TAM ASSET MANAGEMENT INVESTMENT NOTE

Bond Yields; that sinking feeling

Should we be concerned that government bond yields remain near historic lows?

In 2013 expectations that the US Federal Reserve would reduce (or 'taper') their quantitative easing program added to speculation that interest rate hikes would surely follow. This was an obvious catalyst for yields to rise on US government bonds. And rise they did. By the end of 2013 the yield on the ten-year Treasury bond had risen from a brief low of 1.7% to above 3.0%, its highest level since 2011. But now, mid-2014, despite three initial rounds of tapering plus modest signs of economic growth and equity markets hitting all-time highs, yields have again fallen to their lowest level since October and show no sign of rising soon. What has created this conundrum and, given frequent 'flights to quality' of the past should we be filled with a sense of foreboding?

There are many factors contributing to the recent fall in yields; growing geopolitical volatility, looser monetary policy, forced bond buying and slow growth in the US economy. In March, for example, we wrote of the 'Bull vs the Great Bear' as the Ukrainian unrest weighed on equity markets. The annexing of the Crimea and further saber rattling from Putin certainly unnerves investors and could justify a rush to the safety of government bonds, but with the equity market shrugging off these events opinion is obviously split. Cynics may argue that Moscow relies on global unrest to buoy oil prices and continue filling its coffers with hard currency and that an outright war was never a realistic outcome and that geopolitical risk has being over played. One must remember, however, that there are plenty of other sources of tension around the world; China, for example, flexing its own muscles in Southeast Asia, picking territorial fights with Japan and Vietnam, the unraveling of Thailand and instability in Iraq. There will always be such unrest but is it the main driver of bond prices?

US monetary policy is another key driver, but shouldn't the withdrawal of quantitative easing be negative for bond values? Unlike in the past the Federal Reserve has managed our expectations well and tapering seems fairly priced into bonds. A greater risk to bonds are inflation and importantly interest rates, which will rise from current historic lows at some point; but when? The newly appointed Fed chairman, Yellen, quickly retracted statements that seemed to imply interest hikes were imminent and many forecasts for the first hikes have been pushed back from mid 2014 to 2015 at the earliest. Given current low levels of inflation and the central banks clear attempt at a softly, softly approach the later estimates now seem more likely to help support bond prices near term.

In Europe, however, the situation is markedly different with central banks now experimenting with more aggressive monetary policies in the face of ultra low and even negative inflation – they certainly want to avoid any Japanese style deflation. With little room to cut interest rates further a number of measures have been implemented including negative ECB deposit rates. Such action could certainly be considered supportive for U.S. debt and thus another weight on yields. Add to this the uncertainty caused by the recent euro elections and one can clearly see why US treasures would be more attractive to euro investors than European debt. But here again we face a conundrum; is Spain more credit worthy than the US as implied by the lower yields on Spanish debt? I think we can agree not. With higher rates on offer and the potential for further euro currency weakness, US debt will remain attractive for European investors.

An often overlooked support of government debt are some of the US's largest investors; pension funds; who can now be considered 'forced' purchasers of Treasuries. Having reduced their funding deficits through a doubling of the equity market since 2009, they are now focusing on matching their future liabilities rather than growth to repair their tattered balance sheets and are thus rotating out of equities into Treasuries, particularly those at the longer end of the market. This change of allocation policy has partly been forced upon them by a budget act of 2013 which imposes larger insurance premiums and hefty fines for underfunded plans. It is estimated that this demand will account for more than half of the outstanding 30 year Treasuries over the next two years, at a time when net issuance is falling.

Economic growth is modest but positive with job creation in the US is improving, new jobless claims falling, good auto sales small-business optimism continues to improve. Aside from the latest industrial-production figures, manufacturing has also been strong. Such numbers surely signal an end of such accommodative policy and thus unsupportive of bonds?

It is difficult to pinpoint, therefore, to pinpoint a sole reason for the recent strength in Treasuries with so many competing forces. What may be more relevant going forward is the effect this is having on our allocation policy.

Our house view remains relatively unchanged. We believe there is limited room for further yield compression and the risk versus reward for holding government bonds is now firmly skewed towards risk. Our growth, inflation and interest rate forecasts remain positive though we have reviewed our timing when these forecasts will materialise. We remain underweight government bonds across all our portfolios, favoring corporate and higher yielding opportunities. We are specifically focused on more dynamic managers that offer the flight of foot needed to benefit in this, and our expected, future environment. To quote an overused phrase 'we are still dancing but dancing near the door'.

The downside to having an active allocation policy and positioning our portfolios ahead of the curve in anticipation of future weakness is that we can experience temporary dislocations from our portfolio benchmarks. We remain confident that, as on many previous occasions, we will ultimately be proved correct.