlier this year, but it hasn't been meaningfully above that level since the first half of 2011.

What's striking about this recent rise in rates, though, is the speed of it all. On October 3, the yield on the 10-year note increased from 3.05% to 3.15%--a one-day jump of 10 basis points, which ranks that day in the top 5% of days in terms of rate increases. If you also measure the increase over the previous five-day period, or thirty-day period, or one-year period, you get similar results. Rates are going up, and they're going up at one of the fastest rates they ever have.

Why Are Rates Rising? And Why Do They Fluctuate At All?

The lowest-ever yield for the 10-year U.S. Treasury note was 1.37%, and it occurred a little over two years ago in July 2016. If you had bought a 10-year note at that time, here is what would have happened. You would essentially be lending money to the U.S. government. Let's say you lent $1,000 to Uncle Sam in July 2016. Each year the government would pay you interest of $13.70 (that is, 1.37% of $1,000) and then in July 2026 you would receive your original $1,000 back. Add it all up and you'll see that you would receive a total profit of $137 over the course of that ten-year period.

Since those lows, the yield on the 10-year note has been pretty steadily increasing and now stands at close to 3.25%. A purchaser of a 10-year note today would therefore make a total profit over the next decade of $325. That's not much from an absolute perspective, but it's more than double what you would have expected just two years ago.

But why? Why has the yield increased from 1.37% in mid-2016 to 3.25% in late 2018? There are many different variables at play in this, but the most important one is that the 10-year yield is often used as a proxy for the bond market's expectations for the country's long-term economic health.

Generally speaking, rising interest rates are a sign of a strengthening economy. That makes sense, since unemployment is currently at its lowest reading in nearly 50 years, and we haven't had a recession in about a decade. However, our capitalist system has some built-in checks and balances that cause things to move in a cyclical way, and interest rates are a key fixture in that ebb and flow.

As interest rates rise, the cost of borrowing becomes more onerous to us consumers. A car loan or home improvement loan these days would be more expensive than they have been in quite a while, which could put a damper on those important components of our economy and cause GDP growth to slow. That's not necessarily a bad thing, since a rapidly expanding GDP could lead to unwanted higher inflation. The natural push and pull of interest rates tends to even things out over time.

But What Do Rising Rates Mean for My Portfolio?

When an investor considers investing in the stock of a certain company, she must compare her expected return from owning that stock against her nearly-guaranteed return from owning a 10-year Treasury note. That's the bogey against which various investment choices can be measured.

Let's say that we're considering investing in a hypothetical stock from which we expect to receive dividends of $1 in the first year, $2 in the second year, and so on up until $10 in the tenth year. The total value of that dividend stream is $55 (i.e., $1 + $2 + $3 + …. $10 = $55), but how much should we be willing to pay today for that series of dividends? To find out, we simply discount each annual dividend back to today using the 10-year Treasury yield. We'll spare you the gory details of the math, but trust us when we tell you that the answer is about $44.

In other words, if we were to pay $44 today and receive the dividends described above over the next ten years, our annualized return from that investment would be 3.25%. Now we can compare that value to a similarly-derived value for other interest rates and see how that changes the final answer:

	Lowest-Ever 10-Year Treasury Yield	Current 10-Year Treasury Yield	30-Year Avg 10-Year Treasury Yield
	1.37%	3.25%	5.00%
Current Value of Hypothetical Dividend Stream from Example Above	$50.03	$44.10	$39.37

The bottom line message from this table is that as interest rates rise, the current value of income-producing assets declines. A certain stock valued with a 2% discount factor will have a higher value than that exact same stock valued with a 4% discount factor.

Or, as Warren Buffett likes to say, interest rates act like gravity on valuation. The higher the interest rate, the lower the values. So if interest rates do continue to rise, you should expect to see a natural dampening effect on the returns generated by both the stock market in general and your portfolio in particular.

Conclusion

Will interest rates continue their ascent and return to their historical average of around 5% for the 10-year note? Will they plateau at their current level? Or will they peak here and decline again to the 2% range?

If anyone had a crystal ball and could exactly guess the answer to those questions, they could design a portfolio that would thrive in the expected environment as the future unfolds. However, we all know that no one can have any certainty regarding the answers to those questions. We simply have to make the best decisions we can today given the information we have at hand, and react wisely when the facts change.

Our goal is to position your portfolio to be able to respond well to any of these scenarios, and we thank you for the trust you have placed in us to do just that.

Inkwell Continues to Grow!

We are thrilled to report that Felipe's wife Yanelys delivered a healthy baby boy, Alexander Nicolas Garcia, on August 10. He weighed 7 pounds 11 ounces, exactly the same as did his older sister Victoria, who is very happy to have a real live baby to play with. The Garcia family is adjusting to life as a foursome, and enjoying every sleepless minute of it.

We look forward to reporting to you again in three months.

Sincerely,

FELIPE

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