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THE END OF THE THIRTY YEAR BOND RALLY

Global bond yields have fallen substantially over the past 30 years. This has provided a tailwind for investors, with returns from the asset class exceeding the income received as a result of appreciating bond values. Looking forward, investors face lower yields and the risk to valuations posed by increases in interest rates in the US and potentially elsewhere, a risk exacerbated as the average length of maturity of the market has extended considerably over recent years. This has significant implications for investors in bonds, as these investments have generally been viewed as the stable, defensive component of institutional investor portfolios.

This article explores what has driven yields to their current low levels, the factors that may lead to future higher interest rates and bond yields, and the implications this may have for the return outlook. The potential risks for the global bond asset class and its role in a diversified portfolio is also discussed.

What has driven this three decade fall in bond yields?

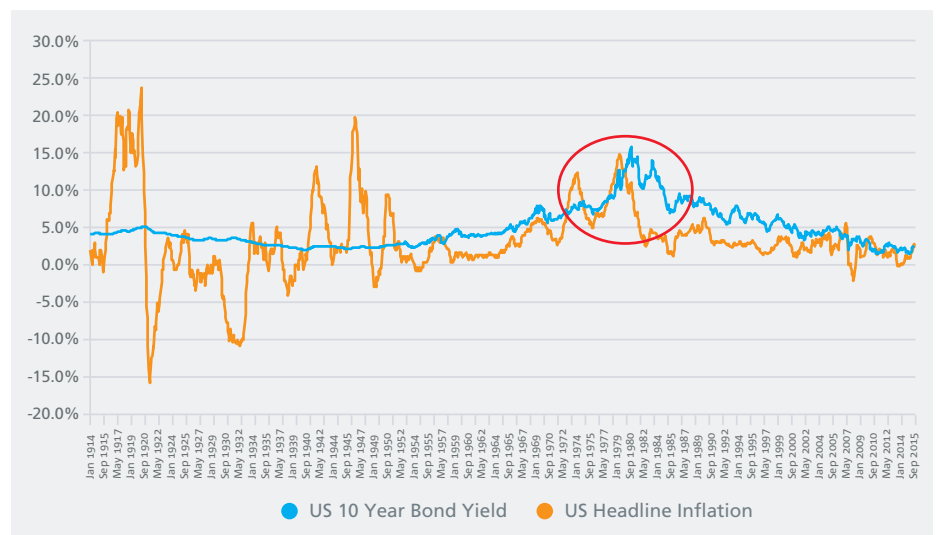
Before considering what has driven bond yields down over the past three decades, we should first reflect on the period from 1965 to 1982,

often referred to as the 'Great Inflation'. During this period, a combination of accommodative monetary policy, the collapse of the Bretton Woods Agreement on exchange rates and two significant oil supply shocks in the 1970s resulted in inflation in the US and most other countries rising to high levels (see Chart 1). By the early 1980s, there was a strong consensus amongst policy makers that more needed to be done to address the inflation problem, particularly in the US. What followed was a period of aggressive monetary policy tightening by the US Federal Reserve (Fed). This resulted in sharp increases in the Fed funds rate and in bond yields, which as Chart 1 shows, peaked at unprecedented levels in the early 1980s. Prior to this period, bond yields had been relatively low and fairly stable.

Over the following three decades, a range of factors have played a role in pushing bond yields down:

- Following the experience of the Great Inflation, central banks redirected their priorities with a greater focus on maintaining price stability, including setting inflation targets as their primary goal.

Chart 1: Performance of US bond yield relative to inflation



Source: JANA, FactSet

- Since that time, inflation pressure has been relatively subdued. The expansion of free trade agreements and the opening up of China and Eastern Europe to global markets saw cheaper labour being sourced abroad, significantly reducing the cost of goods manufactured around the world.
- Productivity gains achieved with the beginning of the 'Information Age' and immense technology gains further reduced inflation pressures.
- From a structural perspective, ageing demographics in most developed and some developing economies has caused a structural shift in the demand for bonds, pushing longer dated bond yields lower. An ageing population is generally associated with greater demand for bonds (often through the purchase of annuities, which are big buyers of bonds) over equities and other growth assets, with a growing focus on income stability as investors age.
- Over the most recent decade since the global financial crisis, there has been significant downward pressure on the price of bonds as central banks have implemented aggressive policy measures (called 'quantitative easing') to try and stimulate economic activity. This included buying billions of dollars of their own bonds, driving bond yields lower still.

How have bonds performed over this period?

Bond investors have benefited from the bond bull market over the last 30 years, particularly in the last 10 years. While the impact is often overemphasised, appreciation in the market value of bonds has contributed approximately 0.5% per year since 1990, which is not insignificant¹. This represents approximately 6% of the overall return of 8.6% pa to bond investors over this period, and has also been the biggest driver of volatility.

Overall returns have also been strong, both relative to equity market returns and in 'real' terms relative to inflation (see Table 1 and Chart 2). Global bonds have consistently outperformed inflation, producing strong real returns to investors over time. Looking forward, investors face one of the few occasions over the last 30 years where yields are only expected to keep pace with inflation.

Have we reached the end?

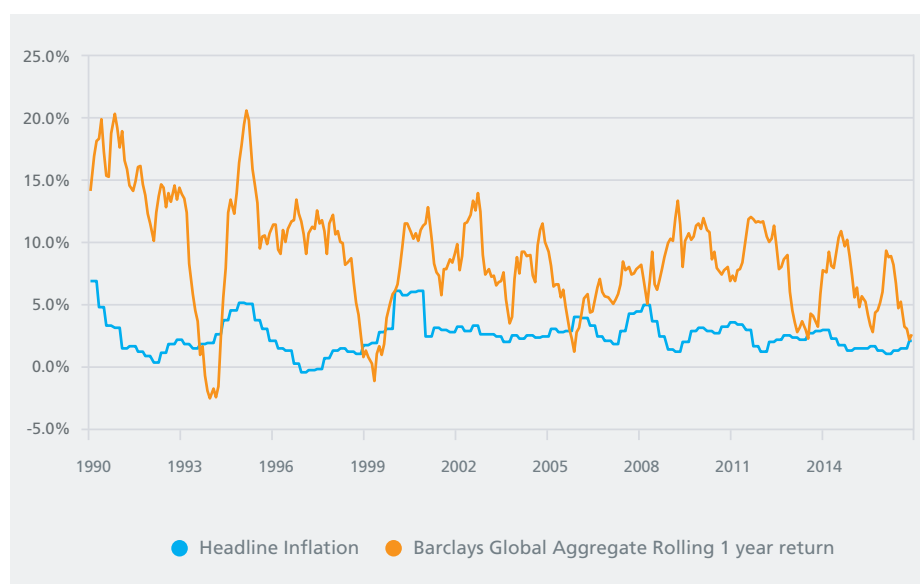
With the Fed making clear statements about being on a path to interest rate normalisation, many are questioning whether we are at the end of the 30 year bond bull market. Certainly, bond yields have increased from the historic lows reached in mid-2016,

Table 1: Returns to 31 May 2017

	5yr	10yr	20yr
Australian Headline Inflation	2.0%	2.4%	2.5%
Barclays Global Aggregate (Hedged AUD)	5.6%	7.5%	7.5%
S&P/ASX300	11.7%	3.4%	8.5%
MSCI World ex Aust Net Hedged AUD	16.4%	6.2%	7.7%

Source: JANA, FactSet

Chart 2: Global bond returns outpacing domestic inflation



Source: JANA, FactSet

Recap on how bonds work

The return an investor receives from a bond is comprised of two components. The first is the income component of the investment, which comes in the form of a regular coupon payment. This may be a 'fixed' rate of return, or may be 'floating', with bond holders receiving a return that varies with movements in a reference interest rate, such as the Reserve Bank of Australia's cash rate. The second, and more volatile component, is driven by changes in the current market price of the bond. The market price of a bond represents the current market value of the future income stream of that bond. If bond yields were to remain unchanged, bonds would simply provide a known return to investors being the fixed income coupon.

However, yields in the bond market vary in response to investors' expectations of future growth and inflation. When market yields fall, existing bonds that have fixed future income streams determined by their fixed coupon become relatively more valuable to an investor today which results in the market value of the bond (and its price) increasing. The reverse happens when bond yields rise, the market value (and price) of the fixed rate bond will fall as the current market value of the fixed future income stream becomes less valuable to an investor today.

The market value of floating rate bonds is less impacted by changes in bond yields as the future income stream is not fixed and therefore its market value is less sensitive to changes in bond yields.

¹ JANA has conducted this analysis on the Bloomberg Barclays Global Aggregate Bond Index, which is comprised of investment grade corporate and government debt. The Index was created in 2000, with historic data backfilled for the period from 1990-2000.

when over one-third of the bonds of developed countries were trading at negative nominal yields, and some bonds were being issued with a negative nominal yield. Recent rises in bond yields can be attributed to a range of factors:

- Some central banks have begun the process of unwinding accommodative monetary policy. Most notably, the Fed ceased its quantitative easing programme and has begun to increase the Fed funds rate, which should place upward pressure on US bond yields. The Bank of Japan has taken the step to explicitly state it will target a zero 10 year yield, ensuring that longer dated Japanese bonds will not trade at negative nominal yields.
- Economic conditions have improved across developed markets over the past year, with falling unemployment and rising consumer and business sentiment. If sustained, this would provide a stronger foundation for future rises in interest rates.
- Market expectations that the election of US President Donald Trump will see higher fiscal spending and tax cuts, which if enacted as proposed, would be likely to place upward pressure on inflation and also interest rates and bond yields.

Despite the improvement in conditions, few market participants are willing to call the end of the bond bull market, or at least that we are about to enter a bear market.

What are the potential risks for bond yields?

While it's clear that continued improvement in economic growth and higher inflation would allow central banks to move toward more restrictive monetary policy that should translate to higher bond yields, there remain risks to the downside that could slow or prevent a sustained rise in bond yields:

- Household consumption represents a substantial component of most developed economies. Higher household wealth leads to higher consumption, thereby creating a virtuous circle of growth. While the period since the global financial crisis has seen asset prices rise dramatically, this has not translated to improved wealth for the general population. Wage inflation in particular has remained subdued despite falling unemployment, arguably due to a fall in the number of people participating in the

labour force. Without improved household wealth, many question the ability for the economic recovery to be sustained.

- While economic growth has improved, there has been a lack of capital investment by the private sector. Theoretically, it is challenging to improve productivity (another key economic growth engine) without investment in capital goods and research and development expenditure.
- High levels of public and private sector indebtedness remain a constraint to growth. As rates rise, the cost of servicing debt rises. This reduces the ability for the private sector to increase capital investment and wages, increases the cost of servicing mortgages and other loans for households and imposes a large burden on public finances.
- In addition to placing direct downward pressure on bond yields, the ageing demographics in most developed countries present additional structural issues for the real economy. An ageing population is a headwind for growth, as less of the population is involved in economic production. Further, spending on pensions and health care increases as a proportion of government budgets.
- There remain a large number of broader geopolitical risks that could be disruptive for economies and markets, most notably the war in Syria and rising tensions between the US and North Korea.

What does it mean for the asset class?

Just as falling yields depress the prospective returns from investing in bonds, investors also

face changing risk characteristics from the asset class:

- There has been a tendency for companies and governments to issue longer dated bonds, locking in low rates of interest for issuers for many years, but increasing 'duration', or the sensitivity of the capital return to changes in yields for investors. The duration of the Barclays Global Aggregate Index is 7 years today, compared with 5.5 years in 2007. This means that an increase (or decrease) in bond yields today will have a more substantial impact on the capital value of those bonds than was the case 10 years ago.
- The volatility of bond returns may increase. The primary driver of volatility in bond returns is changes in capital values. Lower yields will reduce the degree to which the income component of return smooths out overall returns.
- One of the key benefits of bonds has been their performance in times of equity market stress. While this relationship has continued to hold in recent modest market corrections, it is likely to be challenged moving forward as low starting yields arguably cap the ability for bonds to rally to the extent that they have in the past.

While there are scenarios where bonds would perform relatively well, such as in a deflationary environment, investors should be mindful of the degree to which the characteristics of the asset class have changed when considering their role in diversified portfolios.

Conclusion

Falling bond yields have provided investors with a strong tailwind, aiding performance for the past 30 years. Forward return expectations now need to be reset with a focus on what bonds can still contribute to a portfolio. Diversification, liquidity and a predictable (although lower than the past) income stream can still be valuable attributes to include in the defensive component of a portfolio.

While bonds still have a role to play in a diversified portfolio of investments, investors also need to be cognisant of the increased risk profile of the asset class resulting from current low yields. Furthermore, the recent extension of potential interest rate risk resulting from the extension of the maturity profile (duration risk) in traditional benchmark indices has also increased the risk profile of bonds. Active management of bond portfolios, rather than replicating benchmark indices, appears to be the most prudent approach given this increased risk profile.

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