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# THE TEMPO VANTAGE

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## Lower for Longer

For the better part of the last seven years many other market observers and I have been expecting higher interest rates. That was the normal expectation as we recovered from the 2008 financial crisis.

Indeed after bottoming at a yield of about 1.5% (yield on 10-year government bonds) in mid 2012 rates did rise to 3% by the end of 2013. Then, just as we were all giving ourselves a pat on the back for being right, interest rates steadily fell, eventually going right back down to 1.5% by mid 2016.

The fall had me wondering if rates could possibly stay lower for longer than anyone expected. Just as I was contemplating doing something about it (i.e. selling our inverse bond position) along came Donald Trump and his litany of inflationary policies. As if on cue rates started rising and didn't stop until they reached 3.2% last October. My belief in higher rates was finally rewarded! Until it wasn't.

Rates started to fall and once again I thought about the potential that rates could stay lower for longer. This time I concluded that they can and likely will. In March I reversed our inverse bond position in favor of long only funds. At the time the 10-year treasury was yielding about 2.5%. Today it is about 2%.

As interest rates have fallen, investors' inflationary fears were assuaged and they reacted predictably by buying stocks. That makes sense when thinking about cost of capital relative to stock market valuations.

In the second quarter most equity categories were up about 4%, which brings the year-to-date gains to between 15% and 18% for most benchmarks.

Of course lower interest rates also means higher bond prices and attractive bond returns. Most bond categories were up between 1.5% and 3.5%, dependent on duration and credit quality.

Interest rates staying lower for longer is not a problem as long as they don't go too low for too long. Although the Fed may not be saying it, I believe they are now as worried about deflation as they are about inflation. We don't want the United States to follow the path of

Japan where they have been desperately trying to ignite inflation as interest rates have hovered around zero or even below for close to 20 years! People in Japan know what people here need to understand. We need inflation for growth!

At current levels we should be cheering inflation! I'd rather have inflation (and interest rates) a little higher than a little (or a lot) lower.

I don't want to scare you. Two percent interest rates are a far cry from zero (or negative) and there is no reason to think the Fed won't be able to keep us in my favorite zone: the Middle. The Middle is where inflation is neither too high nor too low. Where interest rates are low enough to spur investment. Where companies don't default on bonds, and corporate profits are attractive. I love the Middle!

There is only one problem with the Middle. No one knows the exact boundaries!

## Tempo Financial Advisors' 2nd Quarter Investment Performance

As a reader of the Tempo Vantage Newsletter you know I measure the success of our investment programs two ways: absolute returns and returns relative to benchmarks.

I am happy to report that all three programs made money on an absolute return basis. Check, check, check. As it happens, though, only two of the three beat their respective benchmarks. Check, check, no check.

**Tempo Dynamic Income** was up 3.8% in the second quarter, which was not only the highest return of our three strategies, but also the most ahead of its benchmark. Depending on which benchmark used we were between 1% and 2.5% ahead. Year-to-date figures are even better. We are up 9%, which is 3% to 6% better than benchmarks.

Why did Dynamic Income do so well? Our model correctly overweighted long-term bonds which was among the best returning sectors of the bond market.

Moving into the third quarter our positions have not changed significantly. That means if interest rates are stable or if they fall a bit (or a lot) from here we will do well. If rates rise significantly we will likely underperform.

**Tempo Dynamic Growth** was up 2.9% in the second quarter, which was a little less than half a percent better than benchmarks. I was pleased to outperform our benchmark even though we were at the minimum required equity (40%). Much as with Dynamic Income, the bond positions in Dynamic Growth contributed mightily to our performance.

Dynamic Growth accounts have been rebalanced for the third quarter and I can report that we are still at our minimum equity allocation. Our models tend to shy away from the segments of the market that have been most volatile in the short/intermediate term.

Despite the attractive equity markets thus far in 2019 many of the highest performing sectors have also been among the more volatile. At the moment our equity consists of utilities and emerging markets. Not surprised that utilities are among the least volatile? Me neither. But emerging markets? Not what you would expect, but the numbers don't lie!

If you haven't figured it out by now **Tempo Lifestyle** is our one program that didn't beat its benchmark in the second quarter. Returns ranged from 2% to about 2.5%, which was about 0.75% below benchmark across the board.

Why did we underperform the benchmark? Good question!

Given risks on the political front as well as the recently inverted yield curve it seems to me that a modicum of caution is appropriate at this juncture. Relative to Lifestyle portfolios that means that two of our equity overweights are in defensive areas (utilities and healthcare). While these sectors did make money in Q2, they underperformed the market. Those of you watching day to day may have noticed that on down days over the past few months these are often the only two sectors that buck the trend and are up. I like that!

The other way we are cautiously positioned in Lifestyle is that the duration on our bond holdings is relatively low (i.e. short to intermediate term). As interest rates fell during the second quarter these positions had positive returns, but not as much as if we held longer term bonds.

The markets continue to be a bit bumpy as we start the third quarter and I am comfortable continuing with this cautious stance for the time being.

**Reminder**

Please contact us if there has been a change in your financial circumstances that would warrant a fresh perspective on your portfolio.

Dan

Daniel J. Traub