A warning to bond bears

Curt Custard | UBS Global Asset Management | July 2014

American bond bulls are a hardy species. A bond bull born in the early 1980s would have enjoyed a healthy life over at least three decades in the US. Why should other countries care about US bond yields? The topic matters for investors everywhere, since US Treasuries are the world's biggest bond market, and to some extent set the pace for global bond markets – witness the global jump in yields when the Federal Reserve surprised investors with talk of 'tapering' in June 2013. And on days when bond yields jump up, equities tend to jump down – again, we saw this in global equities markets in June 2013. Every investor should therefore care about the future direction of US bond markets. The bull market that started when 10-year US Treasury yields peaked in 1981 may or may not be over. The 10-year yield dropped to a record low of 1.4% in July 2012. Was that a trough that won't be revisited for decades, or just the latest in a succession of new records in a secular bull market that is still going? It's too early to say.

Many commentators had made up their minds by the end of last year. As we closed 2013, most investors looked at their checklist of factors that hurt US government bond prices. Improving economy? Check. Falling unemployment? Check. Tapering of quantitative easing by the Federal Reserve? Check. And so on – other factors such as steep yield curves and low real yields also supported the 'safe bet' that yields would go higher.

As is often the case, the consensus was wrong. While the 10-year US Treasury yield started 2013 at just over 3%, it is now hovering at around 2.5%. Similarly, German Bunds have fallen 80 basis points from 1.95% at the start of the year to circa 1.15% currently. Even Japanese bond yields have retraced to the 2013 lows, as shown in Figure 1. Most of this rally has taken place at the long end of the yield curve so there has been substantial curve flattening across most major developed markets. This is all against a backdrop of gradual post-crisis recovery and potential normalization of interest rates in the US. It seems as though the bond market is telling us something. Do the flat yield curves – normally a reliable predictor of economic activity – mean that global economic activity is about to slow down? Will yields rise?

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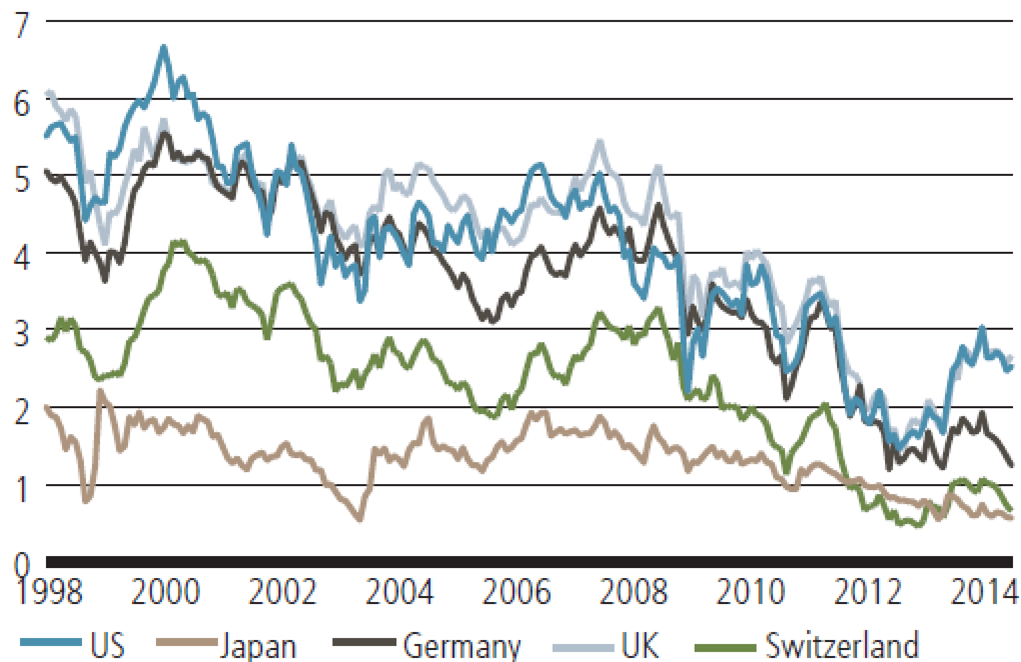
Figure 1: Lower for longer
Yield on 10-year government bonds (%)



Source: Bloomberg Finace L.P. As of 30th June, 2014

Over the short term, the rally lower in yields could be explained by positioning. Bond investors went into 2014 already short their benchmark, and when economic momentum failed to pick up they quickly had to cover their short and buy back duration. Conventional wisdom again says that yields will end up higher eventually and central banks will 'normalize' rates - even as the date for that normalization gets pushed further and further out.

There are a number of reasons why yields may not rise over the medium term - or at least not rise by as much as people have predicted. We might be in for a new era of lower yields for as long as a decade.

For the first reason yields may not pick back up, we need to look to Japan. The demographic situation in Japan has been discussed broadly and the impact of the declining ratio of working population to the rest of the population has been analyzed from a variety of perspectives. Recent research has shown that as a society gets older, the real interest rate it demands declines. Simulations from a 2012 Bank of Japan working paper show that as a population ages, the real rate demanded declines. The mechanism for this is fairly simple: An aging population supplies more savings to the market while simultaneously its total factor productivity - the demand for those savings - declines, pushing down real yields.

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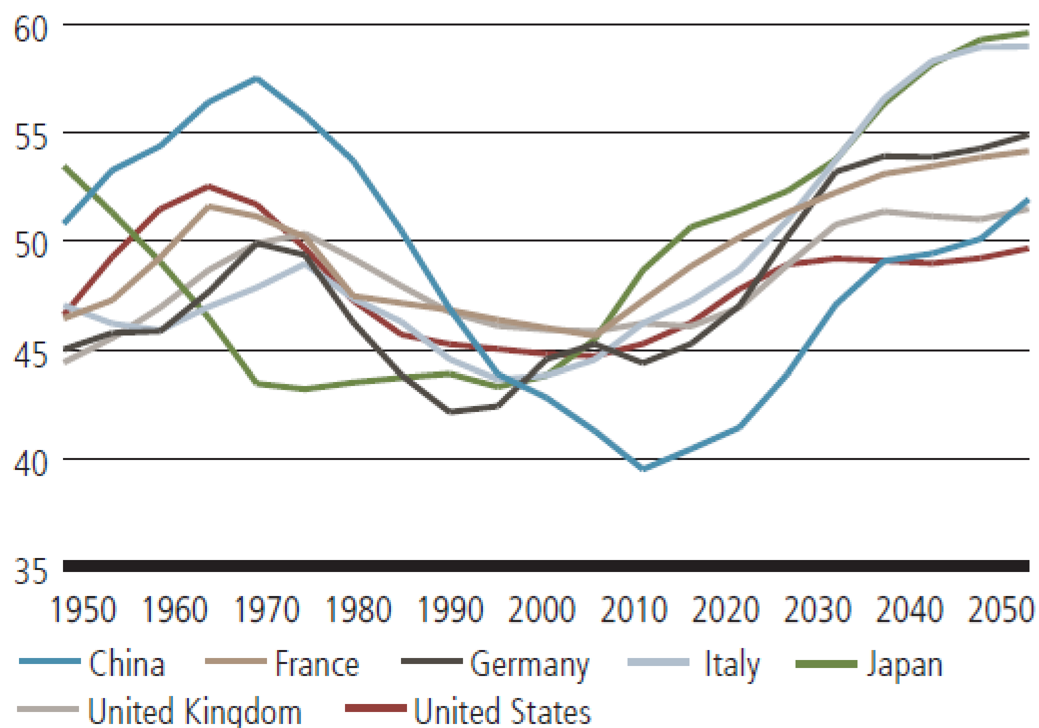
If this were only a Japanese phenomenon, then we could dismiss it, but most of the developed (and some developing) markets are seeing similar if less pronounced changes in their demographic profile - whether it is the baby boom generation reaching retirement in the West or the impact of the one child policy in China coming to the fore. As countries age, the supply of savings will exceed the demand for savings globally exerting a downward pressure on real yields. The dependency ratio, a key metric of ageing demographics, is shown in Figure 2.

Figure 2: We're depending on you

Dependency ratio (population below and above working age, as a percentage of total population)



Sources: IMF, UBS Global Asset Management. Forecast as of 2014.

For the second factor restraining yield increases we need to turn to the example of the United Kingdom. In the late 1990's and throughout the 2000's the UK corporate defined benefit plans driven by regulatory changes started to engage in liability driven investing (LDI). This meant that they bought longerdated government bonds, swaps and corporate bonds and sold equities in order to immunize their liabilities. So with a change in legislation, we suddenly had a change in the supply and demand dynamics over an extended period. Pension plans in the UK bought long-dated bonds, forcing down yields and contributing to an inversion of the yield curve. Why didn't the low real rates dissuade them from investing? Because the buyers of these bonds were not 'profit maximizers' in the traditional sense.

They were buying to fulfill a regulatory requirement and as such were less 'price sensitive' than would otherwise be the case.

The US is on the brink of a similar industry-wide transformation. There are currently USD 2.3 trillion in corporate defined benefit pension liabilities. The long maturity credit market is currently approximately USD 1.4 trillion or just over 60% of the potential demand for credit. Government bonds issuance will fail to fill out that gap. Indeed, estimates are that the supply of bonds worldwide will fall short of the demand by about USD 460 bn over the course of 2014. As more companies move to an LDI framework for their DB plans, this demand will increase. As the global recovery picks up speed, the supply of bonds will likely diminish further.

Finally, investors may be willing to accept a lower real yield because they are more certain about receiving that yield. Yield curve steepness is inversely related to the volatility of inflation. The lower the volatility of inflation, the higher the certainty of receiving the real yield and hence the lower the risk premium demanded. As central bankers become more fluent in communicating their strategy and take uncertainty out of the marketplace, investors may be willing to accept lower real yields than they have historically. As Figure 3 shows, where term structure (in this case, we are using the difference between US 30-year and US three-year Treasuries) is lagged 36 months, there is a relatively tight relationship between the inflationary volatility and the subsequent term structure of interest rates. Combine this with the current seemingly insatiable demand for income from investors of all stripes, and you have a potent cocktail that could keep rates much lower than the current consensus suggests.

So what does this mean for investors and policymakers? I can see at least five big implications.

First, the previous heuristics may no longer apply. The foundations of policymaking such as the Taylor Rule - a monetary policy rule of thumb that indicates an interest rate based on divergence from the target inflation level and potential GDP - may not be in force.

Second, when yields 'normalize,' they may be at levels that would be much lower than previously thought. Yield curves may be flatter than in the past, and their predictive power about the future state of the economy may be weaker.

Third, future real returns for bonds may be boring, with neither a dramatic rally from current yields nor a selloff to pre-crisis levels.

Fourth, valuations for equities may trend higher for an extended period as low discount rates persist.

Fifth, this may encourage lower hurdles for the return on investment as companies expand because of lower borrowing costs and ample funding available in equity markets.

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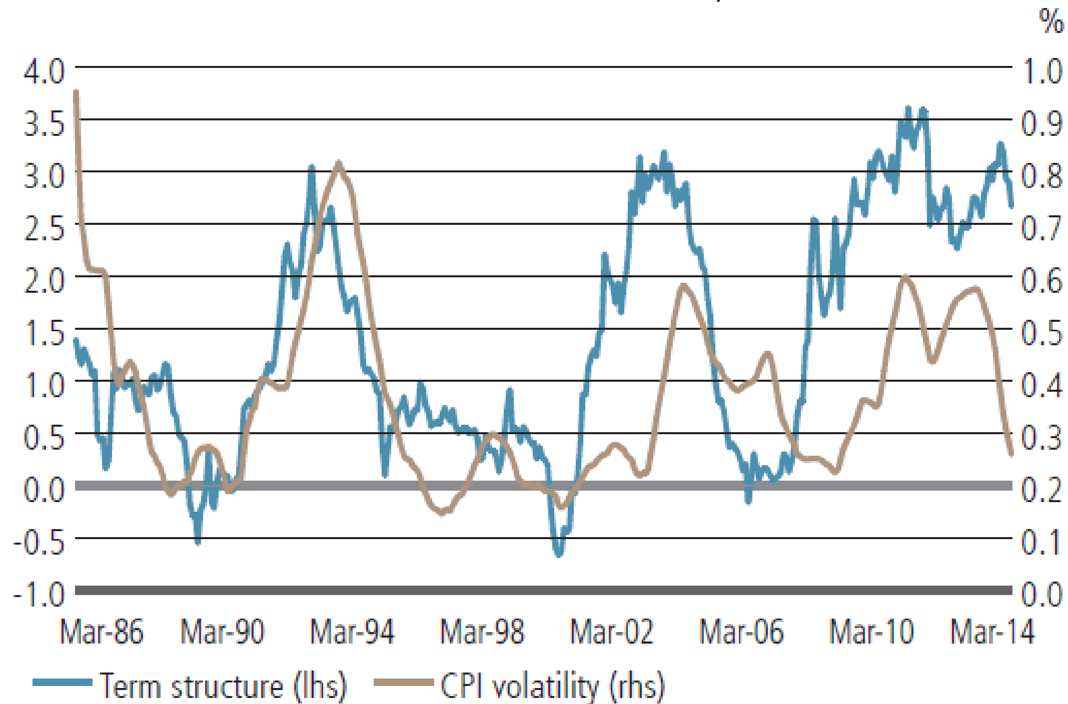
Figure 3: Stable inflation means a flatter yield curve

Government bond term structure and inflation volatility in the US



Sources: BBloomberg Finace L.P., UBS Global Asset Management. As of 31st March, 2014

All of the above means that, in the post-crisis "new normal," rules of thumb for both policymakers and investors need to be rethought. Nothing is certain - there could be a spike in birth rates in one or more countries, policymakers may change the regulations, and inflationary expectations and yield curves could reassert some of their pre-crisis norms. However, for now the consensus still thinks that yields will rise. The current forecast is that the 10-year US government bond will be at 3.25% at the end of the year, even as the Fed pushes the date of the first interest rate rise further and further out. An old investing maxim is that the market likes to cause the most pain to the most people most of the time. I guess that is another way of saying that the consensus is usually wrong. I think that it is in for a surprise.

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