Diminishing Returns: The Incredible Shrinking Bond Yield

As we enter the last quarter of the year, the time is right to check out our latest edition of investment strategy. Written by Kevin Barry and Sam Kirby, it provides a down-to-earth take on the global interest rate environment, how rates got so low, what this may be telling us, and how long low rates are likely to last. Read on for the full story.

The first three quarters of 2019, by almost any measure, have been very good for investors. The bull market in U.S. stocks that began in March 2009 continues apace and is now easily the longest on record. Even amidst a slowing global economy and a fog of policy risks, including U.S.-China trade negotiations, increasing political uncertainty ahead of the 2020 U.S. elections, and Brexit drama, U.S. stocks (as measured by the S&P 500) were up another 1.2 percent in the third quarter, bringing year-to-date returns to a very strong level of 20 percent.

But perhaps the bigger surprise is the simultaneous strong performance of core U.S. bonds (as measured by the Bloomberg Barclays U.S. Aggregate Bond Index), which tacked on another 2.3 percent last quarter, lifting the year-to-date total return of this index to 8.5 percent. If the total return of this index were to remain at this level through year-end, it would make 2019 the best year for core U.S. bonds since 2002—well before the financial crisis.

Thus far, 2019 has been an everything rally, with bond price returns strongly supported by a sharp decline in interest rates (even from their already low levels by historical standards), and with stock market investors seemingly willing to shrug off the risks of a synchronized global growth slowdown and shaky business confidence. As we enter the last quarter of the year, this edition of Investment Strategy will focus on the global interest rate environment—how rates got so low, what this may be telling us, and how long low rates are likely to last.

How We Got Here
Since the financial crisis, interest rates across the globe have been on the decline. In the immediate aftermath of the global financial crisis, with few good alternatives available, risk-averse investors poured money into safe haven assets, such as U.S. Treasury notes and bonds. At the same time, the Federal Reserve embarked on a massive application of stimulative monetary policy intended to reignite economic growth. This included the use of its primary tool—cutting its target rate for overnight loans to banks (the fed funds rate)—as well as newer and more untested tools, such as asset purchases through its quantitative easing program intended to inject liquidity into the system and encourage banks to make more loans.

The goal of Fed policy was simple—to bring down short-term interest rates, thereby inducing businesses and investors to expand and invest. As interest rates decline, businesses not only have less incentive to hoard cash, they can also more easily borrow money and put it to work to increase production, invest in new technology and hiring, expand via acquisitions, and buy back their own stock. Interestingly, the beneficial effects of exceptionally low interest rates may be particularly strong among larger (and better capitalized) companies, which leads some researchers to suggest that if the current, exceptionally low interest rate environment persists, it could cause harm to the overall level of competition within the economy, as smaller companies are left behind.[1]

Consumers also benefit from falling rates via lower credit card, car loan, and mortgage payments. The average rate on a 30-year fixed-rate mortgage in September 2007 was 6.4 percent, significantly higher than today's level of 3.6 percent.[2] This translates to a monthly principal and interest payment that is about $340 lower on a $200,000 mortgage.

Investors benefit as well, as their stock portfolios are lifted by higher growth and profitability, and bond portfolios benefit from price appreciation as current (higher coupon) bond holdings become more and more valuable.

Alas, not everyone stands to benefit from lower rates—something that savers and retirees seeking to generate current income from savings know all too well, as they search for any sort of return on savings or CDs. Similarly, banks suffer from lower rates as they have a harder time earning income on interest-bearing assets, which reduces their net interest margin and harms profitability.

In response to this monetary stimulus, interest rates in the U.S. have declined to extremely low levels by historical standards, with bond yields, depending on maturity, near or below all-time lows. In the U.S., the yield on a 10-year Treasury bond has fallen from 5 percent in mid-2007—which was not far from its 60-year average of approximately 6 percent—all the way down to 1.47 percent in September. As shown in Figure One, virtually every instance when the 10-year Treasurys yield has fallen below 4 percent has occurred since 2007.

Figure One: 10-year U.S. Treasury Yields (1962–Present)
Economic conditions within the U.S. have reacted favorably, leading to a steady (if unevenly distributed) recovery. This allowed the Federal Reserve to pause, and even reverse, its stimulus activity in 2014, as it ceased asset purchases through its quantitative easing program and began raising its fed funds rate in 2015. Even as the monetary policy tool was given a breather, the other major policy tool—fiscal policy—was put to work in late 2017, with the passage of the Tax Cuts and Jobs Act. This legislation provided fuel to the growth engine in the form of corporate and individual tax cuts (for most, but not all taxpayers) and increased government spending. Notwithstanding longer-term concerns over the size of government budget deficits, it makes sense from a purely economic basis that the government would borrow at record-low interest rates via deficit spending.

Within the U.S., the combination of monetary and fiscal stimulus has proven to be potent. As we pass the tenth anniversary of the conclusion of the Great Recession, we now see a U.S. economy with strong fundamental underpinnings. Consumer sentiment is supported by a level of unemployment at a 50-year low of 3.5 percent, and as of September 30, the S&P 500 Index was only about 2 percent below its all-time high reached over the summer.

When the economy is good, there should be many attractive places to invest capital, and these alternatives should drive up interest rates. If an alien economist were dropped to Earth today, he would be likely to conclude that the levels of interest rates and inflation should be well above their cycle lows, and near (or above) their long-term historical averages.

However, our visiting economist would be quite wrong. Inflation is low. And as of September 30, the yield on the 10-year Treasury note stood at 1.68 percent—just 36 basis points above its all-time low of 1.32 percent, reached in mid-2016. In August, the yield on the 30-year Treasury plunged below its all-time low of 2.06 percent, and at the end of September, it stood at just 2.12 percent.

This leads us to one of the biggest questions today: why has this economic recovery not translated to higher interest rates?

Keeping a Lid on Rates

It may be tempting to blame the Fed for low rates. However, its role—although powerful—is also limited to the very short end of the curve; the longer-maturity bond yields are much more market-
In addition, the Fed’s actions are (or should be) made in reaction to economic conditions, and in relation to its objective to promote full employment and stable prices. If inflation is well below the Fed’s policy target sweet spot of 2 percent, it’s reasonable to expect the Fed to continue pursuing policy to reach that objective. After all, although high inflation is an often-cited economic risk, the absence of inflation (or deflation) can also be damaging.

If we can’t fully blame the Fed, something else must be going on with bond prices, particularly longer-maturity bonds—something that relates to supply and demand. We believe there are several demand forces working to keep a lid on interest rates, despite the improving conditions of the past decade.

Demand from Foreign Buyers

In contrast to the impact of post-recession stimulus within the U.S. described above, the conditions are less rosy in other parts of the world. Europe, in particular, remains on wobbly ground. Unlike the U.S., where both monetary and fiscal policy tools have been used to reignite growth, Europe’s strong austerity preference creates a reluctance to use deficit spending. In 2014, the failure of traditional measures to stimulate growth, combined with a less dynamic economy, demographic headwinds, and continued weakness in the banking system, led the European Central Bank (ECB) to embark on an aggressive and daring course.

It reduced short-term policy rates below 0 percent, with follow-on rate decreases moving the policy rate to negative 0.4 percent, where it stands today. This dramatic action was intended to provide a jolt to the system—if reserves were penalized with a negative interest rate, banks should be much more willing to lend.

The phenomenon of negative interest rates, once viewed as a financial oddity, now represents a sizeable and growing share of the global bond market. Worldwide, more than $17 trillion of bonds carry negative yields, representing about 30 percent of the global bond market.[3] Unfortunately, thus far, this policy has failed to achieve its desired results. In late September, the ECB’s latest effort to stimulate growth—a longer-term bank borrowing facility benchmarked to the ECB’s negative 0.5 percent interest rate—received a lukewarm reception, suggesting that the monetary policy may have reached the end of its effectiveness as a stimulus tool.

However, one likely consequence of negative interest rates abroad is lower interest rates in the U.S. Low or negative interest rates are not contained within national borders; they can be exported across boundaries to the U.S.

If an investor in Germany can choose between a 10-year bond yielding negative 0.57 percent, and a U.S. 10-year note yielding 1.68 percent, the U.S. security is attractive, even before considering the relative strength of the two economies. Of course, the German investor in this scenario must acquire dollars to purchase U.S. bonds, muddying the economics of the transaction. Nonetheless, U.S. Treasurys remain a very attractive asset in a negative interest rate world, as evidenced by the growth in purchases of U.S. Treasurys by foreign investors, as shown in Figure Two.

Figure Two: Growth in Purchases of U.S. Treasurys by Foreign Investors
Sources: U.S. Treasury, Bloomberg

**Demand from Structural Buyers**

Another source of demand for U.S. Treasury bonds derives from domestic buyers that have no choice but to buy Treasurys, irrespective of yield (or the absence of yield). These structural buyers include pension funds and insurance companies that must purchase long-maturity assets to match the liabilities of their long-lived obligations, as well as public purchasers with assets to invest (e.g., Social Security, Medicare, and military pensions). As baby boomer retirements begin to accelerate, an aging population should serve to increase this structural demand. By 2034, the U.S. Census Bureau expects there to be more Americans over age 65 than children under age 18, for the first time in history.[4]

In some cases, falling rates may spur even more demand for Treasurys, thereby putting additional downward pressure on rates. For example, as interest rates fall, the amount of assets required to fully fund a future liability (such as a pension payment to a retiree, or an insurance death benefit) may increase faster than the value of securities held to support those obligations, spurring additional bond purchases to help close the gap. And as another example of a negative feedback effect, as mortgage rates fall and more homeowners refinance their mortgages, premature principal repayments represent an unwanted return of capital to investors in mortgage-backed securities (such as banks or fund managers), which must be reinvested.[5]

**Higher Demand from Risk-averse Investors**

A third source of demand for Treasury bonds is from risk-averse investors, seeking a safe haven for their assets as global risks increase. Despite the strong fundamental data described above, nearly 40 percent of economists surveyed in a recent study by the National Association for Business Economics expect a recession in 2020, with nearly a quarter of respondents expecting a recession by 2021.[6]

Pessimism is also rising within the business community. Results from the CFO Global Business Outlook survey released in September report that 55 percent of U.S. CFOs have become more pessimistic versus the prior quarter, and 67 percent expect the U.S. to be in recession by the end of 2020. The sentiment picture is even worse in other parts of the world, with more than 65 percent of CFOs in Asia,
Europe, Canada, and Latin America expecting a recession by the third quarter of next year.[7]

While CAPTRUST does not view a recession in the next 12 months as our base case, we do believe the odds of a recession have increased on the heels of slowing global growth and unresolved policy risks.

How Long Will It Last?

Economists and mean-reversionists will say that, over the long term, interest rates should return to their historical average, just as a ball dropped on a trampoline must eventually bounce back to the surface. That said, interest rates are notoriously difficult to forecast, even for professionals. As Figure Three shows, over the past two decades, professional forecasters have consistently projected higher future interest rates as shown by the dotted line—even as the 10-year Treasury has continued its significant downward trend.

Figure Three: Professional Forecasters’ Projections

Source: Federal Reserve Bank of Philadelphia Survey of Professional Forecasters

The path of interest rates is impossible to predict in the short to intermediate term. Instead, it’s more useful to think about what forces could shape their path.

If there were a material release of policy-risk pressures (such as a resolution of the U.S.-China trade conflict or a Brexit resolution), combined with evidence of a firming of conditions in China and Europe and a stabilization of business confidence in the U.S., we could see a relief rally in risk assets, a re-emergence of inflation, and an accompanying increase in interest rates. On the other hand, if policy risks remain unresolved or increase (particularly as we head into the 2020 U.S. elections), or if we begin to see cracks emerge in consumer confidence or weakness in consumer balance sheets (in the form of loan delinquency or credit availability), we could see further declines in rates, to fresh all-time lows.
Thanks in part to falling interest rates, portfolio returns this year have been outstanding. Even if the yield of a bond portfolio is depressingly low, from a total return perspective, bonds have been an excellent contributor to portfolio returns so far this year.

The path forward, however, is uncertain—both in terms of the future trajectory of interest rates, and the growth prospects of the global economy as a whole. The general consensus within the investment community seems to be, notwithstanding short term, headline-driven volatility, that interest rates may remain lower, for longer.

During periods of slowing growth and rising uncertainty, it can be tempting to head to the sidelines. However, it is quite easy for sentiment, both negative and positive, to outrun fundamentals. It is therefore prudent for long-term investors to remain invested, but cautious in positioning, until there is more clarity.

We believe fixed income investors should be careful not to stretch too far for yield, and to make sure there is adequate compensation for the risks they are taking. And, as always, it is important to remain diversified as the range of potential outcomes increases. CAPTRUST continues to invest in research staff and capabilities to explore diversifying investments that may help buffer portfolio volatility and provide fewer correlated sources of income, irrespective of the future path of rates.

[4] “Older People Projected to Outnumber Children for First Time in U.S. History,” United States Census Bureau, 2018

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