Dear Client,

Lots of folks are shifting their focus from picnic blankets and coolers to their investment statements, now that the year if officially half over. The S&P 500 finished the second quarter with a year to date gain of 2.70%--a number which belies an incredibly difficult stretch for investors to stomach. Let's review the first half of 2016. January and February were horrible, and we don't mean the Chicago weather. Each saw a plunge in the S&P 500 of minus 11% from the 12/31/15 closing level. The culprit for the swoon was our old friend China, specifically their economy slowing and their currency weakening. Then there was a not-so-secret meeting of central bankers to discuss the situation. Amazingly the dollar stopped rising, and by the end of March, the market had clawed back all of its losses! April and May treaded water, averaging less than 1.0%, and June was progressing nicely until, out of the blue, the world woke up on a Thursday morning to a shock: Despite the London bookmakers predicting an 80% chance to the contrary, the British voted to leave the European Union. The effect on global stock and currency markets was swift and nasty: A record plunge in the value of the British pound and a worldwide stock market rout. Three days after the Brexit vote, the S&P 500 was again negative 2.56% for 2016. It looked like it was going to be a long, hot summer. Then last week, just as swiftly, the market staged and incredible rally, bring the year positive again.

The biggest story in the financial world right now is not the stock market, which despite the gyrations detailed above, is basically where it was in November of 2014. The real excitement has been in the bond markets worldwide. Since the words "exciting" and "bonds" generally are not found in the same sentence, let me elaborate. The world's government bond markets are much, much larger than its stock markets. The two are closely linked, because bond prices are primarily determined by interest rates, and stock prices are inextricably linked to interest rates, among other factors like earnings, dividends, and growth rates. Stocks date back a few centuries, but people have been loaning money since biblical times. Interest rates are, of course, the "price" of money. When you buy a bond, you are basically loaning money to someone who agrees to pay you back your principal at a future date plus some interest.

It is important to understand the difference between nominal interest rates and real interest rates. The nominal interest rate is simply the yield to maturity of a given bond. For instance, a ten year US government bond has a yield of 1.385% at this moment. The current rate of inflation according the CPI index is about 1.0%. **Real** interest rates are approximately the nominal rate (1.385%) minus the inflation rate (1.0%), or about 0.385%. Interest rates (the price of money) and inflation are ALWAYS linked. The higher the level of inflation, the more interest a lender is going to demand to lend money. Even back in the early 1980's, when bond rates hit 18%, inflation was nearly the same level. Since 1900, the average nominal yield on the ten year Treasury bond is 4.90%, and the average inflation rate is 3.2%. For 116 years, the average **real** return has been 1.70%.*

Today, something like $10 trillion worth of government bonds are trading at **negative yields**. Japan, Germany, Switzerland, and Sweden all have **negative** interest rates. People are willing to lend the government of Switzerland at a rate guaranteed to return them less money than they lent! Why would any sane person to this? Why don't the just hoard cash? Well, a stack of $100 bills piled one mile high would total about $1.4 billion. It is just not feasible for a bank, insurance company or country to store physical cash in huge quantities. But there is another factor at play which is less obvious than the physical constraints. Remember that the real interest rate has always been about 1.70%? Well, throughout modern history, we have always had at least a little inflation, except for the 1930's during the Great Depression. Back then we had deflation, with terrible consequences for the country. Europe

right now is teetering on the brink of zero inflation to deflation. **Deflation** is negative inflation—prices getting cheaper by say one percent a year instead of more expensive. Everyone remembers from fifth grade math that if you subtract a negative number you are really adding. So, if the ten year German bond yield is now -0.18%, and things getting cheaper over there by 1-2% per year, the **REAL** return on those German bonds is not negative. It is a **positive** 0.82-1.82% per year.

A lot of inflation is bad (see 1979-1982). A little inflation is good, because it give companies some pricing power. Deflation is a central banker's worst nightmare. Companies' cash flows shrivel as the price of their wares drops. Yet they still must pay back principal and interest on their debt. That is why so many businesses and households went bankrupt in the 1930's. It is very hard to get rid of deflation when it starts. One way is massive fiscal stimulus. An example is the government printing money and spending it on major infrastructure projects like roads and bridges. Another way is transfer payments, the direct transfer of money to consumers who will likely spend it, spurring the economy. Ben Bernanke once said he would drop cash from helicopters to stop deflation. This earned him the nickname "Helicopter Ben".

Recently some very sharp folks like Jeffery Gundlach have suggested that when the central banks realize that all this monetary stimulus (zero interest rates, quantitative easing) is not helping against deflation and may actually be making things worse, they will eventually turn to "Helicopter Money". This could lead to a massive new bull market for stocks and much higher inflation. Go get your butterfly net ready and keep an eye towards the sky.

*http://observationsandnotes.blogspot.com/2010/12/us-treasury-bond-real-return-history.html

Regards,

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