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Wrong Rates at the Wrong Time

Sorry Boomers – Rates Have (So Far) Not Been Your Friend

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Generally speaking, life for baby boomers has been good. Those fortunate enough to be born in the U.S. between 1946 – 1964 have experienced a growing economy and rising home and stock market values, with their collective net worth reaching levels their parents likely never imagined. They have also benefited from some of the greatest advancements ever in the areas of science, technology and healthcare, as well as music, entertainment and the arts. Baby boomers were not bystanders as these changes occurred but active participants, contributing dramatically in each area to enhance the quality of life for all. Their parents and grandparents fought the great wars and built the nation's infrastructure, providing baby boomers a more peaceful world filled with tremendous opportunities on which they fully seized and helped move this country forward in amazing and impressive ways.

At least one thing that has not worked in their favor, however, is interest rates. On this measure baby boomers have been in the wrong place in life at the wrong time – in part due to their own influence on growth and inflation. When they were first entering the labor force, getting married and raising a family, borrowing costs were elevated. The rapid expansion of the workforce and rising consumption spurred economic growth but also boosted the demand for credit. Before they were able to accumulate assets, they were net-debtors. Many borrowed to buy cars and houses, to put their children through school and to start businesses − all at the highest interest rates this country has ever experienced. Ask almost any baby boomer what their highest mortgage rate was, and they will very likely say it was double digits.

In fact, high lending rates were the norm through most of their working career. The oldest baby boomers were 21 years old in 1967, and assuming they remained in the workforce until age 65, began transitioning into retirement in 2011. During that period, the average yield on the 10yr Treasury was 6.14%, and the rates they paid on loans exceeded the then-current Treasury yields. Additionally, the average Treasury rate during this time span was nearly 200 bps higher than the 21-years prior to 1967 (4.28%) and nearly 400 bps higher over the last ten years since baby boomers started retiring (2.16%).

Baby boomers also were the first demographic group to fully embrace credit cards, and the higher interest rates associated with them. The first credit card came out in 1950, but broad adoption was relatively slow. In 1970, only 16% of families had a credit card, according to the Federal Reserve's Surveys of Consumer Finance. But by 1998, two-thirds of families had at least one credit card and many carried an unhealthy balance from month to month, paying confiscatory rates as they did.

Nonetheless, baby boomers prospered during their working careers. U.S. GDP grew at an average annual rate of 2.9% from 1967 – 2011, and household net worth rose at a 5% average annual rate. For those able and willing to invest a portion of their retirement savings in stocks, the Dow Jones Industrial Average rose at a 10% average annual clip if dividends were reinvested.

But baby boomers need that nest egg now. Interest rates have not been their friend on the retirement side of life, so far. If you consider short-term rates, such as the 3mo T-bill yield which serves as a fair proxy for rates earned on savings and money market deposits, they have averaged just 0.58% since that first baby boomer retirement date in January 2011 – and this includes the "spike" in short-term rates to 2.50% at the end of 2018, during the Fed's last tightening phase. The story has been the same for longer-term yields with, as mentioned above, 10yr Treasury yields averaging just 2.16% since 2011.

This has an enormous impact on what baby boomers can earn in retirement from their core fixed income assets. It takes significantly more income producing assets today than it did at any time during their working years to produce even a modest level of retirement income. The table below is illustrative:

Baby Boomer Age and Rate Trend – Assets Required to Produce Inflation-Adjusted Annual Income

Age Range (yrs)	Age Mid-Point (yrs)	Year	Jan. 1st 10yr Treasury Yld	Annual Income Infl-Adj @ 2.8% ($)	Assets needed @ 10Yr Yld to Produce Annual Income ($)
17 - 35	26	1981	12.68%	10,000	78,864
22 - 40	31	1986	9.05%	11,481	126,858
27 - 45	36	1991	8.01%	13,180	164,550
32 - 50	41	1996	5.58%	15,132	271,183
37 - 55	46	2001	5.12%	17,372	339,307
42 - 60	51	2006	5.14%	19,945	388,030
47 - 65	56	2011	3.37%	22,898	679,459
52 - 70	61	2016	1.92%	26,288	1,369,171
57 - 75	66	2021	1.07%	30,180	2,820,595

Source: Bloomberg

Note: The average annual inflation rate from 1/1/81 – 5/1/21 was 2.8%. The asset value needed is the amount required to produce the desired annual income when invested at the 10yr Treasury rate on January 1 of each select year.

In the net-debtor stage of baby boomers' financial life cycle, interest rates were at record highs. The 10yr Treasury yield peaked in September 1981, at 15.8%. While their parents enjoyed the ability to earn record rates on their cash and long-term bond investments – in fact, able to earn $10,000 of supplemental retirement income with less than $80,000 invested – baby boomers were primarily paying, rather than earning, those rates. Obviously, inflation rates were also high during the period, so baby boomers benefited from paying debt with inflation-discounted dollars, but it required significant cash flow to service this debt.

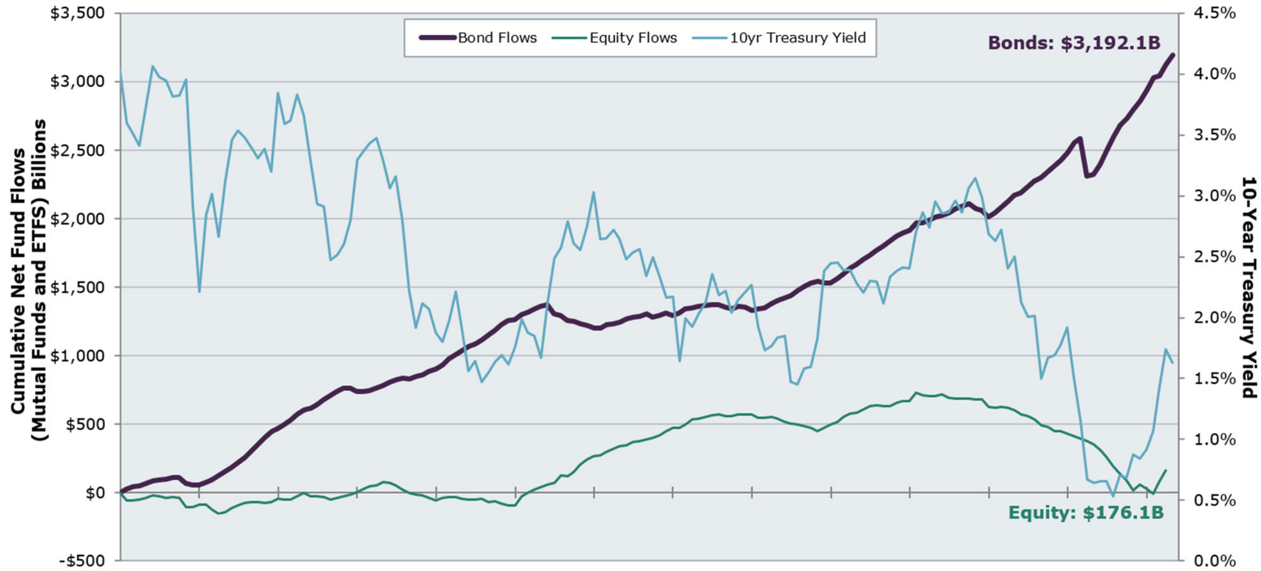
For those first baby boomers who retired on January 1, 2011, at age 65, the value of retirement assets required to produce the same $10,000 of inflation-adjusted income (now $22,898 in 2021 dollars) had risen to $679,459. Not only had the annual income requirement in inflation-adjusted dollar terms increased, but 10yr Treasury rates had also fallen to 3.37%. Fast forward ten years to January 1, 2021, when the age range of baby boomers was 57 – 75 years old, and the mid-point is age 66, and it required a staggering $2,820,595 to produce the same $10,000 of equivalent income!

Of the more than 70 million baby boomers in the U.S. today − which is now the second largest demographic cohort behind the millennials (born between 1982 – 2000) − 60% are still working, according to Pew Research data. So, while the pace of baby boomer retirements spiked in 2020, as the Covid-19 pandemic caused (or forced) many to adjust their plans, most of this demographic group has yet to transition into retirement. According to Jo Ann Jenkins, CEO of AARP, "Over the next two decades, the number of people aged 65 and older will nearly double to more than 72 million – or 1 in 5 Americans. And most 65-year-olds today will live into their 90s."

This strong demographic trend and the amount of invested assets required to produce even a modest level of supplemental income in retirement goes a long way in explaining the seemingly insatiable demand for bonds since 2008's Global Financial Crisis. That experience, in which both home prices and stock values collapsed, left a long-term impact on baby boomer psychology regarding risk. The pandemic-related volatility and uncertainty likely reinforced this cautious perspective for many.

The chart below illustrates the dramatic and largely sustained flows into bond funds since 2008. According to the Investment Company Institute and Strategas, net U.S. bond fund flows have totaled nearly $3.2 trillion from 2008 dwarfing the $176B of equity fund flows (data through April 2021 and March 2021, respectively). And while short-term fluctuations in rates, in either direction, often draw a lot of investor attention, the fluctuation in rates seems to have had little influence on flows over this period. Only in 2013, during the Fed-induced "taper tantrum," when 10yr yields rose 127 bps during the year, did fund flows turn negative as interest rates rose. Even then, the outflows were relatively modest. Also noteworthy is the fact that bond fund flows have been positive YTD in 2021 even with the sharp rise in rates early in the year.

Bond/Equity Fund Flows and Changing Treasury Rates



	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD April 2021
Bond Annual Flows (Billions)	$54.4	**$417.2**	$262.0	$163.7	$358.5	**-$59.0**	$94.5	**$29.4**	**$190.1**	$381.1	**$103.0**	$458.5	$445.7	**$293.0**
YOY Change in 10yr Yields	-1.81%	**1.63%**	-0.54%	-1.42%	-0.12%	**1.27%**	-0.86%	**0.10%**	**0.18%**	-0.04%	**0.28%**	-0.77%	-1.00%	**0.71%**

Source: Strategas Investment Company Institute, Bloomberg; data as of 4/30/2021

Maybe we are at an inflection point in interest rates as some suspect. We are clearly experiencing the strongest pace of U.S. economic growth since the 1980s as the economy reopens and pandemic relief stimulus has left many consumers with cash to spend. Inflation is also rising due to both base effects and supply chain disruptions, and some fear that inflation may be stickier this time around, rather than transitory as the Fed expects. If true, and if growth and inflation concerns continue to push rates higher over the next several quarters/years, it will be an uncharacteristic and perhaps long overdue rate gift to the baby boom generation. Every basis point that yields rise helps in their transition from collecting a paycheck to living off their invested assets.

Investors should not underestimate the likely strong and ongoing demand for fixed income from the baby boom generation. There is a generational wealth gap between baby boomers and other demographic groups that will not be closed any time soon. According to Fed data, baby boomers controlled 52.7% of all U.S. wealth at the end of 2020, compared to 26.9% for Generation X and just 4.8% for the millennials. As rates rise, demand will likely *increase* for bonds rather than decrease. Because rates have been near historical lows for an extended period, assets that would normally have been allocated to core fixed income have gone searching for more yield in other sectors and asset classes, often at greater risk levels. If yields on higher-quality fixed income assets rise, baby boomers will likely be even bigger buyers—enjoying the fact that they finally were able to capture the right rates at the right time.

Past performance does not guarantee future results.

Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing.

In a rising interest rate environment, the value of fixed income securities generally declines and conversely, in a falling interest rate environment, the value of fixed income securities generally increases. High-yield securities may be subject to heightened market, interest rate or credit risk and should not be purchased solely because of the stated yield. Ratings are measured on a scale that ranges from AAA or Aaa (highest) to D or C (lowest). Investment-grade investments are those rated from highest down to BBB- or Baa3.