The consequences of relentless borrowing

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The BNY Mellon-commissioned report on policy and the search for yield 'Policy: the Road to perdition or salvation' highlights the difficult environment investors face. Volatility, policy interference, political risk and an abnormal return environment all lead to the question of where and how investors will find yield opportunities. The independent economist group that authored the report, Llewellyn Consulting, notes the danger is that, in desperation to meet the challenges of low returns, long-term institutional investors pursue herd-like behaviour in the search for yield and in doing so acquire excessive holdings of high risk, illiquid assets prone to shocks and fire sales.

Newton's fixed income investment leader, Paul Brain, poses a similar question, wondering 'what next for bonds?' after 35 years of a bull market, and how might investors cope with a significant change in fixed income prospects?

Executive summary

- The introduction of fiscal schemes will be different for each country, and central banks' response will also be varied. As a result, the bond market reaction will likely be diverse.
- Adjusting interest-rate exposure when yields are expected to rise, and diversifying into other countries which are not subject to falling bond markets, is going to be more important than ever.
- The addition of fiscal stimulus to the mix of options from the authorities has introduced a potential negative for bond markets.
- Expect a great deal of volatility in government bonds in the early part of 2017, followed by a decline in yields later in the year as the global economy starts to lose momentum.

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To answer the question, we should analyse how we arrived at this point, and see if the circumstances that got us here are going to change.

From the high-inflation peaks of the 1970s and 1980s, bond yields have come down. They haven't fallen in a straight line and there have been a few tantrums along the way but the decline in yields over the past 35 years has been a significant bull market trend. The move by central banks to kill high inflation, which was spearheaded by chairman Paul Volcker's Federal Reserve, brought about a reduction in inflation expectations, undermined the power of unions and allowed interest rates to fall.

One of the consequences of this benign environment has been the relentless growth of borrowing. After all, if borrowing rates are low and declining, why not borrow as much as you can? Consumers, companies and governments have all joined in and now the world is awash with debt – US$152 trillion of it, according to a recent International Monetary Fund study.[1] Declining returns on capital (as measured by the cost of capital) spurred on increased borrowing and the occasional spectacular asset blow-up. An example of this are the Latin American debt crisis of the 1980s, while housing bubbles have brought about the necessary response from the authorities to act by loosening monetary policy – thereby restarting the relentless decline in interest rates.

Policy approaches

This constant imperative to support indebted markets hasn't allowed capacity to be removed; nor has it reduced debt, although it has made debt more sustainable (as interest rates have been reduced). Politicians and their central bankers are unable to break this cycle. Defaulting on debt or causing mass unemployment is not a vote winner, and the rise of populism makes it increasingly unlikely that the authorities will change direction in the near term.

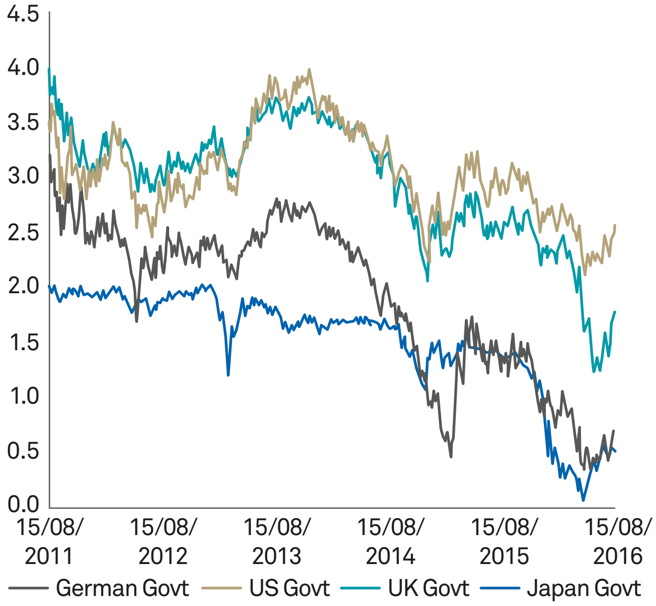
So when does this cycle to ever-lower yields end? If loosening monetary policy is the only tool being used, then it could come to an end when the policy becomes counterproductive. The move to negative rates, and the crowding out of investors from the bond markets, suggests we may be reaching that point. Given the inherent self-survival characteristics of politicians, it looks like they want to try a different tack – fiscal stimulus.

Tax cuts and the loosening of the relentless increase in regulations could reignite some of the 'animal spirits' that have been lacking since the financial crisis. Economic growth could be supported and investment reignited with government investment in infrastructure. As a result, government debt would increase, but this would be funded by the central banks, who print money to pay for the debt. Everybody wins.

Hold on though, if growth is picking up, won't this ignite the latent inflationary trends that are just below the surface? Won't we then get the bear market in bonds some have been anticipating?

Possibly, but given very high debt levels authorities may be tempted to try and lock bond yields at low levels. This has happened before, and has started again. The Bank of Japan's recent change in strategy is reminiscent of the US in the 1940/50s, which locked in the US 10-year borrowing rate at the same time as it helped Europe and Japan rebuild following the WWII through subsidised borrowing (the Marshall plan). Many in the US harp back with some nostalgia to that era when investment in highways and other transport infrastructure brought about significant increases in output.

Long-dated government bond yields



Source: Thomson Reuters Datastream, October 2016.

1 https://www.imf.org/external/pubs/ft/fm/2016/02/pdf/fm1602.pdf

There are a number of issues with this type of approach. First of all, are governments good at leading investment trends? The current idea may be to invest in existing transport infrastructure (owing to its poor maintenance) when, actually, building electric charging stations and improving grids and electricity production may be better as we shift towards electric cars.

Fiscal repercussions

Another issue could be that not all populations will respond to an increase in government spending positively. In Japan, for instance, there have been 42 fiscal programmes since the economic peak in 1989, but each time there has been a temporary pickup in activity before the consumer has decided to increase savings and the economy has fallen back.

Finally, if many governments try this at the same time, it will cause a global increase in capacity and inflation won't necessarily rise.

However, this is a significant change from the predominantly loose monetary/tight fiscal policy that has been in place since the global financial crisis, and as such we expect it to have a significant impact on bond yields. The short-term expectation that this will lead to higher inflation could cause yields to rise but in some countries this will be offset by central-bank buying (aimed at keeping a lid on borrowing costs).

It is easy to see that the fiscal schemes will be different for each country, and that central banks' response will also be varied. As a result, the bond market reaction is also likely to be diverse.

How can investors cope with this significant change in prospects for bond markets? First of all, adjusting interest-rate exposure when yields are expected to rise, and diversifying into other countries which are not subject to falling bond markets, is going to be more important than ever.

Without doubt, the addition of fiscal stimulus to the mix of options from the authorities has introduced a potential negative for bond markets. The concern that such stimulus won't be effective could be irrelevant if the authorities believe it is the solution and just keep applying it until it works. The result could be inflation (the nemesis of bond markets) if it works, but increasing debt loads if it doesn't. Ultimately bond yields can't rise too far in an environment of high debt, and we would expect the authorities to cap government bond yields if they do.

How to cope with this significant change in prospects for bond markets

We expect a great deal of volatility in government bonds in the early part of 2017, followed by a decline in yields later in the year as the economy starts to lose momentum.

Investors' inflationary concerns could rise and it is our conviction that bond investors will need to be more inventive.

The following are seven ideas we feel could be useful this year.

1. US Treasury Inflation-Protected Securities (TIPS)

When long-term inflation expectations drop, these securities start to offer value. This occurred at the beginning of 2016, when the falling oil price was expected to push headline inflation to very low levels. Once the oil price had stabilised, we concluded that it could continue in a well-defined, but low, range for some time. This would mean that the year-on-year inflation rate would start to rise once more (as the previous years' falls dropped out of the calculation).

Also, as it became clear to us at the beginning of 2016 that monetary policy was reaching its limit, we began to anticipate a shift towards fiscal stimulus, which could be interpreted by the market as more inflationary.

2. Look to countries where rates could be cut and where there is unlikely to be a fiscal programme

If a country is still looking to keep rates low, or even cut them further, and does not need to resort to a combination of fiscal and monetary stimulus, bull-market trends may be maintained. Both Australia and New Zealand fit into this category.

3. Cross-currency positions

After a prolonged period of easy money, and then a collapse in the main export of several countries, there are bound to be national differences. If you add in the inevitable political uncertainty, there is scope for significant divergence in the performance of individual currencies. For example, there are concerns about the political and economic stability of the European Union and countries such as South Korea. On the other hand, the relative value of currencies such as the Australian dollar and Swedish krona could be attractive if rates are no longer being cut and commodity prices are rising.

4. Targeting companies that could benefit from an increase in infrastructure spending and tax changes

Investing in the relative performance of companies that are able to increase profits from the extra money that could be put into various infrastructure plans seems a sensible thing to do. Companies that benefit directly, such as cement companies, or perhaps indirectly, such as utilities, can be used to gain exposure to this changing trend in spending. Existing infrastructure companies, which could gain extra capital, could also be attractive from this perspective.

5. Yield-curve positioning

As some countries move towards a mixture of loose fiscal and monetary policy, the corresponding rise in inflation expectations should tend to make the longer end much more volatile, while the front end is likely to be locked by the maintenance of low short rates.

6. Floating rate notes

In some countries, short-term interest rates will rise. Floating rate notes have coupons that are directly linked to cash rates, and therefore their income return will rise as well.

7. Bank bonds

History suggests, steeper yield curves and fewer regulations, plus a better economic growth outlook, should help the profitability of banks and their bonds.

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