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Pierre Mouton of Notz, Stucki & Cie on questions of yield and financial repression

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1.1% March 2019 annualised rate of inflation in France

Does yield still yield?

Amid signs of inverse yield curves, there is a debate over the validity of yield as a measure for fixed income investors in particular. Jonathan Boyd, Ridhima Sharma, Eugenia Jiménez and Elisabeth Reyes report

Recently, shareholders in Royal Dutch Shell have enjoyed a dividend yield of 5.8-5.9% depending on whether they own securities in Amsterdam, London or New York.

For the pensioners of Europe, this may be particularly helpful given, for example, the negative rate of -0.4% on deposits offered by the European Central Bank or -0.25% on its repo rate by Sweden's Riksbank.

So, if there is such a gap between interest paid on deposits and dividend yields of some of Europe's biggest and most cash generative companies, where does that leave fixed income instruments?

The challenge is illustrated in the charts for US government debt (see page opposite) which show national debt rising since the sharp drop in yield in the last quarter of 2008.

DIFFERENT FORMS OF RISK

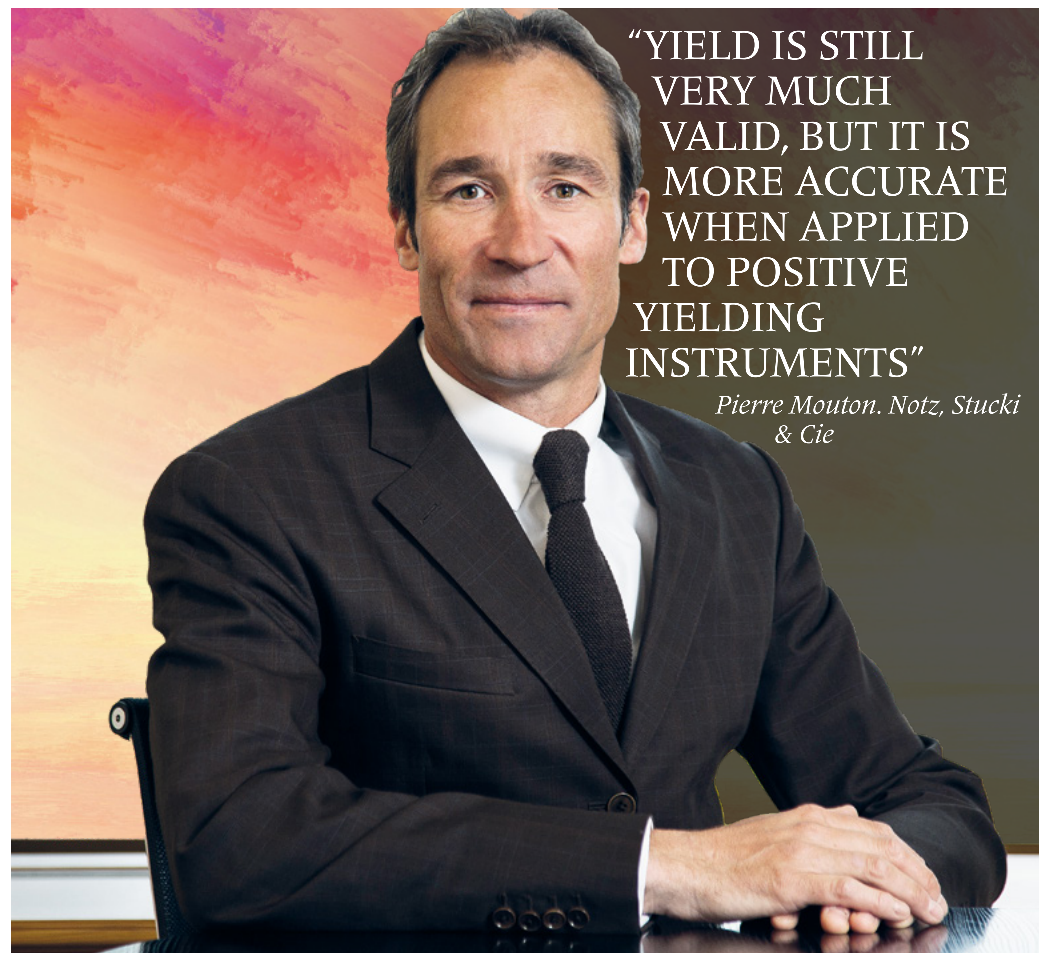
Steve Bleiberg, portfolio manager at Epoch Investment Partners, says: "If you take the view that the return that equities generate is simply the return on bonds plus a nebulous 'equity risk premium' then yes, lower bond yields would imply lower equity returns.

"Our view is that this kind of additive approach to forecasting equity returns is incorrect, because it assumes that bond risk and equity risk can be measured in the same single dimension (price volatility).

"We believe equity risk and bond risk are different forms of risk, and that equity returns come from the ability of companies to earn a return on invested capital that is higher than their cost of capital. Changes in government bond yields may have an indirect effect on this dynamic, but equities do not necessarily have to generate lower returns simply because government bond yields are low– see, for example, the 1950s."

Brian Singer, head of Dynamic Allocation Strategies, William Blair, also points to an element of "confusion in the industry about interest rates and income, with 'yield' being the nexus".

"The meaning of 'yield' has shifted from the internal rate of return (IRR) or return on an asset (ROA), to various measures of cash flow comprising assets and non-assets. Central banks' suppression of market interest rates have made investors talk – and think – about yield as a result of central bank policy—to include any purported



"YIELD IS STILL VERY MUCH VALID, BUT IT IS MORE ACCURATE WHEN APPLIED TO POSITIVE YIELDING INSTRUMENTS"

Pierre Mouton. Notz, Stucki & Cie

€52.4bn Annual interest payments on German national debt (Federal & State)

source of cash flow. Only when central banks' manipulation ends might market participants return to more traditional definitions."

"We are unconvinced about the central banks' abilities to raise rates to what we see as long-term sustainable levels. This makes us less negative on bonds in countries with very low rates. These yields may look unsustainable, but central banks do not see low real rates as harmful and, therefore, perceive little incentive to raise rates," Singer adds.

INTERPRETING THE YIELD CURVE

One of the challenges stemming, then from this untraditional era of monetary policy is how to interpret what the yield curve suggests.

Erick Muller, head of Product and Investment Strategy at Muzinich & Co. notes that historically the curve has been considered a good indicator of economic cycles, with inversion often associated with high probability of recession, but that there are reasons to challenge conventional wisdom.

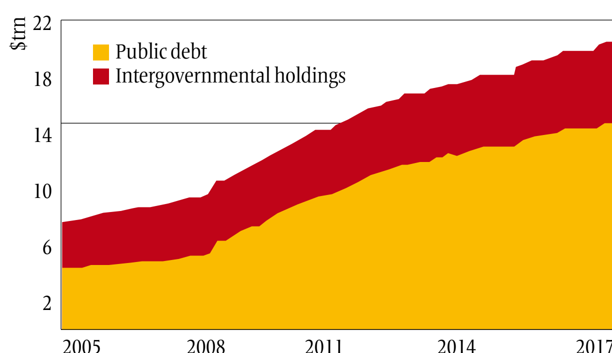
"We believe an inversion of the yield curve provides very incomplete information. For instance, the lag between the inversion itself and a recession occurring is far from stable and therefore provides little information on the timing of any recession.

"In addition, we believe it does not provide any insight regarding the nature of the recession: is it the financial sphere that is driving the macro cycle or is the origin of the recession rooted in macro imbalances?

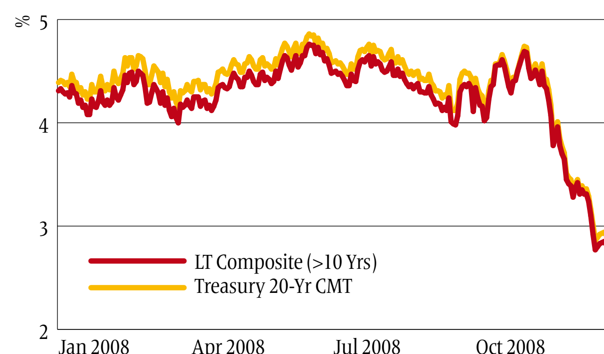
"It does not inform on the severity of the crisis. A mild and temporary recession will not have the same consequence on asset allocation decisions, but the yield curve inversion is unable to measure the intensity of a possible recession in our opinion."

Kim Lubbers, senior portfolio manager at Kempen Capital Management, points out that in response to a dovish Fed and poor economic data in the eurozone, the US 10 year to 3 month yield curve inverted on 22 March. Investors noted that all of the last nine US recessions were preceded by

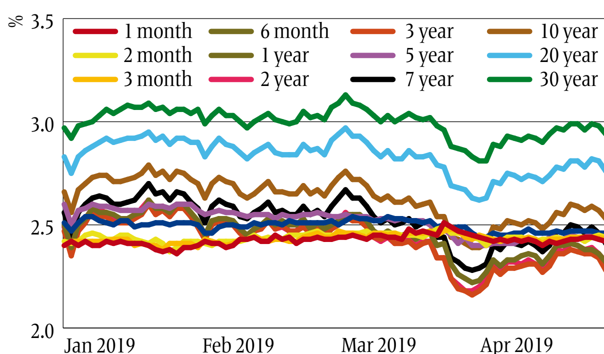
US NATIONAL DEBT



US GOVERNMENT DEBT YIELD 2008



US GOVERNMENT DEBT YIELD 2019



Source US Treasury

an inversion of the 3M10Y and 2Y10Y curve, Lubbers adds.

That said: "…inversion needs to continue for a longer period according to history and the 2Y10Y curve hasn't inverted yet. Furthermore, the question arises whether these lessons apply in the current situation.

"The difference now with history is that the 10 year yield is kept artificially lower by zero or negative yields outside the US and QE activity. Bond purchases by the Fed, the ECB and the BoJ pushed yields down, making the curve more prone to inversion. The large yield differential between Germany and Japan on one side and the US on the other side keeps a lid on any yields increases in the US. But I do not think 'this time is different'.

"An inverted yield curve should still be an indication of a recession. Furthermore, if investors believe an inverted yield curve is a predictor of a recession, it could become a self-fulfilling prophecy."

Mark Benstead, head of Active Credit Solutions at Legal & General Investment Management, says: "With negative yielding government debt recently rising back to its historical high levels of circa $8.5trn and 15% of the euro corporate market also yielding negatively you could easily be forgiven for thinking that the generally accepted definition of yield, ie, a positive income return is no longer valid. Indeed yields are regularly cited as being much too low and therefore they must rise causing capital losses for investors.

"We do not ascribe to that view. Yields are low for a multitude of reasons, not just central bank buying of bonds which after all, with the notable exception of Japan, has ceased (for the time being). Yields will remain low in our view due to an excess of debt in the system whether personal, corporate or government. As a result, we are hard wired into that environment where normalisation could easily be a catalyst for recession. "

INFLATION RISK

April LaRusse, head of Fixed Income Product Management at Insight Investment, part of BNY Mellon IM, still sees 'yield' as a useful and relevant indicator of expected future returns on bonds, but also of other risks.

"The natural worry is that if fiscal policy stimulus is eventually pushed to its limits, we could be at risk of an inflationary crisis several years down the line. Making use of inflation hedging instruments where cheap today may therefore be worth considering."

15% Certificates of deposit rate paid by Danish central bank in 1992

Yann Lepape, senior portfolio manager Flexible Bonds at Vontobel, suggests that the practical challenge is the absolute low level of yields combined with the historically low level of volatility. In this context, it means putting more weight to 'relativity'.

"Our methodology did not change in itself, but we put more weight to relativity. It changed the sources of performances of our funds: less duration oriented, and more relative value."

Robert Tipp, head of global bonds and chief investment strategist at PGIM Fixed Income, says: "Central banks have backed out of the markets to varying degrees and yet the yields remain low. So there is a good chance that the 'financial repression is keeping yields low' story is a red herring. That may be keeping investors from accepting the real drivers of low yields: presumably these are globalisation, demographics, high debt levels, inequality, etc. — and these are not going away."

"As a global multi-sector investor we have to analyse bonds taking into account all factors: yield and credit spread, likely yield changes, including roll down and spread changes, hedging costs, etc. The new environment of low yields still includes bouts of volatility. So the opportunity for adding value through active management is as high as ever. But expectations for yield levels given the macro backdrop have to be 're-benchmarked', marked to market. There's no way around that."

Bastien Drut, senior strategist at CPR AM, says: "First, I think it is important to underline that central banks are nowadays terrified by the idea of breaking the business cycle. We are in a kind of permanent risk management mode where central banks give up any will to tighten the monetary policy as soon as there is a risk.

"One of the consequences is that the relationship between the yield curve and recession might be broken. In the previous cycle, the Fed did not hesitate to hike the fed funds four times after the first yield curve inversion and by doing so to precipitate a recession in the US. Nowadays, the Fed has already said that it would not hike this year, without any serious sign of economic slowdown. As a consequence, yields will remain what constitutes a challenge for asset managers."

SELECTOR COMMENTS

Pierre Mouton, who heads the Long Only Strategies at Notz, Stucki & Cie, feels that the generally accepted definition of yield is still valid.

"We live in an unprecedented era of negative yielding assets in fixed-income investments which must not make us forget that yield is paramount when measuring the profitability of an investment.

"You could feel very smart having doubled your money on an investment made 25 years ago but this capital gain equals to a 2.8% annualised yield over the period. You would have done much better by holding a long term government bond.

"The funny thing today is that normally yield has a positive connotation, so when you buy today a negative yielding instrument like a German 5 year BOBL, it is difficult to define the notion of yield associated to it. So, let us say that, yes, the notion of yield is still very much valid, but it is more accurate when applied to positive yielding instruments."

Like portfolio managers themselves, Mouton also feels that there is a discussion to be had as to the monetary objectives that have given rise the question of yields.

"Financial repression finally aims at conducting money to the real economy by killing the rentier and pushing all investors to 'put their money at work'; the problem is that in an ageing western world, objectives clearly diverge: governments need to issue debt to finance the welfare state, and at the same time retirees need safe returns on their investments to finance their improved life expectancy.

"Ideally, governments would issue debt at low or zero yields and retirees invest in acceptably yielding securities. This mismatch, especially in countries or economic zones where the banking system is not rock solid, could have been anticipated by observing what has happened in Japan during the last 25 years: lower and lower yields, ageing population, more and more savings chasing 'safe' assets yielding less and less.

"Maybe this conundrum could have been avoided, or at least postponed, if the global financial crisis had not happened. Too much debt by governments which need to spend more and more can only be supported if yields are at zero or super low, so if the developed markets policy makers really started to spend less, hence issue less debt, this financial repression could be changed and monetary conditions come back to normality."

Mouton adds: "It is extremely difficult to see this happening in the near future, especially in the eurozone and in Japan. But ideally this financial repression should be changed so that the price of money gets back to normal levels. In our view it is completely absurd to lend money to a government and accept paying for it; how could the future be more certain than the present?"

Mouton comments that it would be a "betrayal" of clients to put their money into negatively yielding assets, but adds that there are pockets of value still in the fixed income space worth considering, such as AT1 securities in Europe.

"Otherwise, still looking at fixed income investments, we are forced to accept lower returns on good quality instruments – but not negative returns – like everybody else. So if we have to buy a single-A rated bond with a 0.5% yield to maturity, which we wouldn't have done some years ago, we do buy it."

Mouton agrees that there is an

-0.65% Certificates of deposit rate paid by Danish central bank in 2019

important question in the debate on what constitutes a 'correct' yield on certain assets in terms of the implications for considering other asset classes.

"This is an important point as the universal discounting factor, although not the only one, is the US 10 year T-Bill; the lower it goes in terms of yield, the higher valuations can go on 'long duration' equities which are generally to be found in 'quality' and 'growth' sectors.

"The strong outperformance of growth versus value observed during the last few years should not come as a surprise then. There are some equity valuation metrics that can be directly compared to government bonds or fixed income yields: dividend yield, earnings yield, free cash flow yield, just to cite a few.

"There again, when comparing an equity dividend yield to a government bond yield, you can place your preference between good yield with equity risk or bad yield with government risk.

He cites an example from Switzerland: "Do you prefer to hold Nestlé, which is a very safe company, expensive by many measures, but paying you 2.5% in dividend annually; or the Swiss 10 Year government bond 'giving' you a negative 0.32% yield? In our opinion, the choice is easy.

"The impact of lower yields in fixed income cannot be ignored, and we definitely accept paying higher prices for good equities consequently, especially as in our opinion, low yields are set to last for a while, especially in Europe."

Rita Cabaço, Wealth Management strategist, Millennium bcp, agrees with the point that central banks are helping governments pay less interest on their debt, ditto companies or individuals with mortgages or other forms of debt. But it has come at a cost.

"Although the measures implemented in the height of the financial or sovereign crises were important to stabilise financial conditions, the magnitude and time length of the measures is highly controversial. For example, is it really critical – let alone beneficial in the long run – to charge banks – and then their clients – on their deposits with the central bank and push some bond yields into negative territory?"

Raul Póvoa, fund selector at Banco Invest, still believes the generally accepted definition of yield is valid, and that the yield curve is a reliable leading indicator of economic activity. But he too picks out the policies of central banks, of seeking to stabilise financial markets and foster economic growth, as having come at a cost.

"In this environment of low yields, stocks tend to be cheap relative to bonds, mostly because of the bond overvaluation. But in absolute basis, stocks are still not cheap. So we tend to focus more on profit and global growth expectations rather than central bank liquidity conditions going forward.

"We still favor a cautious, patient position in high quality defensive growth and reduced exposure to cyclical beta."

Luís Andrade, fund selector and macroeconomist, IM Gestão de Ativos, sees a secular downward trend in yields since the 1990s, which "do not necessarily compromise the validity of the yield concept", yet which have left markets expecting lower rates.

"The nature and length of the 2008 financial crisis entrenched expectations of low real interest rates. It is now widely acknowledged by investors that policy rates are to remain lower in the current cycle, when compared with previous cycles."

The danger now, however, is that while rules of thumb such as as "don't fight the Fed" or "don't fight the ECB" remain appealing to investors, central banks' policy toolboxes seem void, Andrade says, increasing investors' anxiety in the wake of a sharp economic slowdown or even a recession.

"The exhaustion of monetary policy may require political compromises and proactive fiscal policies, which could be of difficult implementation."

Pablo Valdés, partner and investments analyst at Orienta Capital in Madrid, notes the success historically of the yield curve inversion indicating a recession and warns against thinking that "this time is different".

"If you join the 'hunting for yield' environment, you must be conscious that you might be increasing your risk profile and buying riskier assets when they are yielding the least in historical terms. So, falling prisoner to market conditions and looking for higher yields implies a huge risk for investors. Nevertheless, following a barbell strategy may be a good choice."

Dirk Söhnholz, managing director, Diversifikator, suggests that on the assumption the generally accepted definition of yield is still valid, and that the focus of macro policymakers on yield can hardly be changed in practice, the debate on what constitutes 'correct yield' is irrelevant.

"Relevant is only the expected yield. And the expected yield on most fixed income investments is too low to include them in a portfolio at all, since even low return fixed income has a significant risk of loss. ■

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