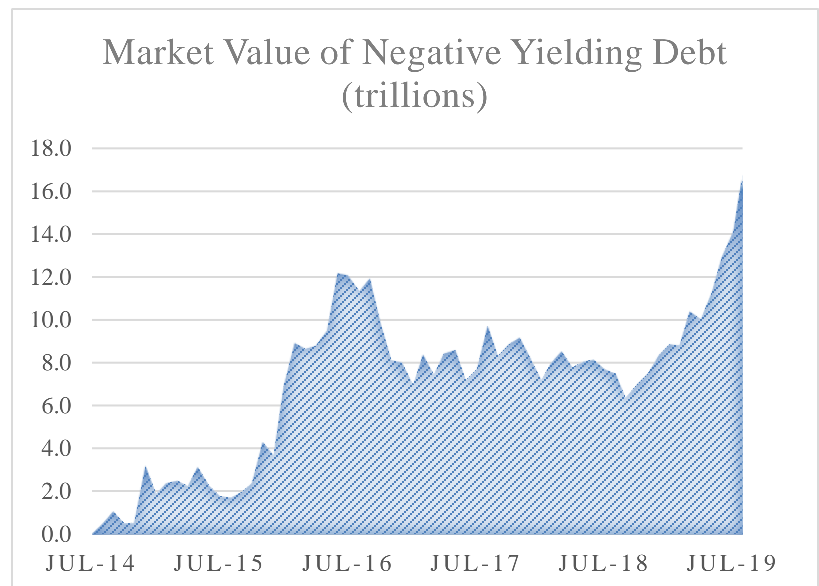
How Low Can Rates Go?

Thinking About Fixed Income in Today's Rate Environment

The recent downdraft in US bond yields paired with negative yields spreading across Europe and Asia have investors pondering whether or not US Treasury yields could at some point encounter a similar fate. The dollar amount of negative yields globally recently eclipsed the $16 trillion mark, a staggering number that has more than doubled in the past twelve months alone. For further context, approximately 29.7% of the Bloomberg Barclays Global Aggregate Index now carries a negative yield, a number that was close to zero only five years ago.

With global headwinds now seemingly gaining momentum and additional monetary easing expected, it is not out of the realm of possibility that US investors could also experience negative yields at some point in the future. The purpose of this piece, however, is not to surmise whether or not yields in the US will indeed fall below zero, but rather to provide a brief reminder of the importance of maintaining fixed income as part of one's asset allocation despite the low absolute level of bond yields in US markets today.



Source: Bloomberg

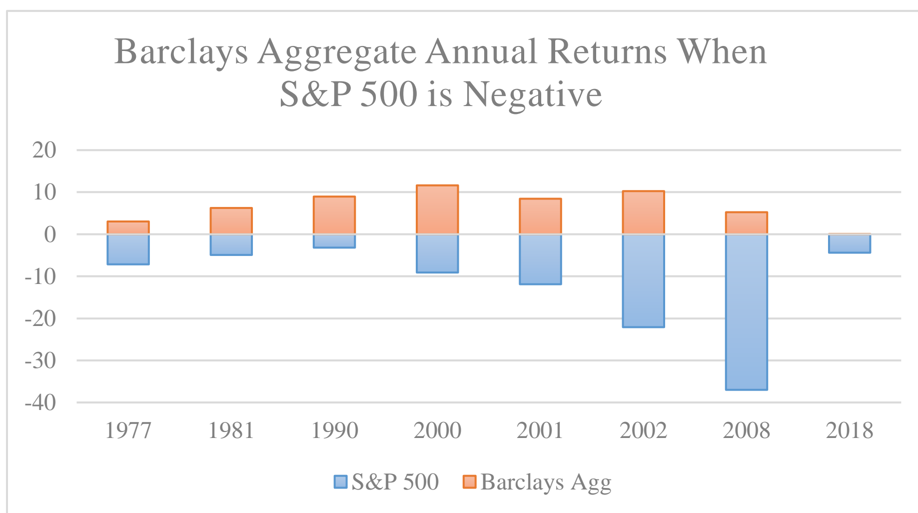
Background on Negative Yields

The negative rate experiment began in Europe in 2014 when the European Central Bank (ECB) began charging banks interest on cash they held at the ECB in an effort to promote lending and stimulate economic activity. The Bank of Japan followed suit posting negative short-term rates in early 2016, and when combined with the massive amounts of bond purchases already being made by central banks, the net effect has been continued downward

pressure on bond yields globally. Structural phenomena such as demographics and technological innovation have further acted as deflationary forces on yields, and even a decade of ultra-accommodative monetary policy by the US Federal Reserve has been less than successful in generating the above-trend economic growth required for higher bond yields here in the US.

Bonds Provide Stability

As bond yields continue to move lower, investors may question why they should own bonds at all in their portfolios. We note that a defining characteristic of bonds is that they have historically acted to counterbalance equity exposure in times of market stress. In fact, in every year since 1977 that the S&P 500 posted a negative annual total return, the corresponding return on the Barclays Aggregate Bond Index has been positive. While that phenomenon has faded somewhat during this cycle as bond and equity prices have moved upward in tandem, we would expect that in increasingly volatile markets investment grade bonds will once again retain their defensive characteristics as safe haven assets. As such, we continue to view fixed income as an integral piece of the asset allocation mix for investors and as a source of ballast in portfolios, particularly in an environment of heightening uncertainty.



Source: Bloomberg

Yields Not Always a Proxy for Returns

Investors may view the yield on the 10 year US Treasury note today and determine quite simply that bonds are expensive and returns in coming years will be modest at best. It is important to remember, however, that bond prices generally maintain an inverse relationship with their corresponding yields, and as yields have fallen this year, bonds have performed better than their expected yield would indicate. As an example, the Bloomberg Barclays US Treasury Index yielded 2.61% on 12/31/18 and year to date through 8/27/19 that index has returned

a healthy 8.7%. Similarly, a 10 year German Bund yielding only 0.24% at the beginning of 2019 has generated a year to date return of approximately 9.6%. This demonstrates that even in a low or negative rate environment, over the short run, bonds can provide total returns in excess of their expected yields if rates continue to move lower.

Buy and Hold

At MAI, we believe in the merits of utilizing a buy and hold investment strategy rather than attempting to time the market. Inevitably, markets will always have their ups and downs, however, by holding a bond to maturity the investor will ultimately realize a return equal to the yield expected at time of purchase. Despite a challenging longer-term outlook for bond returns, the fact that bonds offer this defined outcome is precisely why we view fixed income as the anchor to windward in our clients' portfolios. Even as yields fall, the combination of principal stability and a steady stream of income positions bonds to continue serving a key role in achieving client objectives.

As always, we value the confidence you have placed in MAI to be your trusted advisor. If you have any questions regarding your portfolio or would like to discuss any changes to your financial situation, please feel free to contact us at any time.

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