Investment Insights

What Do Collapsing Global Bond Yields Mean?

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Highlights

- The 10-year U.S. Treasury yield fell to a record low Wednesday, below 1.32%.
- While lackluster U.S. growth and low U.S. inflation are pushing down U.S. bond yields, perhaps even more important is foreign demand for U.S. bonds driven by even lower yields overseas.
- Without a sudden rise in inflation or a major U.S. policy shift, U.S. bond yields seem unlikely to rise far or fast in the foreseeable future.
- We increased our bond exposure in May, and our fixed-income mandates have tilted more toward longer-term bonds to capture the falling-yield trend.
- Beyond bonds themselves, we think this low-yield regime is marginally supportive for equities globally as well as emerging markets.

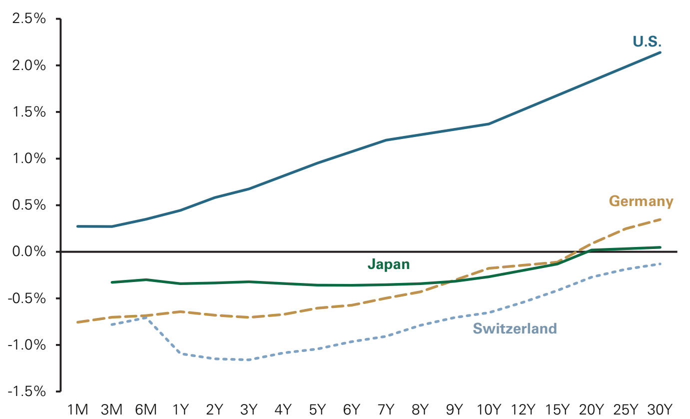
The nominal yield for the benchmark U.S. bond — the 10-year Treasury — touched a record low Wednesday, below 1.32%, down from levels around 1.85% at the end of May. Normally, such a collapse in yields would presage or accompany a sharp slowdown in U.S. economic growth and inflation. Certainly today, U.S. growth is not accelerating sharply, and inflation is not high. The Federal Reserve, partly in response, is moving very cautiously on monetary policy. But neither the Fed nor economic indicators are suggesting the type of doom and gloom that would warrant such a plunge in yields. Consensus forecasts target U.S. GDP growth around 2% in 2016 versus a year earlier, while U.S. inflation is seen rising by some 1.3% this year versus only 0.1% in 2015.

If U.S. yields are not simply reflecting U.S. economic dynamics, what is behind the recent collapse in yields? Maybe more importantly, how long can the trend continue and what does it mean for portfolios more generally? Let's consider each question in turn.

What's Driving U.S. Yields

Trends overseas. The global economy and financial markets are more interlinked today than ever. Such links are actively at work in global bond markets. As we noted in our May *A Closer Look*, "Bonds and Late-Cycle Investing," a critical weight on longer-term U.S. yields over the last few quarters has come from overseas. Foreign private investors — such as asset managers, pension funds and individuals — have been rushing to buy U.S. bonds (pushing yields down in the process). Even if the U.S. yield today feels measly versus history, it is increasingly compelling versus foreign yield alternatives. Just this week, Germany saw government bond yields turn negative for maturities up to 15 years, Japan saw negative yields out 20 years, and Switzerland saw its entire government bond yield curve structure (out to 50 years) turn negative (Exhibit 1). The term "NIRP" (or "Negative Interest Rate Policy") has moved from obscure economics to a household conversation around the world.

Exhibit 1: Term Structure of Interest Rates for Government Bonds



As of July 6, 2016.
Source: Bloomberg

The June 23 decision by the U.K. to exit the European Union, in our view, is a material event that will likely result in further monetary easing, especially in Europe. Even as far as Japan, Brexit-related fallout is likely to influence the Bank of Japan to ease monetary policy further (especially as it wants to fight against yen strength that could undermine local exporting firms). Without any catalyst — at least that we can identify at this stage — to suggest sustainably higher yields outside the U.S., it is difficult to see this capital flow into U.S. bonds reversing anytime soon.

Beyond perceptions of the U.S. economic outlook and overseas developments, we see a few other, more secondary factors pushing down U.S. yields — now and potentially for some time to come. Consider:

- **U.S. bond supply.** As mentioned in our May research note, U.S. bond prices have been supported (and yields depressed) by declining supply — we estimate that total U.S. fixed-income issuance this year will fall to the lowest level since 2008. Unless the next U.S. administration and Congress agree on aggressive fiscal stimulus that requires bond financing, a limited supply backdrop could persist.
- **Structural considerations.** While cyclical factors drive U.S. bond yields, so too do structural ones. Here we would focus mainly on inflation. Globalization and technology have helped limit upside pressure on U.S. wages, a key driver of inflation. They have also acted as a deflationary force on goods and services prices, providing consumers with greater price transparency via online shopping.
- **Central bank inflation targeting and communication.** Over the last few decades, central banks globally have placed more emphasis on inflation targeting, helping to keep a lid on longer-term inflation expectations and actual inflation. Add to that a broad move by central banks in recent years to be more communicative, including via press conferences and published meeting minutes, which has reduced uncertainty around the future path of interest rates and helped to lower the bond term premium (the excess yield that investors require to commit to holding a long-term bond instead of a series of shorter-term bonds).

It seems like a very bold statement to expect the 10-year U.S. Treasury yield to remain at or below 1%, compared with average levels since 1990 of about 5%. But from current yield levels, such a view seems increasingly within reach.

What Puts This Trend at Risk

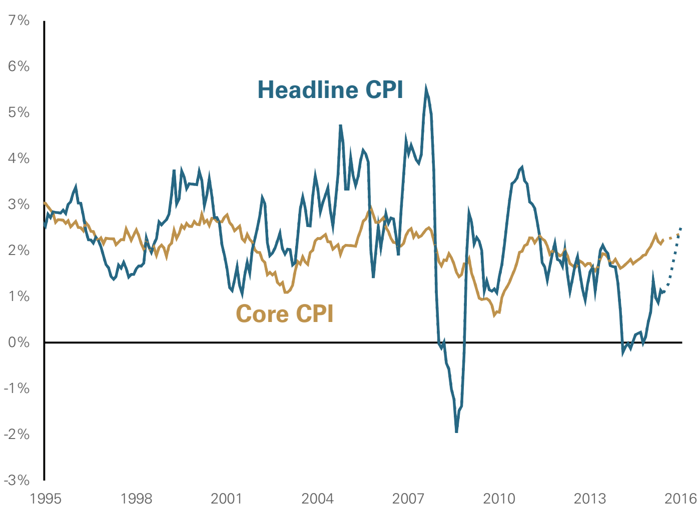
In our view, a significant rise in inflation is the major risk for the falling U.S. yield trend. Even with continued uncertainty in the global backdrop, if U.S. inflation unexpectedly increases, bond investors will likely start to question the safe-haven nature of Treasuries. Nominal interest rates would rise to account for an increase in inflation expectations, and it is likely that the Fed would accelerate its now-sluggish rate-hiking cycle, putting additional upward pressure on U.S. yields. Given the heavy positioning in bonds, a sell-off under such circumstances could become disorderly and extended.

While worth monitoring closely, we put a relatively low probability on this type of scenario developing. Instead, we see U.S. inflation increasing only moderately into 2017, putting only limited upward pressure on local bond yields and only partially offsetting the earlier-mentioned other factors weighing on longer-term yields.

In particular, we see decent U.S. growth and labor trends supporting key underlying measures of inflation, namely service prices, which have been increasing at an above-3% annual pace since February. Considering the dissipating dual headwinds of a strong dollar and weak energy prices experienced over the past two years, headline and core measures of inflation could easily accelerate to 2.4% and 2.5%, respectively, by year end (Exhibit 2).

Exhibit 2: U.S. Headline and Core Inflation Rates

Consumer Price Index, year-over-year % change



As of July 1, 2016. Forecasted inflation rates span between June 2016 and December 2016 and are indicated by the dotted portion of each line. Estimates assume the dollar, import costs, and energy prices remain flat, while the unemployment rate drifts to 4.5% by December 2016.

Source: Bloomberg, Bureau of Labor Statistics, Census Bureau

Other potential risk scenarios for bonds, which we discussed in our May publication, include the risk of large foreign holders selling their Treasury holdings as well as a sudden, unexpected policy shift around the November U.S. election which leads foreign investors to seek different defensive assets.

What Does It All Mean for Bessemer Portfolios?

One of the most basic investment rules of the road is "buy low and sell high." Buying bonds, as the investment team did for portfolios in May, at first glance would go against that dictate, given yields approaching record lows. But if our view outlined earlier proves correct, prices may be high but still have ample means to rise even further, both short term but potentially looking out over the next few years (especially should a U.S. recession emerge in this time frame).

Falling longer-dated U.S. yields simply mean greater returns for holding these longer maturities. Bessemer's fixed income mandates have had a barbell approach in recent quarters — focusing bond holdings on the two ends of the curve with little exposure in the middle. That allows the mandates to capture returns from falling longer-term yields, but also have the ability to reinvest short-dated bonds quickly should the Federal Reserve raise interest rates later this year or next year. Heading into Brexit and immediately after, portfolio managers added some exposure to these longer-dated securities, but kept the overall strategy in place. Further, both municipal and taxable bond mandates continue to look for yield opportunities, ranging from high-grade corporate bonds to 'unrated' municipal bonds that offer a yield premium for the lack of official credit rating.

Beyond these bond mandates, the Strategic Opportunities mandate holds exposure to a number of credit instruments offering relatively higher potential upside than traditional, high-quality fixed income, including non-agency mortgage-backed securities.

What does that backdrop mean for the rest of one's portfolio? Frankly, a lot. We have tried to at least touch on some of the more meaningful implications below.

Equities. As we noted in our latest *Quarterly Investment Perspective*, "America the Beautiful," capital flows into the U.S. tend to support the dollar, which for U.S. dollar-based investors helps local stocks at the margin versus foreign counterparts. With that in mind, we want to stay overweight U.S. equities.

That said, we also see a measure of support from this yield backdrop for emerging markets — both equities and debt. Low developed-market yields push investors to hunt for yield elsewhere. That includes emerging markets, where the average, GDP-weighted short-term policy interest rate is 5.6% (versus effectively zero for developed economies). Since the start of May when U.S. bond yields started their latest descent, emerging-market currencies have been range-bound and the MSCI emerging-market equity index has held in better than its global equivalent (through July 5).

We increased our emerging equity weighting to neutral in late March, partly because of attractive valuations and early signs that growth in many of these countries was bottoming out — but also because of our view that a cautious U.S. central bank would limit upside for U.S. yields. We are reluctant to add further to emerging markets at this time, however, given our view that later in the economic cycle, bouts of volatility will tend to increase correlations between markets, with greater risk for less liquid securities (often the case for emerging markets).

Still within equities, a "hunt for yield" world tends to favor high-dividend companies. Currently, the global equity dividend yield (measured by the MSCI ACWI IMI) is 2.6%. To see yields on equities higher than those on bonds for a sustained period is highly unusual; to see the U.S. dividend yield double the 10-year Treasury yield is extraordinary.

Perhaps not surprisingly against this backdrop, some of the best-known "yield" equity investments have been the most popular. Just since May, for instance, the U.S. utilities sector has seen an 8% gain (versus an effectively flat S&P 500). In recent months, our portfolio managers have added to their equities with attractive dividends, but with a catch: They are looking for firms that can sustain and ideally grow dividends in the future, firms with strong free cash flow (that is, cash a firm can generate after needed capital expenditures). They are also screening for valuations to ensure that they aren't overpaying for dividends.

A further equity consideration is growth versus value-style equities. Growth equities — firms that are expanding more because of organic factors relative to the overall economic backdrop — tend to outperform "value stocks" in an environment of falling yields. Some of this may have to do with what's driving yields — if they are falling because growth is moderating, investors are more willing to pay for that organic growth and expected revenue. The disparity in performance may also stem from the types of firms grouped by industry benchmarks in "growth" and "value" buckets. Value tends to have more financial firms, for instance; such companies can be pressured by low interest rates as they feed into their net interest margins (i.e., what they make by borrowing at lower rates than what they receive for lending). Bessemer portfolios include both growth and value-oriented securities; the team regularly examines those tilts and adjusts as needed, mindful of tax implications of such tactical shifts.

Commodities. The link between bond yields and commodity prices is tenuous. As with other financial instruments, much depends on why bond yields are falling. If lower yields reflect slumping demand and less inflation risk, commodity prices might fall in tandem. However, if falling yields are partly a response to the more structural factors we noted above, the relationship may not be as strong. Indeed, the Bloomberg Commodity Index has risen about 2% since the start of May even in the face of collapsing yields in the U.S. and overseas.

One commodity sector that has been a pull higher on the broader asset class is precious metals. Gold, silver, platinum and palladium have all seen double-digit gains in recent weeks, we believe for a few reasons. Precious metals in general are often held as defensive assets that are more likely to hold their value in extreme deflationary or inflationary environments (falling yields are reigniting deflationary worries). In addition, these metals offer no yield; their return is a function of the change in price alone. In a world with NIRP, on a relative basis, suddenly these metals look yield friendly as the opportunity cost versus bonds has declined. Finally, with bond valuations increasingly questioned, precious metals are seen as an alternative defensive asset to hold in the event of a sustained equity correction.

Since the start of May, gold prices have risen more than 5%; for the year-to-date period, they are up

28%. We note that this climb has followed a four-year decline in prices; we note as well that gold is far from a substitute for bonds. It faces very different supply and demand dynamics, and the gold market has a fraction of the liquidity of U.S. government bonds (which in turn suggests room for much greater short-term volatility). Our portfolios currently have a very modest gold exposure via the Strategic Opportunities mandate. We are researching the potential upside for gold and other precious metals from here given our views on bonds as well as other drivers.

Final Thoughts

Every economic cycle is unique; the latest, which began in 2009, is no different. Following the global financial crisis of 2008-9, and with many governments unable or unwilling to agree on fiscal stimulus to spur growth, the onus fell on central banks to jumpstart economies. What ensued, and led us to our current market environment with more than a third of global government bonds sporting negative yields, has no historic parallel. In times like this, Bessemer emphasizes probabilistic thinking: what do we think is likely to happen, what are the risks to our view, how strongly do we feel about different scenarios. Answers to these questions create our investment thesis and result in our asset allocation. That allocation will change over time, but our investment philosophy will not: We constantly look to protect our clients' irreplaceable capital to the best of our ability, while also striving to grow that capital by finding compelling investment opportunities.

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