December 2015 Investment Publications Highlights

Deep Undercurrents

John Rubino, *CFA Institute Magazine*, Sept/Oct 2015

The persistence of negative yields on several developed countries' sovereign debt this year has challenged traditional economic theory. The author argues that an extended period of negative rates would encourage market instability and impact both retirees and dollar borrowers negatively.

After the 2008 global financial crisis, many developed countries increased fiscal spending and cut interest rates in an effort to revitalize their economies. But interest rates have remained low for many years, and even turned negative in 2015 for some European countries. According to economic theory, in a negative yield environment, savers would simply withdraw cash from institutions and store it themselves. While this act would put upward pressure on rates, the author argues multiple dynamics in the current marketplace have undermined this theory.

One dynamic that has not helped lift rates is demographics. To preserve savings, retirees in many developed countries have been willing to put safety first by keeping cash in negative yielding instruments. Relatedly, many in the market are not borrowing despite easing measures, leaving commercial banks flush with cash, on top of low rates. To a large extent, the slow pace of recovery in many countries and the uncertain outlook has made many reluctant to borrow.

Ultimately, the author believes negative yields will prove risky to markets. Conservative savers and investors may increasingly look for yield rather than accepting extremely low or negative interest rates in high-quality government bonds. This may encourage a broad-based fixed income asset bubble. Separately, if negative interest rates fail to increase growth and another financial crisis occurs, many investors would likely shift their capital towards Treasuries, prompting the US dollar to appreciate. Dollar borrowers would be particularly stressed in this scenario because of the low-yield environment.

Global Rates Strategy: A Small Step for the Fed, a Giant Leap for Markets

Rajiv Setia, Anshul Pradhan, and Amrut Nashikkar, *Global Rates Outlook 2016*, Barclays, November 2015

Monetary policies in developed markets remained broadly unchanged during third quarter 2015. Heading into next year, the authors believe the United States and United Kingdom will tighten interest rates, while Europe will continue to pursue easing policies. The authors argue investors next year should focus on US government bonds with long maturities versus short, as they will be more likely to deliver stable returns.

In the United States, the pace of tightening is the focus for investors, with the authors believing the Federal Reserve will avoid a mechanical style exhibited in past cycles, choosing instead to raise rates more gradually. Key policymakers expect only three hikes in 2016, bringing the lower bound of year-end rates to 1%. In the United Kingdom, policymakers are expected to initially lift rates in late 2016, as economists expect inflation pressures to warrant a decision at that time.

The authors believe US front-end rates will continue to be volatile, as the market further adjusts expectations for the pace of the tightening schedule, but they argue long-end rates are poised not only to be less volatile but also to potentially rally. Given that global economic risks continue to be skewed to the downside and that the correlation between stocks and bonds remains negative, portfolios are likely to maintain higher allocations to long-end rates, limiting selling pressures. In the unlikely event that core inflation accelerates more than expected, long-end rates could threaten a move higher.

Even with long-end rates, investors should pay close attention to bond liquidity and upcoming political developments. Bond dealer liquidity has been a focus of concern this year and is likely to be a key challenge in 2016. A number of liquidity metrics, including dealer balance sheet levels and repo activity, have declined in recent years. Coupled with key votes next year, including the US presidential election and the UK referendum on EU membership, both of which may impact domestic fiscal policies, central banks may be forced to reconsider tightening schedules. ■

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