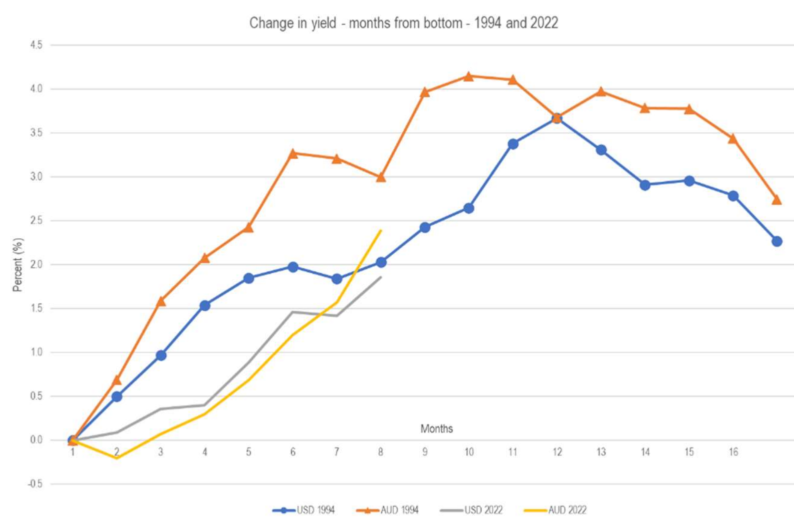
Back to the future: remembering 1994

Lots of psychologists don't believe in repressed memory syndrome. We do. Back in 1994, 2 members of Elstree's investment team were working for a large insurer managing around A$8billion of bonds. That year, the insurer's bond portfolio lost around 11% of its capital value when the bond market drew down 9 months in a row. It's worth repressing the feeling of waking up almost every morning for at least half that year and wondering why you lost money again yesterday and knowing you will most likely make further dumb decisions today.

2022 is reminding us of 1994: both are a bond/inflation led sell offs. In 1993 the US economy was experiencing reasonable growth having just emerged from a nasty recession in the late 80s/early 90s, when all of a sudden, the US Federal Reserve became concerned about inflation and investors started the 'behind the curve' commentary. Then kaboom. The Federal Reserve raised interest rates 0.25% in February 1994 followed by another 0.25% in March with a 0.50% increase in April. And bond markets got scared, very scared. Sound familiar?

The chart below shows the increase in 10year bond rates in the US and Australia from December 1993. We've also shown the increase in bond rates in the US and Australia from November 2021 to date. The data is based to 100 when bond yields were at their lowest point.

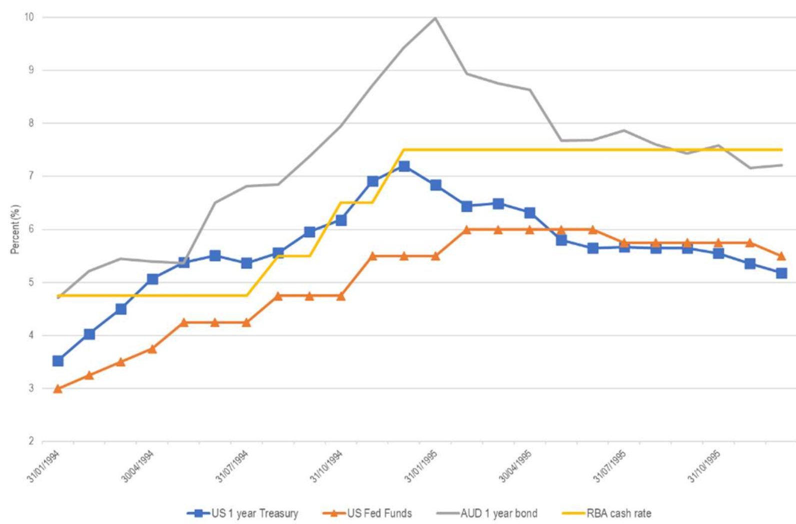


The rise in bond yields has been similar so far this year, but maybe not as fast as 1994. And if you believe in parallels, it's still got longer and further to go. To be fair the bond market overreacted in 1994, as evidenced by the c1.5% fall in bond rates in the 6 months after they peaked.

Markets get ahead of themselves

Everyone knows markets often overreact and it's always easy in hindsight, but 1994 was a masterclass in market dysfunction. The chart below shows the 1year bond rate for the US and Australia and the

Fed Funds/RBA cash rate over the 1994/1995 period. 1year bond rates are what the market is predicting the average cash rate will be for the next 12months, so the peak AUD 1year bond rate of close to 10% in December 1994 implied average cash rates of just under 10% in 1995 when the cash rate at the time was 7.5%. AUD cash rates had risen 2.75% already that year, but the market was predicting another 3% over the next year. As it turned out, cash rates remained at 7.5% for the next 18months. Never have so many highly paid market economists and traders got something so wrong. US market predictions were only slightly better. The obvious parallel here is with markets anticipating RBA cash rates of over 4% by early 2023. Is that likely to happen?



So, what did happen in 1994 and 1995.

This is where we think the more interesting discussion should be.

- c2% increases in 1994 cash rates were enough to do what central banks wanted; not the 4%+ markets were anticipating.
- Inflation in the US and Australia didn't take off. In the US it went from c4% to just under 5%. Australian underlying inflation went from 2.3% to 3.0% (we acknowledge that things could be different this time as present indications are that the changes are more structural in nature).
- There was no recession in either the US or Australia.
- Despite big mortgage rate increases, house prices didn't collapse. US mortgage rates went from 6.5% to 9.5% (c.f. the 3.0% to 5.9% increase in 2022) but housing prices went up by 3%. Australian mortgage rates went from 8.75% to 10.5% and house prices increased by around 3%.

Compare that to the current orthodoxy that we'll end up in a recession and the housing market will collapse due to the current increase in interest rates and we think there is a useful discussion to be had.

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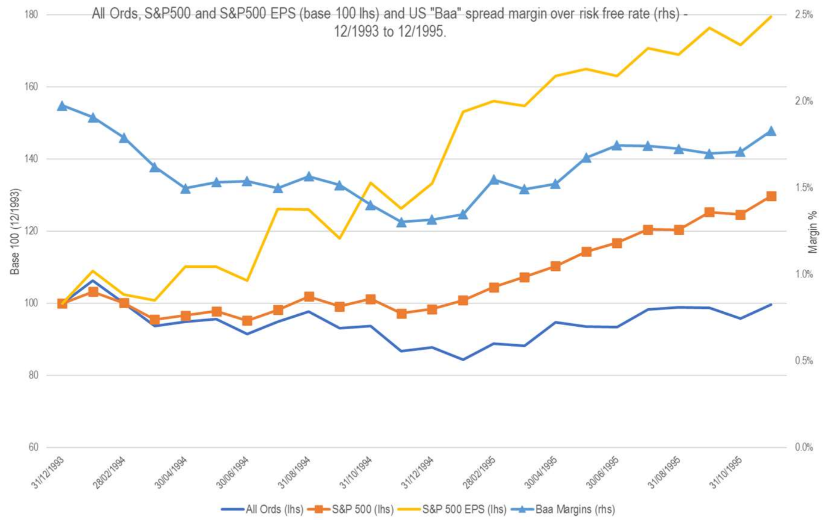
And what about other markets ?

In hindsight, it wasn't worth losing much sleep over (leave that to the bond portfolio managers). The chart below shows the path of US and Australian equity markets (December 1993 = 100) and we've added the US "Baa" margins and S&P 500 earnings per share (EPS) for a bit of extra flavour.



The All Ords lost close to 15% (which is not that much worse than the average annual drawdown) while the S&P500 experienced a 5% drawdown. The saving grace was that the S&P500 experienced stunning earnings per share growth through late 1994 and 1995, so equity markets bought that. We didn't experience the same EPS growth Downunder, so PE margin compression offset the existing earnings growth for a year resulting in a flat 2 years for the index.

And credit margins were largely unchanged. They even compressed in the early part of 1994, which we suspect was investors chasing the high absolute yield (they got well into the 9% region)