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How Low Will Yields Fall?

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How Low Will Yields Fall?

- Recent yield declines look to be largely cyclical.
- The current low-yield environment is probably here to stay, but we do not expect the US to follow Europe or Japan to negative yields.
- We see policy as the main risk that could push yields lower, but also higher.

Global bond yields have been on a steep decline over the last ten months. The 10-year US Treasuries yield dropped 177bps from last November's high to this September's low. Other industrialized countries experienced similar yield declines (see Table 1 below).

Moreover, yields are increasingly turning negative. Currently, about 30% of global investment-grade bonds have a negative yield.[1] And, this is not limited to bonds. In Denmark, Jyske Bank has recently offered a negative mortgage rate.[2]

Table 1: 10-year government bond yields

% p.a.	Nov. 8th 2018	Sep. 4th 2019	Bps difference
U.S.	3.23	1.46	-177
Canada	2.54	1.13	-141
Japan	0.12	-0.29	-41
France	0.82	-0.37	-119
Germany	0.45	-0.67	-113
Italy	3.40	0.88	-251
U.K.	1.56	0.44	-113

Source: Bloomberg [3]

What lies behind the decline in bond yields?

Will negative bond yields become a regular feature in the US?

In our judgment, the recent drop in bond yields is largely driven by falling growth expectations and the anticipation of significant monetary easing. This is primarily a cyclical phenomenon and, thus, should be temporary.

This said, we believe the low interest rate environment is here to stay for some time. Yet, structural differences should prevent the US from following Europe and Japan into persistent zero or even negative yield territory. Then again, the main risk is policy, which could push yields both lower as well as higher.

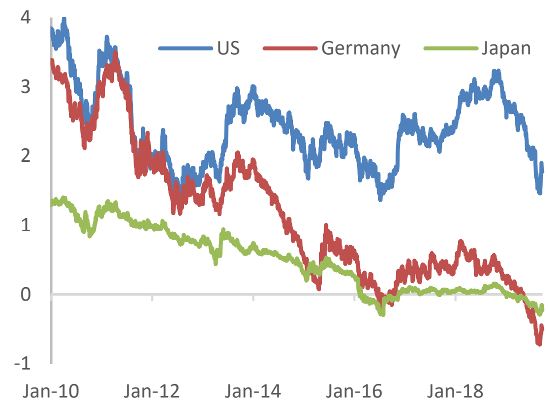
Downtrend versus sideways range

It is useful to put the recent decline in bond yields into perspective. Bond yields in Europe (German Bunds) and Japan have been on a downtrend over the last ten years (see Chart 1).

In contrast, bond yields in the US have been moving sideways in a broad range. Indeed, even the recent lows in US yields failed to break the lows of the last 10 years.

To understand the difference between the US and German/Japanese situations, it is important to distinguish between shorter-term forces, which are influenced by business cycle dynamics and monetary policy expectations, and longer-term forces, which reflect growth and inflation trends, as well as the structural supply and demand of funds.

Chart 1: 10-year government bond yields



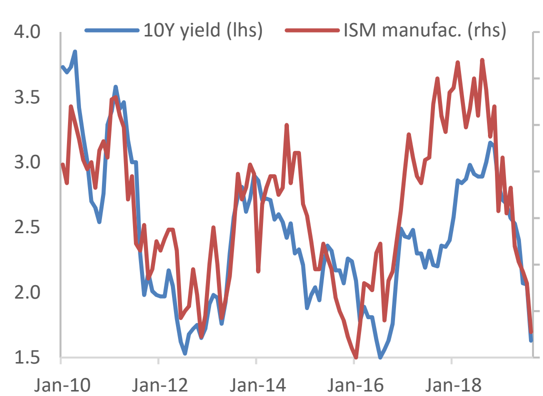
Source: Bloomberg [4]

It's the economy, stupid!

The deterioration in economic growth expectations seems to be the key factor responsible for the recent decline in bond yields.

Chart 2 shows the close cyclical relationship between economic sentiment in the US, (proxied here by the ISM manufacturing index and 10-year Treasury yields), where the recent decline in bond yields was foreshadowed by a sharp drop of the ISM manufacturing index.

Chart 2: US 10Y yield & manufac. ISM



Source: Federal Reserve Bank of St. Louis & ISM [5]

The decline in economic sentiment seems to have market participants expecting significant rate cuts by the Fed.

So far, the Fed has lowered the funds rate by 75bps; Fed funds futures suggest the market expects another 50bps of rate cuts over the next 12 months.[6]

Still lower yields possible

In our view, recession is not the most likely outcome over the next 12 months, but the business cycle has aged and the economy has become vulnerable to shocks, like the fallout from the trade conflict with China.

In the event of a recession, we believe the Fed will have to cut the funds rate to zero and will most likely resume Treasury purchases.

In this environment, we see bond yields as bound to move even lower. However, we would view that as temporary.

A more important question is whether structural forces could push US yields permanently lower to a range near the yields seen in Europe and Japan.

Low-yield environment to stay

We believe the global low-yield environment will persist for some time. There are many country-specific factors that contribute to this environment; we have observed three trends that appear to stand out:

- The shift from physical to intellectual capital, as well as from manufacturing to services, and the simultaneous moderation in productivity growth have reduced investment demand.
- Aging populations and greater income inequality have pushed up savings rates.
- Increased competition in goods and labor markets through technological progress, globalization and the fading of union power have flattened the "Philipps-curve"[7] and, thus, reduced the threat of inflation.

US is different from Japan and Europe

Within this low-yield environment, however, there are structural differences that explain the different yield levels, especially between the US, Japan and Europe (see Table 2).

Table 2: Fundamental trends

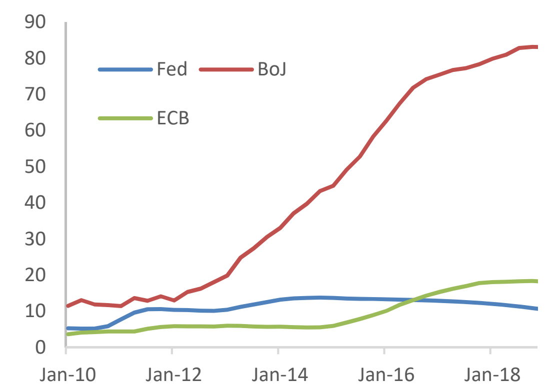
% 2010-19 avg.	U.S.	Japan	Euro area
Real GDP growth	2.3	1.3	1.4
Inflation	1.8	0.5	1.4
Fiscal bal./GDP	-5.5	-5.8	-2.6
Curr.acc./GDP	-2.4	2.7	2.1

Source: IMF [8]

- First, the US has higher GDP trend growth, thanks to fewer structural rigidities and more favorable demographics.
- Second, while US inflation is moderate, it is higher than in Japan and Europe. Moreover, we see no signs that a deflationary mindset has developed in the US as was the case in Japan, where goods and asset prices as well as wages stagnated and even declined during the last 20 years.
- Third, the US has a large and rising budget deficit and not enough private savings to offset it, resulting in a current account deficit. Europe and Japan also have budget deficits, but have sufficient domestic private savings resulting in current account surpluses.
- Fourth, the US has been quick to restore banking-sector health after the financial crisis. The poor shape of banking, especially in Europe, has undermined the intermediation of savings and investments there.

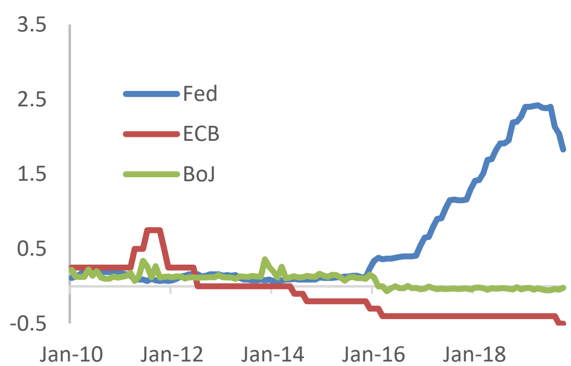
- Fifth, and not least, the Bank of Japan (BoJ) and European Central Bank (ECB) have been more aggressive in lowering bond yields, the BoJ through very large purchases of government debt and the ECB through a combination of bond purchases and negative policy rates (see Charts 3 & 4). Moreover, the BoJ and ECB are trapped in negative policy rates. Unlike the Fed, the BoJ and ECB failed to normalize their policy stance as recoveries broadened.

Chart 3: Gov. debt holdings % of GDP



Source: Fed, BoJ, ECB [9]

Chart 4: Central bank policy rates (%)



Source: Fed, BoJ, ECB [10]

Policy is the biggest risk factor

It is possible that some of these differences change. However, it is unlikely in our view, that all the differences disappear and the US becomes like Europe or Japan.

The biggest risk comes from monetary policy, for example, if the Fed becomes tempted or forced to monetize the government's debt. This could push yields much lower, as in the case of Japan, but could also unleash higher inflation expectations, especially if fiscal policy becomes expansionary, which would result in much higher yields.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com.

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1 Bloomberg "The Unstoppable Surge in Negative Yields Reaches $17 Trillion" https://www.bloomberg.com/graphics/negative-yield-bonds/

2 Bloomberg "Negative Mortgages Set Another Milestone in No-Rate World" https://www.bloomberg.com/news/articles/2019-08-18/negative-mortgages-set-another-milestone-in-a-no-rate-world

3 JPMorgan Website at https://markets.jpmorgan.com/#dataquery

4 Refer to JP Morgan data at Footnote 3

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European Central Bank – Statistical Data Warehouse: Euro area (changing composition), Eurosystem reporting sector – Securities of euro area residents denominated in euro, Euro – Euro area (changing composition) counterpart (ILM.W.U2.C.A070000.U2.EUR);

Data Source in SDW: http://sdw.ecb.europa.eu/quickview.do?org.apache.struts.taglib.html.TOKEN=104d2024449314690f421a32a5a8df71&SERIES_KEY=123.ILM.W.U2.C.A070000.U2.EUR&start=&end=&submitOptions.x=0&submitOptions.y=0&trans=N&periodSortOrder=ASC

European Central Bank – Statistical Data Warehouse: Gross domestic product at market prices – Euro area

19 (fixed composition) - Domestic (home or reference area), Total economy, Euro, Current prices, Non transformed data, Calendar and seasonally adjusted data (MNA.Q.Y.I8.W2.S1.S1.B.B1GQ._Z._Z._Z.EUR.V.N);

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