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# Why Bonds Are Important Even if You Don't Own Them

By James P. Freeman

*"I used to think that if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market and intimidate everybody."*

– James Carville, political consultant and presidential adviser (1993)

Do bonds intimidate *you*?

Notwithstanding your political persuasion, James Carville's sentiment about the bond market was a fair assessment of how many people -- investors, market watchers, government officials -- viewed the formidable and arcane market. Given its sheer size and sway the bond market was the supreme arbiter that howled with either roaring approval or roaring disapproval about both monetary and fiscal policies. And those in charge paid attention.

Generally speaking, there's been more cheers than jeers. The bond market saw a remarkable record bull run that has lasted for nearly forty years. It began in the early 1980s -- when bond yields were approaching 15 percent for the U.S. 10-Year Treasury Note -- and continued with yields falling dramatically through 2020, with an all-time record low of 0.52 percent. The same treasury is yielding approximately 1.30 percent today.

Nevertheless, there were some brief moments of outrage during the early 1990s when the market was concerned about rising debts and deficits during President Clinton's first term. Similarly, in early 2018, markets reacted unfavorably to President Trump's reliance on borrowing to finance tax reform. In both instances, the market responded with a spike in bond yields (yields are related to rates, more about which below). As a form of punishment, the market scolded policymakers, warning investors that it would be more expensive to borrow money.

Few markets, if any, have experienced a 40-year bull run. At some stage, normal cyclical factors (and others) eventually take hold. Applying a bit of Newton's force of gravity -- what goes up must come down -- in reverse, it shouldn't come as a surprise if yields were to swing back to more historical norms, notwithstanding a global pandemic (the long-term average rate for the 10-Year Treasury Note is 4.33 percent).

But something remarkable happened over the last decade in the wake of the Great Recession (2009) and during COVID-19 (2020). Instead of necessarily listening to the market, those in charge effectively took over the market. Through extraordinary intervention the Federal Reserve (the Fed) has virtually nationalized the bond market. Accordingly, this has affected all of the capital markets and has impacted choices made by investors -- especially investors inhabiting the retirement space.

And even if you don't own bonds -- a majority of Americans do not -- you should appreciate and understand bonds as they impact every corner of American finance. Furthermore, one can reasonably make the argument in 2021 that the American bond market is at its most pivotal point literally since the first bond was traded on American soil over 200 years ago.

This is not the same market Carville observed nearly 30 years ago or the same market before 2009. Indeed, were you to go back to The Great Depression -- or to its founding in 1913 -- nothing in the Fed's history approaches the kind of intervention seen today. The Fed's recent actions have distorted a free, rationally functioning marketplace. If the market were not held hostage to the Fed, bond yields would certainly be much higher, and we would be seeing a record number of bond defaults and bankrupt entities. That alone is reason for everyday Americans to pay attention.

The Fed has kept rates artificially low in the bond market -- a market that at one time produced fairly reasonable rates of return for investors, especially for seniors

and those whose risk tolerance was conservative. As a consequence, investors have been forced to seek higher returns in other markets, perhaps taking on more appreciable risk for the same kinds of returns they once experienced in the bond market. Of course, one such "other market" has been the stock market.

According to a forbes.com analysis this past May (using Morningstar Direct data) since the Great Recession stocks have averaged annual returns of 10.32 percent while bonds have returned 5.79 percent. And look at performance since the pandemic began: stocks have returned 36.98 percent while bonds have returned minus 5.36 percent. Since the dotcom implosion in 2000, stocks returned 7.48 percent and bonds 6.74 percent. Quite possibly, then, given these historical market benchmarks, there may be a causal relationship between unprecedented Fed action and underlying market performance. The Fed has upset normal market dynamics regularly associated between stocks and bonds.

Stocks get all the glory.

Consider the hype around the recent Robinhood initial public offering or IPO. The company raised $2 billion. And think of other IPOs like Uber or Facebook. They were *celebrations!*

Verizon raised nearly $49 billion on September 11, 2013, in the biggest bond issue in corporate history (underwriter fees alone approached $500 million). The size of the offering is today roughly equal to the total gross domestic product for all of the country Slovenia. In 2013, there was no confetti, no ringing an opening bell, and no round-the-clock media interest. No talk of it being a "disruptor" event.

Nevertheless, the bond market *still* offers a much better representation of the America's macroeconomic landscape and financial condition than the stock market. It's arguably more important than the stock market, too. And the Fed knows this better than anyone.

But look around you. American society carries more debt than ever. Leaving aside individual debt levels for now -- different topic for a different day -- the federal government has borrowed record amounts of money; the same may be said of state and local governments (which comprise the municipal bond market) and corporations. Debt is as common as, well, the common cold.

The bond market is so big and so complicated that it impacts all aspects of American finance and the overall economy. Just take a peek under the kimono of this often misunderstood market.

The total size of the U.S. bond market (excluding other debt instruments) is roughly $46 trillion. If you were to include in the definition a more generic "fixed income markets" allowance it rises to $51.6 trillion (treasuries, corporates, municipals, money markets, federal agencies, ABS (asset-backed-securities), and MBS (mortgage-backed-securities).

The Fed has used its extraordinary powers to directly support and shore up the bond market since 2008-2009 (with various facilities and purchase of securities; the practice continues today unabated). Yields fell and rates hovered at historic lows. A novel argument can be made that the Fed's actions have forced investors into the stock market because it was keeping yields artificially low in the bond market; stocks prices went up, bond yields went down. While it may have indirectly fueled record highs in the stock market, so far as anyone can tell, it never purchased any individual stocks during this same period. This was financial sleight of hand on a massive scale.

Stocks and bonds are very different. But quite possibly the Fed did this because it views the bond market as more systemically important. Until recently the bond market in the U.S. dwarfed the stock market in terms of market capitalization or size. The market cap of the stock market is today virtually the same as the bond market -- roughly $46 trillion -- but that is an anomaly. Stock market capitalization was typically smaller than bond market capitalization.

Much of what has transpired over the last 18 months (and going back to 2008-2009) has been unusual. In fact, we have witnessed the implementation of wildly unconventional monetary policies during this time, but especially in 2020 and into 2021. Bond yields were purposely made artificially low. The Fed did this (and continues doing this) by adding liquidity or money into the system. It did this by buying incredible amounts of debt securities via a program called "Quantitative Easing" or QE. And it did this for two reasons: one, to keep long-term rates low; and two, to encourage more spending (along with borrowing at these low rates).

A little over a decade ago the Fed's balance sheet totaled just over $2 trillion, according to the St. Louis Federal Reserve Bank. As of August 2021, that figure stands at $8.2 trillion.

With the Fed acting as a backstop for the bond market, it allowed stocks to effectively become an alternative market where price appreciation was theoretically unlimited.

There is plenty to support this thesis.

A quick snapshot is telling: For several months in 2021, the Standard & Poor's 500 index of stocks reached new record highs at the same time the Fed balance sheet hit its own record highs. Further analysis is just as compelling.

The U.S. stock market capitalization was just shy of $47 trillion as of June 30, 2021, according to research published by SIBLIS. That is up by nearly $7 trillion from December 30, 2020, when total market cap was over $40 trillion. That figure stood at $33.9 trillion as of December 30, 2019. (Curiously, for the years ended 2017 and 2018, respectively, market cap was in the $30 trillion range.)

The rise in stock market capitalization can be attributed largely to the effects of Federal Reserve monetary policy that has disproportionately and positively impacted stocks.

Recall that one basic measure of a stock's performance is earnings. Earnings for much of corporate America were flat in 2019 and, in some instances, lower than they were on a comparative basis in 2014. But stocks were roaring ahead in early 2020 (incidentally, that year marked the 11th year of a record bull run in stocks and, by that time, very late in the business cycle). Typically, there is a positive correlation between company earnings and stock prices. But there is now a disconnect with this equation. Arguably, the Fed's actions have distorted this correlation, too.

Given a short but intense recession, economic dislocation, and staggering job losses in 2020, there is no fundamental, technical or financial reason why the stock market increased capitalization by nearly $14 trillion from early 2020 to the middle of this year considering these unique circumstances. None!

Only Fed intervention can possibly attempt to explain it.

And it is not as if private companies decided to, in herd-like numbers, roar off to the stock market to go public issuing shares, thereby organically raising market capitalization.

Today, there are approximately 6,000 publicly-listed companies on the NYSE and NASDAQ. That is down from 8,000 listed companies in the mid-to-late 1990s. Clearly, there are new alternative financing vehicles like SPACs, (special purpose acquisition companies) and the rise of private equity and venture capital that has affected capital markets in ways unforeseen in the 1990s and even more recently. For instance, the number of securities that trade on the over-the-counter markets reached about 11,500 in 2020, more than double what it was a decade ago. And it is understood that with more companies able to raise money in the private markets, it is easier to stay private.

Still, there has not been a significant increase in number of exchange-listed companies that would correspond with a commensurate rise in market capitalization. That rise is attributable to supply and demand: nearly an infinite amount of cash (formerly invested in bonds?) chasing a finite number of stocks. Prices or valuations must go higher. And they have.

But the size of the bond market has grown substantially. Unlike stocks, there has been a flood of new issuance in bonds.

As noted, bonds enjoyed an incredible bull run that began in the early 1980s which more or less continues today, however distorted. Understandably, favorable technological and regulatory environments certainly facilitated this run. And for nearly 40 years rates have steadily declined, fueling the craze to finance and monetize everything with debt and synthetic products -- derivatives and swaps and other casino-like products. The asset-backed and mortgage-backed business really took off in the early1980s, fueling the mad rush to securitize bonds. Conceptually, this new securitized market made sense, too.

Initially, it worked really well and it was manageable. But with attendant greed, excess and avarice, things got out of hand leading up to the mid-2000s. The mortgage-backed market (which operated similarly to the asset-backed market but was far more evil) collapsed in 2007 and 2008 with debt upon debt and derivative on top of derivative crushing investors underneath it all. The Great Recession was a financially-induced debt recession. It took years to unwind everything or, in proper Wall Street parlance, “deleverage” everything.

Never again would the Fed allow another implosion of the very market it was entrusted to oversee -- let alone allow anything to limit its ability to maintain the dollar as a legitimate store of value. A pesky global pandemic by the name of COVID-19 was certainly not going to get in its way a decade later.

The Fed may have realized that if it could control the bond market it would create the effect of allowing theoretically unlimited gains in the comparatively benign and untroubled stock markets. The thinking may have been as follows: Investors would still see superlative price appreciation in their investments but they would have to shift assets from bonds to stocks to do this. Investors would forgive the Fed for socializing losses in the bond market but seemingly privatizing gains in the stock market. As said in scripture, so it was written, so it was done. The Fed chair became one of the most powerful people in America and determined who lived and who was condemned. The bond market was rescued and redeemed.

Moral hazards be damned.

In so doing, the Fed has encouraged limitless borrowing with virtually no consequences all by maintaining absurdly and artificially low interest rates while managing Everest-like debt levels. What was more troublesome? Inflated stock prices or cataclysmic bond defaults?

A stock market collapse would be painful. A bond market collapse would be catastrophic.

Few Americans would or could appreciate the latter scenario. While only 50 percent of Americans individually own stocks a lower percentage of them own bonds (it is believed that 45 percent of households own municipal bonds while just 6 percent own corporate bonds). Yet much of America is financed with bonded debt which in turn is owned mostly by institutions and foreign governments.

Your local fire station was financed by a muni bond. But your local bank likely doesn’t hold the mortgage note on your home; on the contrary, thousands of bondholders hold the note as the mortgage was probably sold and bundled into a mortgage-backed bond. Bondholders technically own slivers of thousands of homes. And insurance companies own lots of investment grade corporate bonds.

A deeper dive into the government, municipal and corporate bond markets is instructive.

First, the U.S. government bond market largely finances the $28.1 trillion national debt (as of March 31, 2021) so it is predicably large. Roughly 22 percent of this is owned by so-called intra-government agencies (like Social Security Trust Fund, the largest single-holder of treasury debt, outside the Federal Reserve, holding

nearly $3 trillion). The rest is broken down by what is called "public" ownership, with $21 trillion outstanding or roughly 78 percent of the $28.1 trillion. This portion is owned by foreign governments, such as China and Japan. And the Fed owns about $11 trillion of this amount.

Almost half of the U.S. Treasury debt is held in trust for your retirement. But the critical matter here is neatly summarized by thebalance.com, from a piece published this past May. If the U.S. defaults on its debt, it rightly says that "foreign investors would be angry, but current and future retirees would be hurt the most."

Public ownership of U.S. Treasury securities still comprises the largest bond market in the world, even if you were to discard the intra-government accounting gimmickry side.

U.S. Treasury debt is issued as bills (maturity dates less than a year), notes (maturity dates fewer than ten years), and bonds (anything beyond 10 years) and what are known as "TIPS" or treasury inflation-protected securities. The amount of Treasury debt has increased by 9.2 percent over the last year. This increase seems small with all the extra stimulus money sloshing around.

Despite the volcanic issuance of debt since the Great Recession in 2008-2009 -- with more eruptions due to COVID-19 -- U.S. debt is still considered the safest investment one can make, as the debt has the full faith and credit of the U.S. behind it. It still retains its vaunted AAA rating from Moody's, and AA+ by Standard & Poor's, two prominent ratings agencies.

The conventional wisdom is that the U.S. has never defaulted on its debts, at least since the days of Alexander Hamilton. However, in late April and early May of 1979 the U.S. technically defaulted on maturing T-Bills. It was small and it was unintentional. But it was indeed a default. (Holders were ultimately made whole and back-office glitches were fixed.) This odd footnote centered around the "debt ceiling," which has been, and continues to be, an issue today.

The Fed, through monetary policy, (think rates and money supply; different from fiscal policy -- under Congress -- which is about taxes and spending) controls short-term maturity rates, such as Fed Funds rates. Treasury securities are used as benchmarks for pricing borrowing needs, from corporate bonds to mortgage rates. When you hear the phrase "bellwether," it typically refers to the U.S. Treasury 10-Year Note. It hit an all-time high yield of 15.82 percent in September of 1981 and

an all-time low of 0.52 percent in 2020. Today, the yield hovers around 1.30 percent.

Yield is related to rates but perhaps yield is a better metric as it simply is the rate divided by the market price. There are many ways to look at bond metrics but one fundamental way to understand is in pricing. For bonds, higher prices mean lower yields and lower prices mean higher yields.

The U.S. government bond market is relatively stable and consistent -- the most reliable and liquid in the world. While the Fed ultimately controls short-term rates, it has little control over long-term rates. But with a broad interpretation of its mandate, the Fed sought control of long-term rates, too. Enter the QE monolith. That program, as mentioned above, involves purchasing longer-term government securities and other forms of long-term credit. For years the Fed has been buying these securities, now at the rate of $120 billion per month. It is one of the reasons why the Fed balance sheet is over $8 trillion today.

As William Cohn, former investment banker wrote in the New York Times this past June, “One of the more important parlor games macroeconomists and Wall Streeters are playing is guessing when the [Fed] will finally stop keeping long-term interest rates at historically low levels.”

The municipal bond market or “muni market” is another subset of the bond market.

As of the first quarter of 2021, total muni debt outstanding was $4 trillion, up nearly 2.7 percent from a year earlier. If you were to go back 40 years ago, total muni debt outstanding was a mere $361 billion; it has risen eleven-fold since 1981 levels. In 2020, the muni bond market saw a record issuance of $451.2 billion. If the general public expresses -- and it does -- confusion and apprehension about the bond market in general, it is likely because of the muni market in particular.

The muni market is incredibly vast and diverse. There are more than 44,000 municipal issuers in America and there are close to one million different bonds outstanding. Muni issuers range from the smallest villages and towns to the largest cities and states. Consider the following: Muni securities include states, their respective subdivisions (cities, towns, counties, school districts), their agencies and instrumentalities (housing, healthcare, airport, port, economic development authorities, etc.); they also include debt from U.S. territories. Importantly, each issuer brings unique borrowing needs to the market.

During the Great Depression, 4,770 muni issuers defaulted on their obligations. While much of today's muni issuance includes various forms of security behind it (letters of credit, bond insurance, reserve funds) defaults do occur.

The City of Detroit's bankruptcy in 2013 was the largest muni default in American history -- exposing $18 billion in debt and long-term liabilities. (It came on the heels of the largest industrial corporate bankruptcy in American history when General Motors filed chapter 11 bankruptcy in 2009. At the time GM had $173 billion in liabilities; $27 billion owed to bondholders.) Detroit was also not helped with the bankruptcy of Chrysler, also in 2009.

Central Falls, Rhode Island, closer to home, is another noteworthy bankruptcy case. It never missed a payment on $19 million of GO bonds in 2011 but given RI's small size, there were fears that a default or insolvency of one RI entity may lead to a contagion effect throughout the entire state.

Both bankruptcies highlighted the new realities in muni bankruptcies: pitting bondholders against pensioners. Each group became creditors in the bankruptcies and each correctly believed they should be pay in full, or 100 cents on the dollar. They weren't.

But the hard truth is that with obligations far outweighing any revenue sources or assets for so many municipalities, both pensioners and bondholders face increasing risks should a municipality actual file for Chapter 9 bankruptcy. Both face the increasingly likelihood that future bankruptcies will be just as ugly as Detroit and Central Falls. And both face the prospect of getting even less in bankruptcy or, in industry vernacular, "taking a haircut."

Many feared an avalanche of municipal defaults after the Great Recession, Some still harbor those fears today in the aftermath of the global pandemic due to overall debt loads and high levels of other municipal obligations -- like unfunded pensions and generous healthcare benefits for retirees. While these fears are not unfounded, widespread municipal defaults have not happened (a lot of that fear was based on lower revenues from taxes and fees, which finance revenue bonds). Yes, defaults surged last year, but interest rates never rose in the market to counter such perceived market risk. The Fed's action may be responsible for these market twists and turns. (The passage of the CARES Act in 2020 granted even more extraordinary power to the Fed, let alone direct assistance to municipal entities.)

Only one state -- Arkansas -- has ever defaulted on its bonds. That occurred in 1933. State government functioned on federal monies for two years thereafter. Today, with securities laws having evolved since then, there is not consensus that a state has the legal authority to file for bankruptcy. But it is fair to say that a state defaulting on it bonds today would be far more problematic than the Arkansas default nearly 90 years ago.

One theory in municipal finance is simply stated: state and local governments have unlimited taxing authority. Therefore, defaults should never occur and, besides, all payments would be made at some point no matter what happens. Who wants to test that theory?

And, finally, the last subset is the corporate bond market.

At the end of the first quarter of 2021, nearly $11 trillion in corporate bonds were outstanding, an increase of 7.6 percent year over year. More than $44 billion in corporate bonds are traded on any given day. The size of the market has increased by 50 percent since 2008, and thirty-fold in 25 years.

There are basically five different kinds of issuers: public utilities, transportations, industrials, banks and finance companies, and international. The market divides bonds in two ways, based on ratings -- "IG" or investment grade or "HY" or high yield which, outside of polite company, would be called junk bonds. According to Fidelity Investments, the IG market consists of 816 issuers and 6,820 issues. The HY side is comprised of 924 issues and 2,111 issuers.

(It should also be mentioned that the Fed started buying corporate bonds in March of 2020 as part of its extraordinary intervention in the bond markets.)

Bonds impact the economy in ways that stocks simply do not.

This past May thebalance.com concluded that "Bonds affect the U.S. economy by determining interest rates, which affect the amount of liquidity and determines how easy or difficult it is to buy things on credit or take out loans for cars, houses, or education."

Because bonds have a powerful relationship to the overall economy, some believe that they can also be used as a kind of forecasting tool. Bond yields may tell what investors think the economy will do. For instance, many industry professionals

have expressed concerns that conditions are now set to fuel a surge in inflation because the government has printed so much money without having paid for it.

The bellwether 10-Year Note saw its yield jump from its low of .052 percent in August 2020 to nearly 1.75 percent this past March. But in September 2021 the yield is closer to 1 percent than it is to 2 percent. (Higher inflation is bad for bonds.)

The market is not anticipating higher yields right now. If the market really feared much higher inflation on the horizon, yields would be spiking; but the market is distorted. We have experienced what the Fed is calling "transitory" inflation as we move out of the economic dislocation caused by the pandemic. Remember, inflation is caused by too many dollars chasing too few goods. Today, unless there is a rampant spike in wages *and* housing, the market will, for the short term, likely believe transitory inflation is not very problematic.

In 2019 the bond market effectively told investors that a recession was coming. And very few people paid much attention to it. Ignoring historical facts and market conditions, investors and market watchers said, "it is different this time." It wasn't.

In March of that year the market did something it only does when it senses it is time for a correction and things seem over cooked. You may remember that the yield curve inverted. That is Wall Street talk for short-term yields exceeding long-term yields. Except for one time in post WWII America, every recession has been preceded by an inversion of the yield curve. For some market observers, therefore, an inverted yield curve is a predictor of a looming recession.

[Some perspective: Many risk factors are considered in determining rates of interest lenders charge borrowers for the privilege of using lenders' monies. One general rule of thumb is that the longer the duration of the loan, the rate of interest goes up for the same credit profile. So, a two year loan might cost 2 percent. A ten year loan might cost 5 percent, and so on. An inversion occurs when the rate on the two year loan exceeds the rate on the ten year loan.]

It can get a bit technical but in March of 2019 the yield on the 3-Monthy Treasury Bill rose above the yield on the 10-Year Treasury Note (it also happened in August of 2019 with the 2-Year Treasury Note and the 10-Year Treasury Note). That inversion should have been a warning sign for the market and economy. Granted, with all the Fed intervention, many professional market participants said the 2019 inversion should have been discounted because normally functioning markets were

distorted by the Fed. Many viewed it with skepticism. The 2019 inversion was merely a technical deviation. "It's different this time."

A Credit Suisse analysis a few years ago showed that recessions follow inverted yield curves by an average of about 22 months (that would have brought a recession in June 2021) -- and that stocks continue doing well 18 months thereafter (that would have meant through February 2021). Recessions have happened as soon as six months after an inversion. The short-lived but deep recession of 2020 (March and April 2020) was indeed within the timeframe of recent recessions preceded by yield curve inversions.

It took COVID-19 to ultimately trigger the recession but, as they say for a slumping superstar MLB hitter, "He's due." The American economy was due; the triggering event is nearly irrelevant. How virtually no one saw a recession coming is puzzling. The yield curve was flashing red ("Danger Will Robinson. Danger Will Robinson…" said the robot in *Lost in Space*.) The U.S. was late in the business cycle and the American economy had experienced its longest period of expansion (2009-2020) ever. But even in the first two months of 2020 very few people took heed of the data points that should have been triggered a pause for concern.

Campbell Harvey, a Duke University finance professor said in June 2019 that, "The yield curve does not cause a recession in my framework. The yield curve is just an elegant way to summarize sentiment in the economy."

The real question is whether the bond market will ever return to normal again.

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