Making Sense of the Bond Market
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A persistent reduction in the US inflation rate and well-anchored inflation expectations continue to contradict the common understanding that interest rates have reached a cyclical floor.

The positive real interest rate embedded in the US 10-year Treasury note reinforces its value and the value of the bond market in general. After all, positive real interest rates in the world of zero and/or negative interest rates have value. Saturna Capital uses a number of reference points to gauge the intrinsic value of the US sovereign bond market. As of August 30, 2014, the US 10-year Treasury note yield was 2.34%, which exceeded the yield on 10-year TIPS (Treasury Inflation-Protected Securities) by 2.13%, the dividend yield on the S&P 500 by 0.43%, and the Personal Consumption Expenditure Implicit Price Deflator, a measure of the change in prices of items consumed by households, by 0.87%.

As a result of falling yields and forward breakeven inflation rates, the Citigroup Broad Investment Grade Index 10+ (an index of investment grade securities with maturities longer than 10 years) returned 14.61% for the period June 28, 2013, through August 29, 2014.

Further, at the end of each round of long-term asset purchases the 30-year bond yield has fallen. Since the Federal Reserve announced the end to its third long-term asset purchase program last December 18, the 30-year bond yield dropped from 3.91% to 3.08% in concert with a substantial narrowing of the difference between short-term and long-term yields.

This narrowing was partly due to investors' anticipating the Fed's intent to increase the federal funds rate in mid-2015. More importantly however, since December 18, 2013, the 30-year TIPS yield declined by half from 1.63% to 0.82% while the 5-year TIPS yield dropped from zero to -0.27%. Driven by a decline in inflation expectations this should comfort bond investors and increasingly worry inflation-hungry Fed Governors. Yet, slowing inflation in the US and other G-7 economies tends to be good news for bondholders.

Is the US sliding into a Japan-Style Liquidity Trap?
Alan Greenspan, Ben Bernanke, and Janet Yellen all insisted that Japan’s deflationary reaction to deficit financing, zero-interest rates, and quantitative easing would not be repeated in the more diverse and dynamic US economy. The US inflation experience is also beginning to look uncomfortably like Japan’s. While Japan and US asset prices have responded positively to monetary and fiscal stimulus, the sought-after reduction in sovereign debt burdens produced by higher inflation has been less than expected. The Fed is searching for explanations for the on-again-off-again economic/inflation recovery. Economists Yi Wen and associate Maria A. Arias of the St. Louis Federal Reserve offered one theory in a recent research paper titled *The Liquidity Trap: An Alternative Explanation for Today’s Low Inflation*:¹

Central bank zero-interest rate policies may depress capital funding to the point of limiting economic activity.

"During a liquidity trap, however, increases in money supply are fully absorbed by excess demand for money (liquidity); investors hoard the increased money instead of spending it because the opportunity cost of holding cash — the forgone earnings from interest — is zero when the nominal interest rate is zero. Even worse, if the increased money supply is through LSAPs [large-scale asset purchases] on long-term debts (as is the case under QE), investors are prompted to further shift their portfolio holdings from interest-bearing assets to cash... The Fed’s policy to pay positive interest rates on reserves can only reinforce the problem by making cash more attractive as a store of value."

Such an unprecedented increase in money demand (versus transaction demand) has slowed down the velocity of money (the turnover rate of dollars in the money supply). The authors posit investors are hoarding money because of poor real wage and job prospects as well as excessively low rates of return on interest-bearing investments. In part, they conclude that when the returns on interest-bearing investments fail to compensate for the inherent risks, investors increasingly prefer to hold cash. In other words, central bank zero-interest rate policies may depress capital funding to the point of limiting economic activity.

The chart at right offers a 10 year perspective on US inflation using the PCE Implicit Price Deflator, US 30-year bond yield, and the velocity of M2 money supply.

Publishing the Liquidity Trap paper indicates the Fed understands the logical end game for this theory, that interest rates should be increased to boost inflationary expectations and the velocity of money. Of course they will have to be mindful of the inflationary potential of the trillions of dollars of the excess reserves in the banking system.

Leaving this theory aside, there are other issues that may contribute to the unsatisfactory economic recovery these Fed economists are trying to explain. Five years of uncertainty about national health care, job benefits, minimum wages, new Medicare taxes, as well as weakened credit ratings from housing defaults, insufficient retirement savings, flagging state solvency, and a drumbeat of cautious economic forecasts from the Fed may have convinced some individuals and employers to self-insure, to save and hold onto extra cash. Real wage and benefit growth has been insufficient to maintain living standards for many.² In the end, wages have to grow faster than the general price level to create a real inflation threat for bondholders. The US is not there yet.
The Logic of Negative Yields and Negative Interest Rates

Bloomberg Professional Services indicates negative yields occur "when savings returns are less than the rate of inflation plus taxes." Carmen M. Reinhart describes negative yield as a form of financial repression consisting of negative real interest rates that help liquidate the huge overhang of public and private debt and ease the burden of servicing that debt.³ However, these interest rates have historically still been positive numbers.

Negative nominal interest rates are actually below zero. If someone says the return on a 6-month Treasury bill is negative 0.25%, many investors will react with a silent "Wait, what?" Why would anyone invest their money knowing they were certain to lose? There are times when the certainty of a known loss is more appealing than the uncertainty of a potentially much larger loss. Investors temporarily paid for negative yields on US Treasury bills during the 2008 financial crisis as opposed to leaving cash on deposit at Bear Stearns, Lehman Brothers, AIG, or Bank of America. During wars, individuals and corporations may decide to deposit money in foreign banks at negative interest rates to protect their wealth. When the return of money is more important than the return on money, negative rates make perfect sense. Sometimes investors have to pay negative interest rates when they are not allowed to invest in any other asset class. Sometimes there is no better alternative.

Even when no imminent threat to principal is present, an increase in the expected purchasing power of money can create sufficient reason to pay negative interest rates. The more familiar circumstance for investors demanding a real rate of return is to avoid the loss of future purchasing power from a general rise in the level of prices.

But what happens when the general price level falls? The purchasing power of cash on hand will be greater next year than now. This could motivate consumers to hoard cash now in order to buy the same item for less in the future. If consumers expect the general price level to fall 1%, they may be willing to pay the bank -0.10% because the cash will be secure and purchasing power will still rise by 0.90%.

Inflation in the eurozone is getting close to zero. Some countries actually have falling price levels (deflation). The European central bank just reduced the overnight deposit facility rate from -0.10% to -0.20% trying to create a greater disincentive for eurozone banks and depositors to hoard cash.⁴ However, if the general price level falls by .25%, a depositor's purchasing power still grows 0.05%. Yields on many eurozone short-term sovereign debt instruments have gone negative.

The phenomenon is real. Unfortunately, the forward-signaling effect of negative deposit rates (a weak economic outlook) runs the risk of reinforcing the psychology of deflation and may not produce the desired economic stimulus. There are countries around the world where domestic inflation is a problem. Brazil, India, Russia, Indonesia, and Turkey would all prefer lower inflation rates. But heavy global debt burdens in G-20 countries and inconsistent economic growth more than offset these cases. Inflation is not yet a global threat to bond investors.

Can the US 10-Year T-note yield decline from here?
On an absolute basis, the yield on the US 10-year Treasury note is still higher than the 10-year sovereign notes issued by Japan, Taiwan, Hong Kong, Singapore, Canada, France, Germany, Italy, Spain, Sweden, the Netherlands, and Switzerland. The global demand for income and security may push US rates even lower as it has in Japan and the eurozone. A cyclical floor in US rates seem unlikely in the context of how much lower rates are in other heavily indebted economies. Perhaps the Japanese 10-year note is pointing the way for the US 10-year T-note yield instead of the other way around.

In last year’s From the Yardarm bond market review (July 2013) we stated, "We do not expect 10-year US Treasury note yields to move up or down more than 1% from a 2.5% fulcrum." For the coming year, we expect the fulcrum to remain at 2.5% and the US 10-year T-note yield to explore the lower half of this range. With the Fed poised to raise short-term rates, and with long-term inflation expectations already well contained, the yield curve may continue to flatten, adding to the risk-adjusted appeal of long-term paper. Global debt deleveraging will continue to overwhelm the fiscal and monetary policies deployed against it, and the deleveraging process is years from completion.

Footnotes


² Shierholz, H., Mishel, L. A Decade of Flat Wages: The Key Barrier to Shared Prosperity and a Rising Middle Class. Economic Policy Institute, August 21, 2013. http://www.epi.org/publication/a-decade-of-flat-wages-the-key-barrier-to-shared-prosperity-and-a-rising-middle-class/


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