Bakers, Bankers and Bonds
The importance of being a bond

On such a tiny scale of economic influence, it still mattered.

I was a young banker with very little ability to influence the big machine, but I did have some. My client was also young, setting up a new bakery, with an abundance of spirit, but precious little capital.

The loan request was a bit of a stretch, even though it was only about $50,000. He had very little of his own skin in the game, but it was all the skin he had, with some sweat equity to boot. He had picked up some used equipment, was sprucing up his marketing efforts and picked up a few small new items for the shop. Professional renovators were hired for the exterior work.

When all the lending analysis was hammered out, we couldn't think of any failed bakeries in memory, and decided that the little town could use a bakery.

I had occasion to drive by his shop a couple of weeks later and saw the professional roofing crew climbing all over the building like so many busy ants. It struck me at that moment that I had helped create some employment for a few families. A gratifying thought. I knew one of the guys on the roofing crew from my hockey team. Around that time he mentioned that he had picked up a little extra work that week and was able to buy his daughter a bike for her birthday. He was a beaming, proud father. My world felt right.

This little microcosm of the wider economy is repeated hundreds, thousands, and millions of times over by investors, businessmen and women, dreamers worldwide -- each of them evaluating opportunities and putting some of their own hard-earned cash in to the venture. And then for the next few decades, they commit themselves to be the one who opens the shop in the morning and close it again at night, and dream of the day they can sell it to a young keener with renovation plans of his or her own.

The grease that moves all this along is not about certainty. This is not to say that calculations are absent, but the complex formulae I was compelled to try and wrap my little brain around in university are almost never employed, other than intuitively, in practical settings. Describing the chemical reactions which occur in your salivary glands while enjoying a savoury stake won't do much to win over your date. (Unless it's my one really sciency daughter, but… never mind.) Most of these matters are felt more than calculated -- are experienced more than parsed.

"I think I can do this. I hope we can do this. Okay, let's do this."

Until now, nothing in this discussion has been about government or central bank policy. Not because policy isn't a factor, but because it isn't the primary factor. Fiscal and monetary policies are not the central features to economic results which that some think they are. Except when they are, and then we wish they weren't.

Fiscal Policy refers to a government using its substantial financial resources (tax base) to spur the economy with projects, usually infrastructure, to help create jobs and to stimulate growth. It sounds good, but it is funded by debt… and the decision makers have no skin in the game, so calculations often strain practicality.

Monetary Policy refers to central banks using their substantial share of the money supply to buy or sell short or long term financial instruments (mostly short term) in an effort to raise or lower short or long term interest rates.

Like pushing a child who is learning to ride a bike, the central bank does not control the laws of economics that make it all work. The central bank provides thrust, in the form of downward pressure on interest rates during an economic slowdown, and resistance, in the form of upward pressure on rates during periods of overheated growth. The lower rates increase the ease with which investors can leverage capital toward their ideas, the higher rates keep growth from accelerating into unyielding inflation.

Especially in the case of long-term rates, central bank pressure does not a market make.

In a recent blog, former US Federal Reserve Chairman Ben Bernanke said:
"… (it is) often heard that the Fed is somehow distorting financial markets and investment decisions by keeping interest rates artificially low… Except in the short run, real interest rates are determined by a wide range of economic factors, including prospects for economic growth—not by the Fed."

In short he is conceding that, while central banks have a firm grip on short term rate policies, long term bond markets are even bigger than the Fed. Bigger than the Fed? Perhaps not a single entity, so much as a collective mood of all the bankers and bakers and candlestick makers in the free world. This fact is easily proved by tracking bond yields over time, and looking at their sharp reactions to world market events, such as the 2008 financial crisis, or the recent Brexit vote, and their relatively small reaction to interventions by the Fed.

As they are the swing investment to stocks, understanding bond markets is crucial to understanding overall financial markets.

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