February 2018

Back to the future: the return of the 'old normal'

I remember full well the day I first sat in a funds management chair after some years on the 'sell-side'. It was Monday 31 January 1994. I was at the time still quite bullish on bonds, believing that despite an expected cyclical pick-up in global growth, there was enough global capacity and sufficient structural changes in the global economy to prevent a renewed outbreak of inflationary pressures. At least not the pressures that had asserted themselves through the 1970s and 1980s. I was young(ish) and keen to make my mark and argued strongly for more duration in our portfolios.

Anyway, on Friday 4 February that same week, the US Fed under Alan Greenspan tightened monetary policy for the first time in five years. This unleashed the biggest ever calendar year sell-off, in basis point (bps) terms, in the US 10-year yield during the approximate 35-year bond bull market that ran from 1982 to 2017.

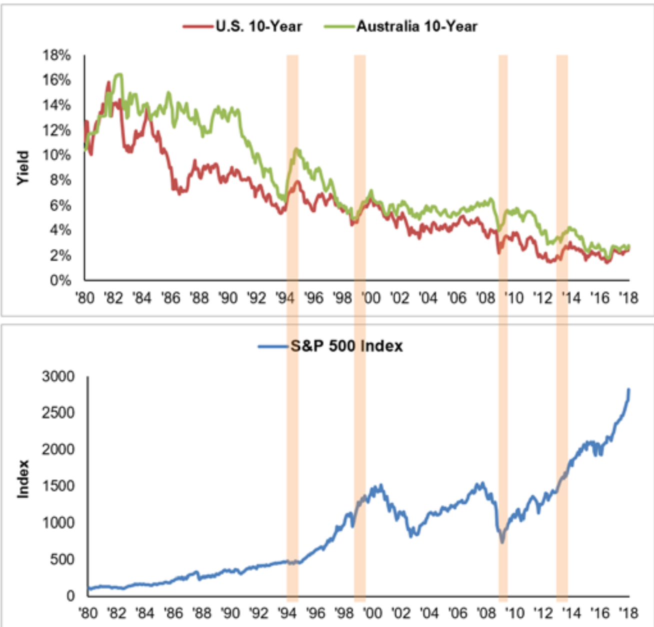
Needless to say, it was a torrid introduction to the nuances of the 'buy-side'. Happily, I survived, and bond markets did re-commence their long bull run and in some measure at least that reflected the precepts I had in early 1994. Much later, of course, the bond bull run reflected the fallout from the Financial Crisis and its aftermath (low global growth, deflation risk, a seriously impaired banking system and the attendant 'unorthodox' policy response from the major global Central Banks).

I was thinking back to that time in the light of what has taken place in the past couple of weeks. A lot of ink has been spilt regarding the impact of rising inflation and rising bond yields on equity markets.

So, what did the S&P500 return in calendar 1994 when US 10-year yields rose around 200 basis points? Well the index itself fell a modest 1.6% but returned a small positive of around 1.3% after dividends.

What about other episodes of rising bond yields?

Chart one: Context is everything



Source: Bloomberg, Standard & Poor's

1994: US 10-year yields rose 203 basis points. The S&P 500 returned 1.3%.

1999: US 10-year yields rose 194 basis points. The S&P 500 returned 20.9%.

2009: US 10-year yields rose 121 basis points. The S&P 500 returned 25.9%.

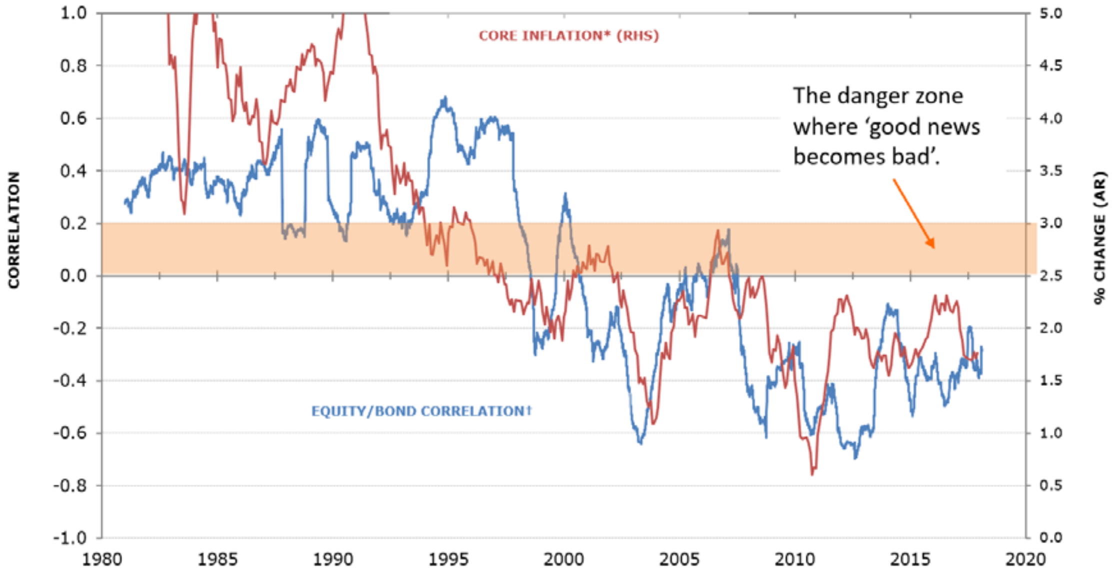
2013: US 10-year yields rose 95 basis points. The S&P 500 returned 32.1%.

The point of chart one is that the relationship between a change in bond yields and the return on equities is not mechanical. Context is everything.

The following chart from Minack Advisors demonstrates that bond/equity return correlation is generally negative when inflation is below 3%.

Or as Minack Advisors would have it, when *"good news is good news"*. Stronger growth leads to improved corporate earnings and bond yield expectations are contained, leading to better stock prices. When inflation gets toward the 3% level, things become a little more problematic and *"good news becomes bad news"*. Stronger growth may lead to improved corporate earnings, but expectations of even higher bond yields lead to a tipping point for stock prices.

Chart two: Equity/bond correlation and inflation



*12 month % change core CPI
† rolling 260 day correlation between 1 day percentage change in S&P/500 Index and 10 Year Bond price.

Sources: Minack Advisors

This is clearly the key risk in the current environment and an even greater one in 2019. But in my view, it is the risk case not the central one (Minack Advisors emphasise my risk case as more likely than I do). It is also exacerbated by higher US budget deficits and Fed balance sheet shrinkage, which both lead to more net Treasury bond supply (higher bond yields).

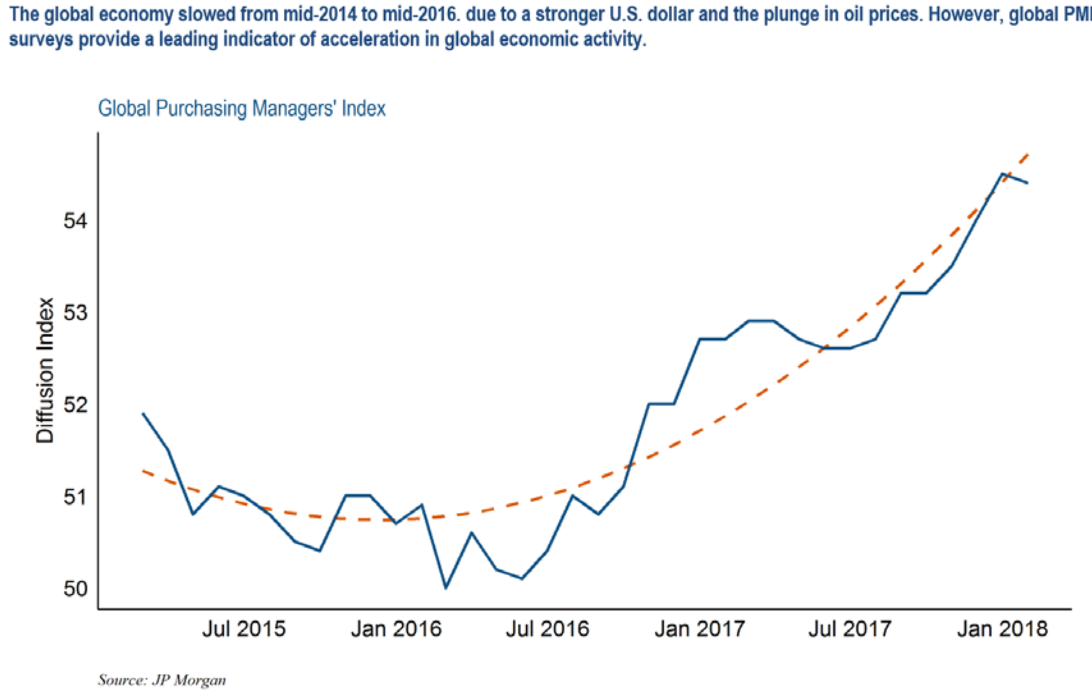
In 1994 the inflationary 70s and 80s were still relatively fresh in investors' minds; so much so that to a large investor cohort, the 70s and 80s represented 'normal' inflation conditions. They weren't in fact normal. Inflation at that level (outside a few outliers like Weimar Germany) were the historical exception rather than the rule. The fear of a return to that normality drove yields rapidly higher. In the event that fear was overdone, and inflation settled at levels consistent with those longer-term historical trends.

In 1999 inflation was low and stayed low, but the Fed increased the funds rate by almost 200 bps and the bond market vigilantes led the 10-year bond yield higher by a similar amount. Remember the bond market vigilantes? They were the guys that in 1994 or 1999 sold bonds at the slightest hint of inflation pressure. This sent yields higher, which in turn tightened the credit spigot, cooled the economy and in an almost serendipitous turn of events, mitigated any potential inflation pressure that was the source of the original vigilantism.

I think the circumstance that applies in the current environment is that inflation is returning (or accelerating) to more 'normal' levels that are best represented by central bank targets. In the main this represents a level around 2% in the major global economies. That being the case, a bond blowoff of 1994 proportions, while not impossible, remains unlikely. And following on from that, the onset of an equity bear market also seems unlikely in the next year or so.

Beneath all the renewed volatility in markets is the notion that we are seeing the return of the bond market ***inflation*** vigilantes on the back of a better global growth outlook – refer to the chart below. For at least a decade or more now, bond market inflation vigilantism has been obsolete. Indeed, what we have witnessed in bond markets since the onset of the GFC resembled ***deflation*** vigilantism. This is why bond yields in a number of countries went negative – think Japan, Switzerland and Germany.

Chart three: Key leading indicator of global economic growth points to an acceleration in world GDP



It is important to bear all this in mind when thinking about the recent grind upwards in bond yields and the concomitant (if overdue?) return of volatility in financial asset prices. Bond yields reached levels that on any historical metric were egregiously low. Why? Because bond markets priced the tail risk of a deflationary spiral. The move in bond yields since September last year if anything represents the 'pricing out' of that deflation risk. It does not in my view represent anything approximating the 'pricing in' of a problematic inflation risk. Why do I say this? Because in general, problematic inflation pricing generally occurs when nominal bond yields exceed nominal GDP growth. In the US nominal GDP growth is around 4%. A 10-year bond yield at circa 3% is a fair way south of being problematic.

Following this logic, recent events are best viewed as a regime shift from one characterised by extraordinarily low bond yields (reflecting not inconsiderable deflation risk) and extraordinarily low volatility in financial asset prices, to one of higher bond yields and heightened volatility. But neither of these are returning to levels that might be thought of as egregiously high. What we can say is that deflation risks have been 'priced out', but by any measure bond yields reflect quiescent inflation – something I'd characterise as still south of the Fed's 2% inflation target.

With me? Let's keep going then. Let's assume, as the economists at Payden and Rygel forecast, the Fed gets to its 2% inflation target. Given trend US real growth of 2% this then implies a 'steady state' long term bond yield of around 4%. If that is anywhere close to accurate, it still implies a further significant grind higher in bond yields. And if we accept that notion, there will be concomitant headwinds for equity markets.

So, does that mean we're in for a year of higher bond yields and significant equity market downside, albeit in the context of stellar returns in 2017? I think the good news is probably not.

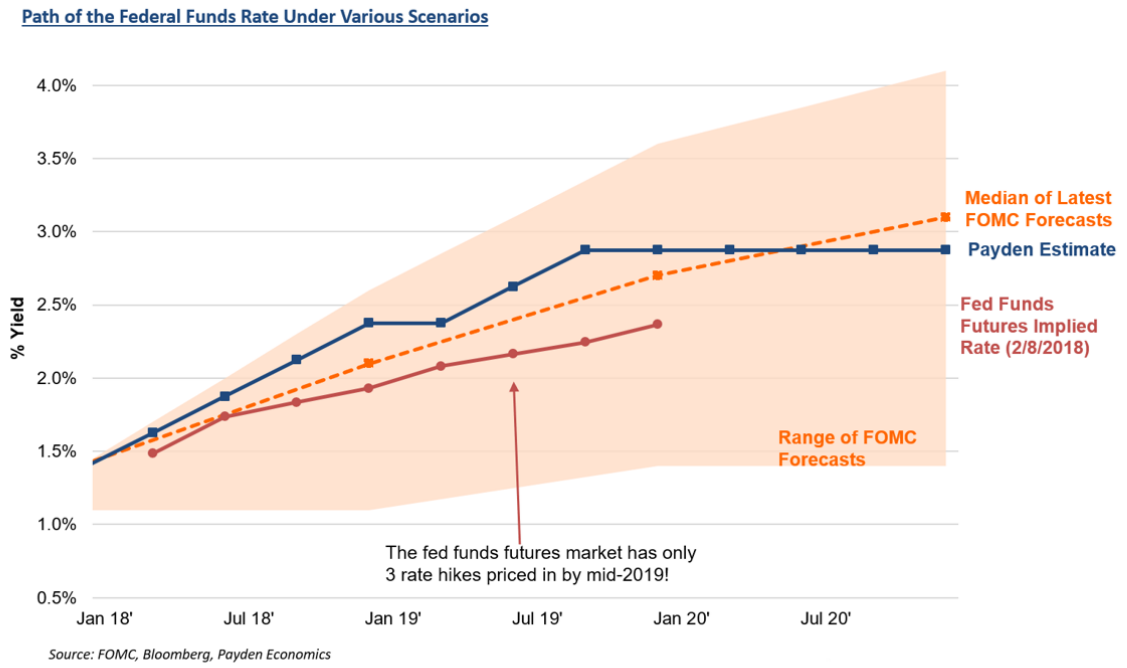
First, inflation pressures are conspicuously absent. Much has been written in the US and locally about sluggish wage growth and the related notion of a 'flat Phillips curve'.

Second, corporate earnings momentum and forecasts are pretty healthy and current equity valuations don't seem unreasonable.

However – and to state the obvious – inflation pressures are absent until they're not. There is pretty clear evidence that wage inflation in the US is accelerating, and this will be ultimately reflected in actual goods and services inflation. But this only happens in the context of continuing economic growth, which in turn supports positive earnings momentum, thereby validating current equity valuations. The events of the last week or so are best viewed as a journey to a new regime.

This does not happen in a 'straight line' and therein lies the catalyst for higher (more 'normal') volatility in financial asset prices. These circumstances do not cause my colleagues at Payden and Rygel to shift their expectation of four Fed rate hikes this year, with more to come in 2019, taking the terminal Fed Funds rate to close to 3%, as illustrated in the chart four.

Chart four: The Fed and monetary policy



The FOMC "dots" point to three rate hikes in 2018. We expect four more in 2018 and another two in 2019

So, looking at the global picture, episodes similar to that witnessed in the last week or two may well be a characteristic of global markets going forward. In my view the next year will see higher bond yields (US 10-year yields could perhaps get as high as 3.50% or more) but in an environment of strong global growth, equity markets should still eke out reasonable returns, albeit significantly less than 2017and in an environment of increased volatility, even with four Fed rate hikes in 2018. Point-to-point that is a benign outcome, but the return of normal volatility may make for a bumpier ride than we've become accustomed to.

The risk will be if inflation breaks significantly higher than the Fed's forecast, to say 3% or more. Historically, in that sort of environment bond yields could get much higher than the 3.50% which is my current working assumption, and excessive budget deficits and Fed balance sheet shrinkage exacerbate that risk. That may prove a tipping point for more challenging equity market conditions.

I think for bond investors, one of the critical implications is to think about exposure to so-called unconstrained bond portfolios. More as a complement to traditional bond portfolios benchmarked to a conventional index such as the Bloomberg Barclays Global Aggregate or the Bloomberg AusBond indices than a replacement. Unconstrained portfolios typically have less duration exposure that conventional bond portfolios benchmarked to an index. They typically will also seek more diversified sources of return such as exposures to other fixed income sectors, such as inflation-linked bonds, corporates, high yield, emerging markets, FX, asset backed securities. The lower duration exposure tends to benefit performance in a rising interest rate environment, while the multiplicity of sectoral exposures diversifies risk and can mitigate total portfolio risk. At the same time, such portfolios retain the conservative return profile associated with bonds.

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