Collapsing Yields and Concerning Curves

September 2019

OVERVIEW

- **Given the existence of low or even negative yields, investors are increasingly focused on finding sources of incremental income**
- **The recent inversion of the US Treasury curve has heightened concern about a potential economic recession**
- **Historical market performance following previous yield curve inversions is a limited and imprecise prediction tool**

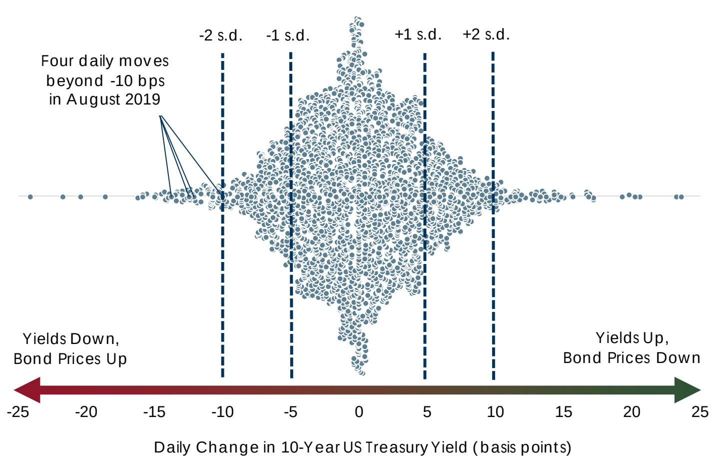
Background

Projecting interest rates has been a difficult task through time, particularly over the past decade as Wall Street and investors alike have consistently predicted rising yields for "safe-haven" government bonds. Looking back at ACG's most recent Year-End Manager Survey, our polling of closely-followed firms suggested that throughout 2019 the Federal Reserve would continue hiking rates, the 10-Year US Treasury yield would rise to just over 3.0%, and the yield curve would maintain its modest upward slope. Through August, it's generous to say that these predictions have missed the mark, and fixed income dynamics are being closely watched as a source of both economic and market direction.

Global Yields Searching for a Bottom

Amid heightened geopolitical uncertainty and threats to global economic growth, investors have flocked to the relative stability of bonds. As shown in the chart below, August alone produced four occurrences where the 10-Year US Treasury yield declined by more than two standard deviations relative to its average daily change. While strong demand has driven year-to-date fixed income performance to previously unimagined levels, it has also spawned record low yields for long-term US Treasuries and a global stockpile of approximately $17 trillion of debt that now trades with negative yields (mostly across Europe and Japan). When investing at negative yields, the prospect of loss in even "risk-free" assets becomes quite certain, with only a continued decline in yields (the greater fool theory) or a more material deflationary environment able to manufacture any real benefit. Although a paradigm shift to lower global interest rates may be justified by lower growth and inflation outlooks, negative rates are not "normal" and it's not widely expected that US investors will be faced with this obstacle. Even as domestic markets anticipate a total of 1% (or 100 bps) in policy rate cuts over the next 12 months, this amount of easing would only correct for a Fed Funds level that currently appears out of sync with the rest of the world.

Interest Rate Volatility Spiking as Yields Decline

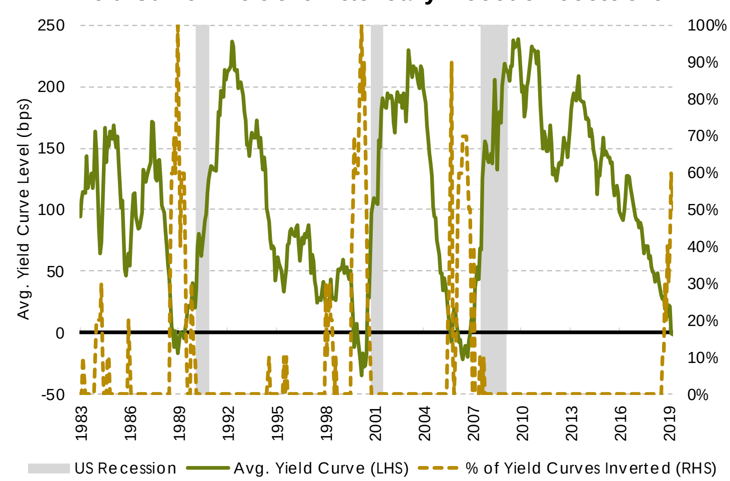


Source: ACG Research, Bloomberg (data covers last 10 years ending August 2019)

Demystifying the Yield Curve

The slope of the US Treasury yield curve is the difference in interest rates across varied points of maturity. The chart below shows the average slope of all possible combinations of 3-month T-bills alongside 2-, 5-, 10-, and 30-year bonds. An upward sloping yield curve is consistent with rewarding savers for committing their capital over time and gives banks the ability to profit by lending at long-term rates while paying lower short-term rates on deposits. The average yield curve over the past several decades has been just over 110 bps, despite notable swings throughout economic cycles. An inverted yield curve, particularly one that involves the majority of key segments, has historically been a reliable leading indicator for recession. Given the current average slope of -1 bp, it's understandable how this issue has captured the attention of market participants. While accepting that an inverted curve is not good news, it's important to distinguish the current inversion from the typical case where the central bank raises short-term rates to slow an overheated expansion and prevent excessive inflation. Instead, the current inversion has been driven by a more rapid decline in longer-term rates, largely due to strong demand for US assets when much of the world is faced with negative yields. With the FOMC committed to "act as appropriate to sustain the expansion," it's feasible that an upward slope can be restored.

Yield Curve Inversions Historically Precede Recessions



Source: ACG Research, Bloomberg, National Bureau of Economic Research (NBER)

ACG's Position

Longer-term rates are at historic lows and despite muted inflation expectations, real rates are turning negative. Thus, outside of a true recessionary scenario, the forward return potential of high-quality bonds appears limited. Concurrently, credit sensitive categories such as high yield and emerging market debt are not offering the spreads typically available in a late-cycle economy. ACG continues to value flexible strategies (absolute return and long/short credit) that can capitalize on current market dynamics and provide diversification. Any marginal allocation to cash would provide a further buffer amid ongoing uncertainly.

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