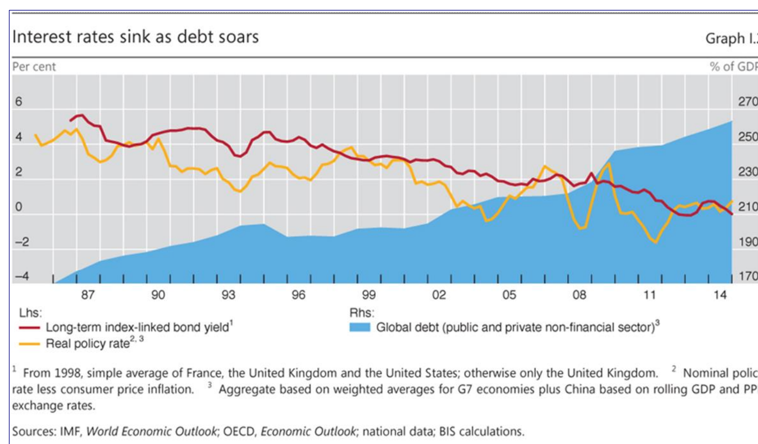
AUGUST 2015

INVESTMENT UPDATE

Basic economics teaches us that the more of something that's available, the less it should cost. "Goods" that are abundant cost less (air is the ultimate example—unless you're on the summit of Mt. Everest or downtown Beijing); things that are rare and useful will cost more. In the bond market, that would mean that bond prices should fall—and interest rates should rise—when there is a heavy supply of bonds available. But the laws of supply and demand seem to be working erratically in the current investment environment, at least as they relate to the bond market.

For an example of where the old rules don't seem to apply, we only need to look at the broadest measures of debt and interest rates in the global marketplace, a place where, more than anywhere, you might expect these rules to hold fast, just based on the magnitude of the numbers. The chart on this page, courtesy of the Bank for International Settlements' (BIS) recent *Annual Report,* shows that over the past three decades, debt has steadily grown among G7 countries (plus China) from less than 170% of combined GDP to more than 250% of GDP. Yet interest rates have been on a steady decline over this same period, meaning that bond prices have been rising. Instead of demanding a lower price (and a higher yield) in the face of a growing glut of bonds, investors have been happy to pay steadily higher prices for securities which pay a fixed level of income.



While we may question investors' motivations, who can blame a company or a government institution for issuing bonds when interest rates are at generations-long lows? Currently, the US Treasury can issue bonds ("Treasury Notes," technically) with maturities as long as five years at rates that are below zero, after accounting for core inflation; meanwhile, a number of European governments (Switzerland and Germany, in particular) have been able to issue short- and intermediate-maturity government bonds over the past few months at interest rates below zero, and that's *before accounting for inflation*.

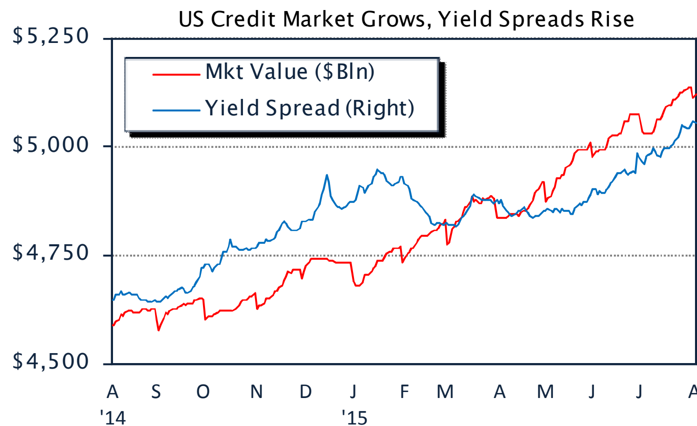
In its study, the BIS points to a number of different factors that might cause interest rates to remain suppressed in the face of bulging supply, including the notion that "low rates beget lower rates"—namely, that low interest costs encourage the issuance of debt, which burdens the issuer with greater obligations to pay down the road, creating "boom and bust" scenarios. These global financial imbalances, instead of addressing the underlying problem of slow economic growth and declining productivity, only increase the risks to issuers and destabilizes the global economy. The Greek situation is an example of this phenomenon.

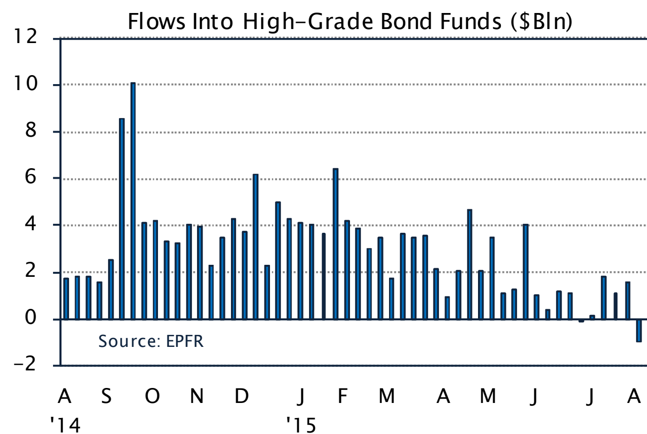
Low rates are therefore a by-product of a lack of policy coordination within, and especially, between countries. In the opinion of the BIS, growth has been artificially boosted by the use of debt by the Federal Reserve and other central banks over recent history, a practice that has papered over deeper problems within these economies while also encouraging risk-taking by easing the financial costs of speculative enterprises. And while there is a natural bias for central banks and other policy makers to encourage growth—including policies that prolong the duration of the business cycle—these measures also can lead to much bigger "busts" when things inevitably turn south. In other words, none of these measures actually end up spurring organic growth or help to build healthy economies, and as a result rates remain suppressed while debt grows.

Its recommended solutions include better coordination and implementation of solid and responsible fiscal policy—saving or spending at the federal, if not international, level depending on the health and growth of an economy. Coupled with more neutral monetary policies and "macroprudential" rules in the financial and banking systems (e.g., adequate capital buffers among financial institutions), fiscal policies that build budget surpluses during economic booms and run deficits in order to fund stimulus projects during tough economic times will normalize interest rates and lead to long-term economic stability. As would be expected from an organization that's called the Bank for International Settlements, it believes strongly in

policy coordination in order to minimize imbalances of the type that can stimulate economies in one region and destabilize those in other parts of the world.

Looking a little more narrowly—and closer to home—we see that the supply and demand equation remains very much intact in the US corporate bond market. With the long-awaited "liftoff" of short-term rates finally looking like it's going to happen in the next six weeks or so, corporate issuers have been making-hay-while-the-proverbial-sun-is-shining by issuing a record amount of debt at still-favorable rates. As the top chart on this page shows, the market value of the high-grade US bond market has taken a steeper trajectory over the past few months, having ballooned by more than $500 billion in the past year alone (this is a "net" figure, and can shrink if maturities and other redemptions outpace new issuance). In fact, new issue volume set a record for the month of July this year at $129 billion. Meanwhile, the yield spread between the average investment-grade corporate credit and benchmark US Treasuries (specifically, the option-adjusted spread, or OAS) has spiked in the past few months, as investors have been demanding an increasingly bigger price concession to buy non-government bonds in the face of all this supply. As the chart shows, the yield spread over Treasuries for the average high quality US corporate bond has gone from right around 100 basis points (1.00%) to just shy of 150 basis points over the past 12 months.





The result of this supply-demand imbalance? Ugly relative returns for corporate bonds over the past year, with the average high-grade credit underperforming like-duration Treasuries in 10 of the past 12 months; for the one-year period, corporates have trailed Treasuries on a total return basis by more than 2.25%—this from a sector that typically outperforms Treasuries.

There is some good news amidst all the pain in the corporate bond market: Now that corporate credits have underperformed due to supply-related price pressures over the past few months, their yields relative to benchmark Treasuries have widened to the point that the corporate sector (at least for investment-grade bonds) is looking quite attractive on a relative value basis. This is particularly true when we look at the historically low levels of market volatility in equities. Currently, the average high grade corporate bond offers more than 10 basis points per unit of equity volatility (the so-called VIX index), which according to Merrill Lynch is the highest level since the financial crisis. This is significant, as VIX and corporate yield spreads typically move in tandem, and is strong evidence that the good relative performance of stocks and poor relative performance of bonds over recent months must be due to something more technical (supply/demand imbalance) than fundamental. After all, if fundamental risks (e.g., pressures on earnings) to investors were rising, both corporate bonds *and* corporate stocks should be simultaneously taking it on the chin; but stocks have easily beaten bonds over the past few months.

The other thing to consider is demand, and here again, we see pressures conspiring to push yield spreads wider on high-grade corporate bonds. The bottom chart shows that demand has been waning over recent months, as flows into non-money market bond funds have slowed to a trickle. Lots of supply and fading demand is a recipe for wider yield spreads, even in a strong economic environment when confidence is high; but even more so when investors are concerned about what happens to longer-dated bonds once the Fed starts pushing up short rates.

Finding the answers behind the global collapse in interest rates is sure to be frustrating, if for no other reason than the panoply of factors—fundamental, technical, emotional, policy-related—impacting rates, especially over the short term, are varied and complex. We can speculate as to where rates "should" be, but ultimately forecasting interest rates is a fool's errand; there are simply too many moving parts. This is particularly true for rates in the government bond market, where policy-makers manipulate their bond markets for their own country-specific reasons. But we'll table that discussion for another day!