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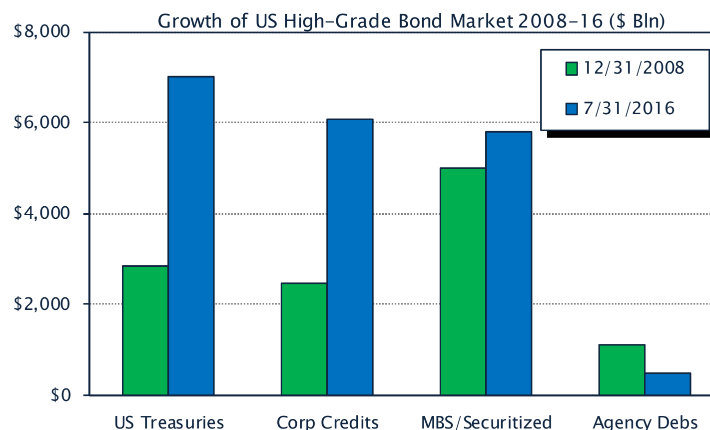
INVESTMENT UPDATE

The investment world has changed markedly since the financial crisis, perhaps nowhere more than in the world's bond markets. At year-end 2008, when it seemed that the global banking system might fall apart, the average yield on a US Treasury bond was 1.55%, while the average yield on a European government bond was 3.30%. Today, seven and one-half years on, US Treasury yields have fallen to an average of 1.23% and in Europe, they're down to a miniscule 0.17%.

Seemingly defying the laws of economics, bond yields have fallen despite the fact that the quantity of bonds outstanding has exploded over this time period, with the US Treasury bond market having grown by 145%, to more than $7 trillion outstanding today (see chart). Similarly, the European government bond market has grown to €10.2 trillion, a 167% increase over the same period. Clearly, the demand for bonds, especially European government bonds, has outstripped the supply, sending their prices up and their yields down to levels never before seen. As we've documented in recent *Investment Updates*, bond yields on Euro government bonds have fallen to below zero for maturities all the way out to ten years and beyond. The same is true in Japan.



But where is this demand coming from, and when will it stop? Those are big questions, with massive implications for businesses, savers, homeowners, investors—anyone who might either borrow money or try to earn interest by socking it away.

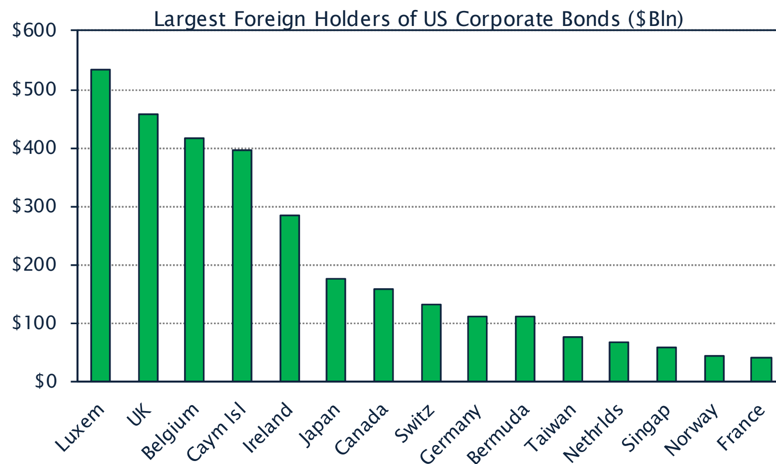
As we all know by now, the demand for government bonds over the past few years has been spurred, in varying degrees, by the "quantitative easing" programs put in place by the Federal Reserve and its foreign counterparts. Even though the Fed has stopped putting new money into its program, it is maintaining the size of its $2.5 trillion Treasury and $1.7 trillion mortgage-backed securities (MBS) portfolios by reinvesting the cash flows from maturities and paydowns. On the other hand, the European Central Bank (ECB) and the Bank of England—not to mention the Bank of Japan and the People's Bank of China—are all currently increasing the scale of their QE programs, continuing to buy bonds in their respective local currencies by the tens of billions. Even after having driven yields into negative territory, the end of these programs is still nowhere in sight.

QE programs not only increase the demand for bonds, they have the double-whammy effect of injecting economies with newly-issued currency, which in turn spurs investors to spend that cash somewhere. As a result, we've seen not just bond prices, but prices on stocks, commodities, real estate, and many other assets soar in recent years. Again, that's good for personal and corporate balance sheets, but not terribly effective in generating real economic growth.

One area where demand continues to outpace a growing supply has special interest for us, and that's in the high-grade US corporate bond market. As the chart on this page shows, like the Treasury market, the US credit market has grown significantly since 2008, more than doubling in that time. And while there have been ups and downs over that period for corporate bonds, they have generated annualized excess returns of 3.7% when compared to like-duration Treasuries since year-end 2008. Of course, the comparison is distorted by the fact that corporate yield spreads (compared to Treasuries) stood at their widest levels since the Great Depression in late 2008; we are unlikely to see those kind of heady excess return numbers again in our lifetimes (let's hope so—2008 was a gut-wrenching experience for us!). Nevertheless, high-grade corporates have generated good excess returns over most any trailing period we care to observe—67 basis points (BP) over three years, 100 BP over five years, and 66 BP over the past decade.

With corporate credits having performed so well over the past several years (including the calendar year-to-date period), and with the overall level of interest rates near—if not at—historic lows, it's only right to ask whether the corporate sector is poised to enter a period of underperformance. From a funda-

mental value standpoint, the answer appears to be "No." Corporate yield spreads, when compared to benchmark Treasuries, stand well above average compared to historical norms, even after adjusting for volatility (which is currently low) and credit quality (which has deteriorated somewhat in recent quarters). Judging on this basis, and against the backdrop of a slow-growth, low-inflation domestic economy supported by expansionary monetary policies, we believe that high-grade corporate bonds continue to offer very good fundamental value. As always, we qualify these opinions with the caveat that things can change quickly; for instance, a major global event can send volatility skyrocketing, which would decrease the valuation of corporates.



Getting back to the first part of this discussion, perhaps an even bigger factor in considering how the credit sector might perform going forward is the "technical" situation—that is, how is the global demand for corporate credits likely to play out in the coming months. Luckily, Wells Fargo Securities just published a fairly comprehensive study on global flows into the credit markets. The source of most of their data comes from the Treasury International Capital System (TICS), which is generally reliable, even though it tracks holdings by the country in custody of the bonds, which may not be the country where the owners of the bonds are actually located. Thus, as we see on the chart on this page, some of the biggest holders of corporates are from smaller countries which act as regional banking warehouses—the Cayman Islands and Luxembourg, just to name two.

Some of the report's findings are surprising—for instance, while so much of the recent economic news seems to focus on what's happening in China, the fact is that purchases from Europe have been approximately three times larger than those from Asia over the last year. Europe now represents 80% of foreign holdings of US corporate bonds, five times larger than Asia. China is nowhere to be seen on the list of largest holders, coming in at #21. Nevertheless, with Asian economies growing faster than those in Europe, it's expected that Asian wealth creation will boost corporate bond demand in that region more than in Europe in the coming years. Taiwan—#11 on the list—increased its holdings of US credits by 43% over the past year, while corporate bond holdings in Hong Kong and South Korea are growing at nearly the same pace, with both just outside the top 15.

The prospects for further purchases of dollar-based corporate bonds are also expected to be stimulated with the relaxation of policies among certain Asian countries that are flush with dollars after years of trade surpluses with the US.

Of course, the study looks at the fundamental drivers of foreign demand for US corporates, and here, the case is strong for continued purchases. One obvious driving force is the yield advantage that US bonds—especially US corporate bonds—have over their foreign counterparts. Nearly all non-US high grade bonds currently offer yields of less than 1%, including corporates. Yields on Euro corporates dropped precipitously over the last year after the ECB added Euro-denominated/Euro-domiciled corporate credits to its asset purchase program. Earlier this month, the Bank of England followed suit, and will be buying UK-issued corporates denominated in pounds. Although they're not even eligible for these programs, US companies have been issuing Euro-denominated bonds (known as "reverse Yankees") to take advantage of the ultra-low funding costs available in Europe. It's no wonder that yield-starved global investors look at US corporates, with yields of 4%, 3%—even 2%—as a relative bargain by comparison.

A close second on the list of critical considerations for global bond investors is the foreign exchange rates between countries' markets. Once again the Wells Fargo study points to continued strength in demand for US bonds. Global investors seek out strong currencies, as a falling currency can easily wipe out the yield advantage of a foreign bond. The US dollar has been remarkably strong among major currencies, with the trade-weighted dollar index having appreciated by nearly 30% in the past five years. US monetary policy, as accommodative as it is, appears to be downright stodgy compared to our free-spending foreign counterparts, which bodes well for the prospects of dollar-based investments. Foreign exchange risks can be hedged, but will get more expensive (and less economic) if volatility increases from its current low level, which should further stimulate demand for US bonds in the coming months.

We repeat—things can change quickly—but from today's vantage point, the growing global demand for US corporate credits is likely to continue unabated, helping to absorb heavy new issuance, and boosting returns for traditional investors like Agincourt.