

MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

3rd Quarter, September 30, 2021		% Change	% Change
	9/30/2021	3 rd Quarter	Year to date
Dow Jones Industrials	33,843.92	(1.46) %*	12.12 %*
S & P 500	4,307.54	0.58 %*	15.92 %*
Russell 2000	2,204.37	(4.36) %*	12.41 %*
BC Aggregate BD Index		0.05 %	(1.55) %
10 YR. Treasury Yield	1.49 %		
30 YR. Treasury Yield	2.04 %		

* Includes reinvested dividend

Save the Rockies

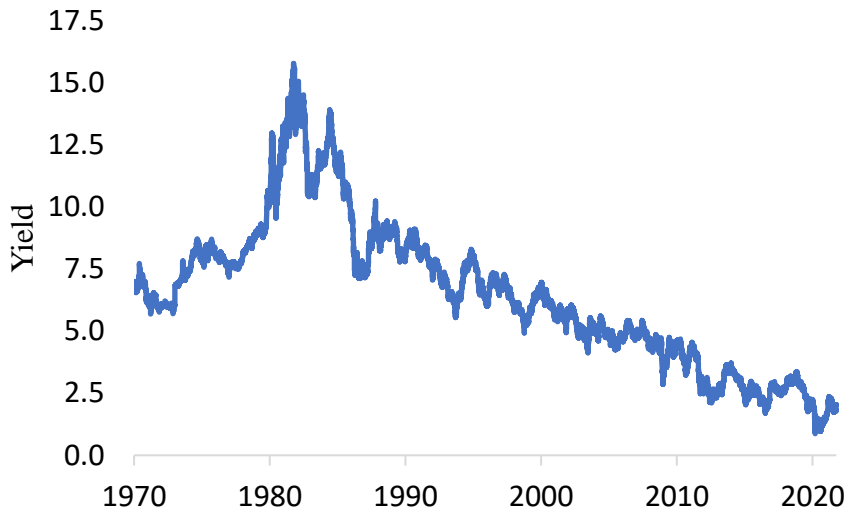
The bond bull market celebrated its 40th anniversary on September 30, 2021. In the simplest sense, a bull market in bonds is defined by lower yields and rising prices. We know with the benefit of hindsight that yields peaked on September 30th, 1981. The table below highlights closing yields on that day.

Instrument	Yield
Money Market Fund	17.00%
3-Month T-Bill	14.34%
10-Year T-Note	15.84%
Fed Fund Rate	17.00%
Prime Rate	19.00%
CPI Inflation Rate	11.00%

It was very difficult in the fall of 1981 to convince investors to purchase 10-year Treasuries at 15.84% when money market funds were yielding 17%. Of course, locking in those yields was the prudent investment decision in 1981. Benjamin Graham quipped “In the financial markets, hindsight is forever 20/20, but foresight is legally blind.”

The chart depicted below captures the extraordinary rise and fall of interest rates, since the peak yield noted on September 30th, 1981.

Historical Market Yield on U.S. Treasury at 20-Year Constant Maturity



Source: Federal Reserve

The oldest known example of an institutionalized, legal interest rate is found in the *Laws of Eshnunna*, an ancient Babylonian text dating back to about 2000 BC. Since that time, an interest rate was understood to be the price one would pay to borrow money. Traditionally the interest rates might fluctuate but in general, there was always a charge to the borrower for use of the money. Over the last decade or so, the machinations of the various Central Banks introduced the concept of negative interest rates whereby borrowers are credited with interest when they borrow money instead of being charged it.

Negative interest rates are an unconventional policy and theoretically can be used by Central Banks to stimulate their nations' economies. When economic times are tough, people tend to hold onto money and not spend it. Overall, this lack of spending can further weaken the economy. To counter a weak economy, the Riksbank of Sweden, the oldest central bank in the world, was among the first central banks to implement a negative policy rate when it announced in 2009 that it would charge banks to hold deposits. Since that time Germany, Japan, Switzerland and several EU nations have experimented with negative interest rates. The jury is still out as to the effectiveness of this policy.

Paul Samuelson, the Nobel Prize-winning economist, once explained that with a perpetual negative interest rate, it would make sense to level the Rocky Mountains to save the cost of extra gasoline expended by motor cars on steep inclines. The essence of Samuelson's argument is that with perpetual negative interest rates almost any investment is profitable. The counter to this argument is that we are not in a perpetual negative interest rate environment, simply a temporary one. That said, the European Central Bank, the Bank of Japan, and the Bank of Switzerland are still in the negative interest rate environment despite the financial crisis of 2009 having ended more than a decade ago.

While we recognize all of us are legally blind to interest rate forecasting, we believe risk is skewed towards higher rates at some point in the future (believing that negative and zero rates are not sustainable). Negative interest rates create the illusion that money is free and therefore investing

risk is minimized at best and eliminated at worst. The implosion of Evergrande Group (Chinese developer with \$300 billion of debt) and the insolvency of Greensill Capital are warning signs and represent the consequence of unrestrained debt. Add higher interest rates to the mix and leveraged balance sheets may become toxic.

In hindsight, we realize what an important inflection point the markets were at on September 30th, 1981. The 40-year anniversary may or may not be a new inflection point in the opposite direction, but it warrants an assessment of portfolio risk. The Federal Reserve is tasked with a dual mandate of stable prices and maximum employment. While the duration of the current elevated level of inflation is unknown, the Federal Reserve is beginning to adjust their forecast and lengthen the definition of “transitory.”

If interest rates rise over time towards historically normal levels, we would posit that there would be a corresponding multiple contraction, i.e. lower stock price relative to earnings. Mindful of systematic risk, like interest rate risk, your portfolio is monitored for sensitivity to uncontrollable risk. Focusing on fundamental analysis like strong balance sheets, sustainable growth strategies, durable and increasing earnings power, increasing dividend payouts and excellent management should allow us to pursue a higher relative return. With the lever of low interest rates fading, individual security analysis is mission critical in an indexed world.