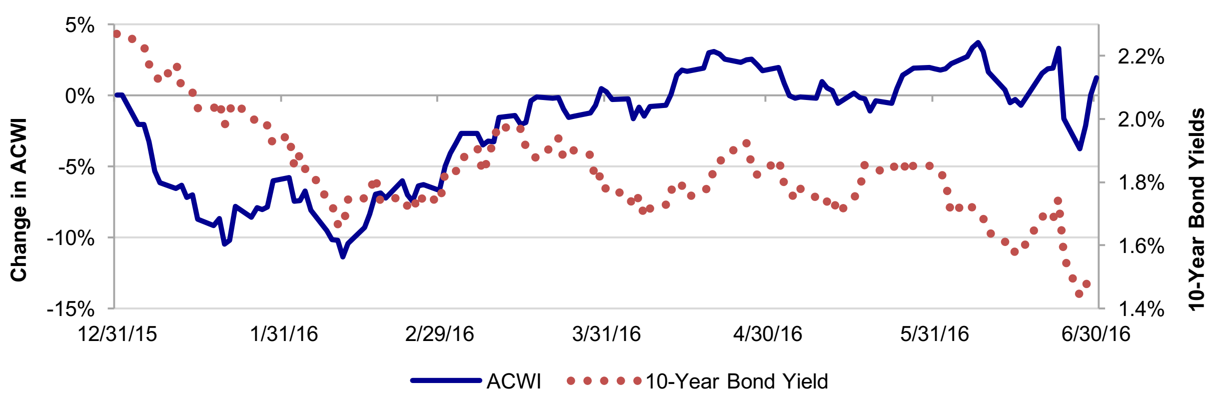
Bond Yields Underpinning Equities

August 5, 2016

This quarter was one in which global equities increased marginally while bonds and diversifying asset classes posted solid gains. As in the prior quarter, the final outcome told only a portion of the story as markets were again very volatile, and lower bond yields again underpinned asset prices. The main event was the Brexit vote, an outcome that surprised market participants and resulted in immediate and dramatic equity market declines. The referendum posed significant challenges for portfolio management, both before and after the votes were tallied. We have now experienced successive quarters in which a risk focus truly mattered as events unfolded.

We live in a difficult economic environment with few signs of improvement. Markets have continued to oscillate in a wide band, and bond yields are down sharply this year (Exhibit 1; the 10-year U.S. Treasury yield has declined 75 bps). Other economic metrics include corporate earnings, which have been in decline for at least the past 12 months, and GDP growth, which is sluggish.

Exhibit 1: Global equity markets have remained flat but volatile while bond yields have declined



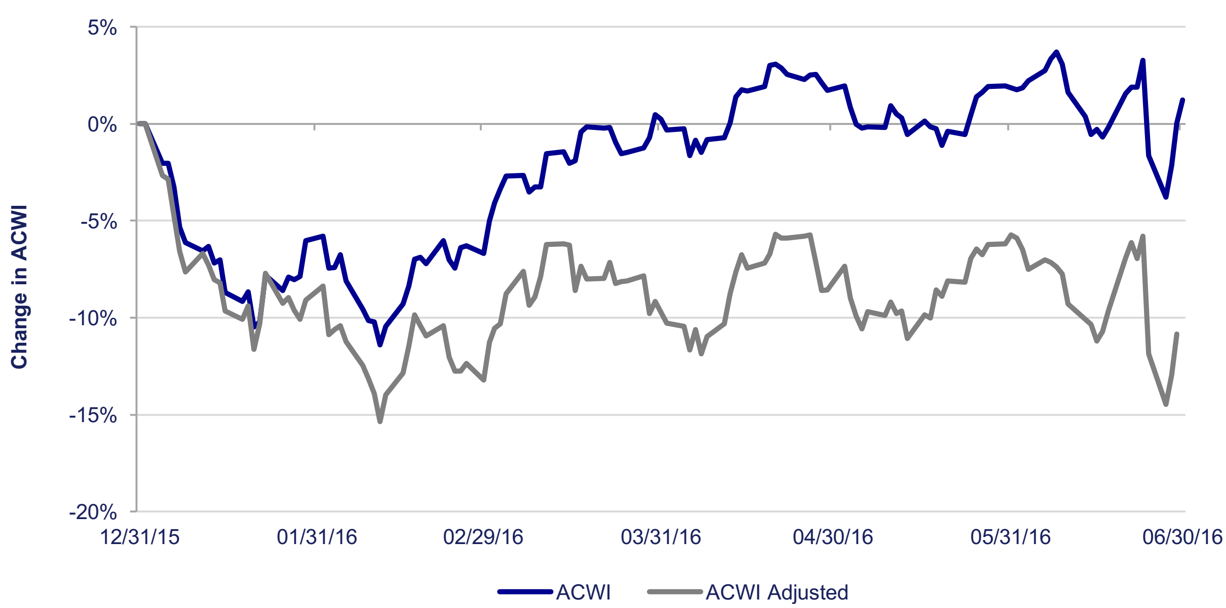
Bond yields are especially noteworthy. They are at levels never seen before in the United States, nor in Germany and Japan where 10-year nominal bond yields are negative, and in Switzerland where the yield on 50-year nominal bonds recently fell below zero. We wrote in our last commentary about this interest rate phenomenon under the heading of “Different This Time?” Different it is indeed.

Today’s yields reflect the lack of investment opportunities for broad categories of investors. Corporate investors are a good example. They could borrow at low rates to finance investments in plant and other corporate assets but are instead choosing to disgorge their earnings. Corporate payout ratios (dividend payouts plus buybacks, worldwide as well as in the U.S.) today stand at 100%, while corporate debt levels have increased only marginally. It is certainly a good thing when firms distribute rather than waste their cash, but it is less encouraging when they do so en masse. With less investment, corporate cash flows will grow more slowly over the long term.

That equity markets have been resilient in this environment is remarkable but perhaps understandable given the reduction in bond yields. Lower yields means lower discount rates which means that the market is placing a higher value on long-dated cash flows. This offsets against slower growth. Said another way: if bond yields had not declined then equities all else equal would today be trading at significantly lower values. We estimate that global equities would be down by around 11% for the year instead of up 1% if bond yields had not declined over this period (**Exhibit 2**).

In short, the weakening of economic fundamentals is real but has been offset by the market paying a higher price today for a dollar in the future. Broad asset class returns from here will likely be lower, and this places a premium on being able to find non-traditional sources of return.

Exhibit 2: Global equity markets have received a significant lift from lower bond yields[1]



[1] Source: HighVista analysis. "ACWI Adjusted" represents estimated YTD performance of ACWI if interest rates had not in fact rallied but had been held constant, thus discounting future cash flows at higher yields.

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