BOND MARKET UPDATE

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Why the Crowd Got It Wrong

"The only function of economic forecasting is to make astrology look respectable."

– ***John Kenneth Galbraith***

The overwhelming consensus at the onset of 2014 was that economic growth would gain traction, generate upward pressure on inflation in the process and push bond yields higher. The consensus proved to be wildly inaccurate as growth slowed, inflation remained benign, and 10-year government bond yields fell by as much as seventy basis points.

In this report, we highlight the multitude of reasons for the unexpected drop in bond yields, as well as explain why the crowd's about-face and comfort with recent trends might be a mistake.

A confluence of factors has put downward pressure on bond yields:

1. **Weaker than expected economic growth:** The U.S. economy got off to a poor first quarter due to brutal winter weather. Meanwhile, growth elsewhere in the world has been disappointing. Japan's experiment with massive monetary stimulus has failed to deliver lasting economic strength. Growth in China and other emerging markets continues to slow.

   Europe's recovery has been especially weak. The expected improvement in its economic growth did not transpire due to ongoing government fiscal restraint and tight lending standards in the banking sector. The yields of European sovereign bonds have plunged to record lows. Indeed, the decline has been so dramatic that seven countries in the EU have two-year bonds with yields below zero. North American bond yields declined in sympathy, as their relative attractiveness improved with the drop in European yields.

2. **Limited inflation:** With the employment situation strengthening in the U.S., the consensus view was that wage demand would kick in and begin to push headline inflation higher. This has not happened. Wages are barely keeping pace with inflation in North America; while in most of the world, especially in Europe, wage growth is less than inflation. Many employers froze wages during the 2008/09 financial crisis and some are still reluctant to allow increases. Commodity prices have been benign as well. After rising 12% in the first half of the year, the benchmark commodity price index reversed course and is unchanged for the year.

3. **Bond demand exceeded supply:** Demand for bonds, particularly long-term bonds, has exceeded supply. The consensus believed that bond yields would rise when the U.S. Federal Reserve started scaling back its $100 billion per month bond-buying program, but that has not happened. Instead, the demand for bonds from other sources, such as foreign central banks and sovereign bond funds, has exceeded the reduction in purchases by the Fed, by a huge margin. In the U.S., investors poured $84 billion into mutual bond funds while U.S. commercial banks increased their treasury holdings by approximately 23% year-to-date. At the same time, the supply of bonds fell sharply. The U.S. budget deficit narrowed as a result of higher tax revenues from an improving economy, while

spending was held to a 1% increase. The result has been a steep decline in the Federal deficit to a mere 2.8% of GDP. Accordingly, the issuance of Treasury bonds and notes to finance the deficit has fallen by 59%. Corporate and mortgage-backed security issuances were also weaker in the first half of the year.

4. **Demographics:** Aging populations and the increasing number of retiring baby boomers have created a global savings glut and increased the demand for bonds. Pension funds and life insurance companies, in particular, need long-term, high-quality bonds to offset long-term liabilities.

5. **Geopolitics:** Conflicts and tensions in various parts of the world have contributed to, and are continuing to contribute to, a flight-to-quality. With the U.S. dollar being the de facto global reserve currency and given the relative attractiveness of Treasury bond yields, money flows into the U.S. Treasury market have been robust.

Given the above considerations, it is understandable that bond yields have fallen this year.

It is human nature to extrapolate the recent past and therefore not surprising that consensus opinion now calls for more of the same - weak economic growth, benign inflation and lower bond yields. Indeed, the fact that the Japanese have experienced meager inflation and ultra-low bond yields for decades makes it easier to believe that bond yields will remain low. Moreover, it will likely take years of concerted monetary stimulus and fiscal reforms to get Europe back to economic health, and thus global bond yields may remain somewhat anchored by persistently low interest rates in Europe. Still, there are reasons to believe bond yields could be bottoming:

1. The U.S. economy has rebounded from the first quarter setback and economists expect growth to be 4% in the third quarter.

2. The U.S. employment situation is healthy, with 1.5 million jobs added in the last six months. With downward pressure on wages easing and some labour shortages being reported, it might not be long before wage demands intensify.

3. Bond supply is expected to increase as the U.S. Federal Reserve reduces its quantitative easing, bond-buying program. Corporations are taking advantage of low interest rates and will likely issue a record $1 trillion in bonds this year. Although the U.S. budget deficit has fallen, there will still be the usual seasonal increase in Treasury bond issuances in the later part of the year due to the timing of tax revenues.

4. The latest round of monetary stimulus by the European Central Bank (ECB) may put upward pressure on inflation expectations and longer-term interest rates.

5. The recent dramatic exodus from high-yield funds is a reminder that investor attitudes can change quickly. If interest rates were to rise, the flight from bonds could extend to investment grade funds.

6. The U.S. Federal Reserve is expected to raise the Fed Funds rate in 2015 and yields on bonds from two-to-five years have started to move up in anticipation of monetary tightening, despite the downward trend in long-term bond yields. Such action could be the canary in the proverbial coal mine with regard to the general trend in interest rates.

It's challenging to reach definitive conclusions regarding the near-term direction of bond yields. There are good arguments on each side of the equation.

While we believe the global economic recovery will remain on track, we continue to expect it to unfold in a muddle-through fashion punctuated by fits and starts. On balance, there is simply too much leverage in the world to expect robust economic growth and significant inflationary pressures. Instead, there is good reason to believe that central bankers will be fighting deflationary forces with accommodative monetary policies for an extended period of time and that interest rates will stay relatively low for longer than many expect.

With so much uncertainty regarding the trend in interest rates, fixed income investors should eliminate the reinvestment risk of having a disproportionate percentage of their fixed income portfolios in either short-term or long-term securities by maintaining laddered portfolios consisting of investment grade corporate bonds.