Let's Get Real

By Richard Thies

Given how eventful the past few months have been from a headline perspective—Brexit, US presidential election campaigns, etc.—it's surprising to see the modest moves that have taken place in most major equity indices of late. That false recollection is heavily colored by the end-of-second-quarter whiplash that followed the UK referendum to leave the European Union, where equities fell 5-6% in two days, only to recover it immediately with seemingly little catalyst.

The lone catalyst that could be identified was the quick repricing of Federal Reserve hiking expectations after the volatility spike, and the subsequent collapse in long-duration bond yields making investors in risk assets more sanguine about the outlook. This, and whether the current goldilocks scenario of lower yields, higher equity multiples and dollar stability is a likely sustainable equilibrium are the focus of our comments.

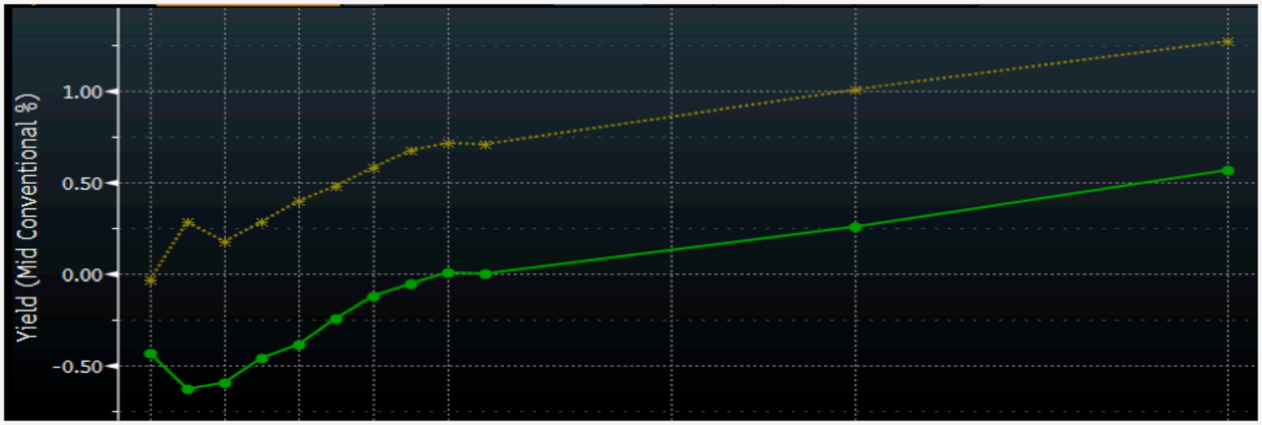
The core of our allocation view remains the same since its adoption at the start of the year, namely that the cessation in dollar strength is the primary determinant of relative asset returns currently. **As such, we continue to believe that investors are better served taking equity risk through emerging markets and other areas where risk premia remain sufficient to compensate for the growing uncertainty in the global environment.**

As we have noted throughout the past year, understanding the US dollar is essential to understanding changes in the market environment. In our last commentary, we reiterated the reasons why the dollar would not significantly appreciate, especially in light of the central bank détente at the end of the first quarter when the major global central banks seemingly called a temporary truce. The fundamental change that has been the most surprising to many this year has been the behavior of nominal bond yields, and in particular the sharp fall of real interest rates in developed markets.

The foundation of currency valuations are real interest rates and real interest rate differentials between countries. As such, the sharp fall in US real interest rates has helped keep dollar strength at bay in spite of much higher nominal rates and a seemingly healthier economy.

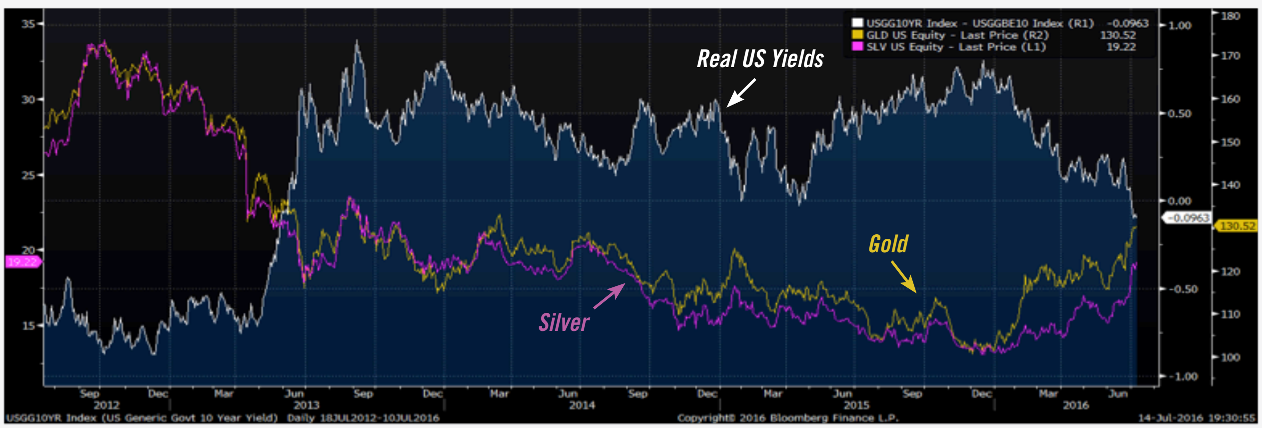
If there's one thing that explains relative asset prices this year more than the exchange rates, it's the large move lower in real yields (Exhibit 1). The decline of almost 75 basis points in the 10-year US Treasury took real yields to their lowest level since the 2013 taper tantrum. In concert with this fall, a relentless search not only for yield but for any real physical assets has also accelerated (Exhibit 2). In turn, assets that correlate more strongly with these areas, like emerging market assets at large, have outperformed this year. What started as just a relative preference for "weak dollar" assets has broadened out, and thus the focus for investors must broaden from simply currency outlooks to the outlook for real interest rates.

EXHIBIT 1: Real yields in the US have plummeted this year (yellow is January 1, 2016 levels) and are now negative until 10 years out (green is current)



Source: Bloomberg

EXHIBIT 2: The sharp fall in real yields in the US this year (white) has accelerated the search not only for yield but for real assets (gold and silver)



Source: Bloomberg

We thought it especially important to decompose this thought in this commentary in large part because of the preponderance of pithy "low yield" observations out there and the regularly-pitched view that "There Is No Alternative" (TINA) to buying equities, which we will discuss later.

We have seen more tweets, talking heads, and central bankers talking about the shocking surprise of how low nominal yields are and clever ways to tell you just how much sovereign debt is negative. (It's a lot, we get it…yields are low!)

What we have heard less about is something that is more important to the majority of investors, which is what's happening to their real returns on fixed income. In a not so shocking twist, this also doesn't look rosy for the growing pool of the population relying on a fixed income. In fact, it looks significantly worse. While it's fun to talk about how low bond yields are in Europe and Japan all the time, we think it's equally relevant to highlight that even in the US, real returns are negative out to 10 years (at the time of writing). In addition to hurting retirees and forcing people to save larger and larger amounts for their future retirements (depressing discretionary spending), changes in real yields have different and equally powerful allocation effects, such as were shown in Exhibit 2.

Where to from here, yields?!

Given how important we think this dynamic is, we'll briefly decompose what we view to be the main points on understanding where yields are going. The natural starting point is how to think about the path for nominal rates. We have been expecting lower bond yields for some time, which is a function of:

1. our view of a low terminal fed funds rate over this cycle;
2. the powerful structural demographic trend and high savings rates; and
3. the fact that US bonds are global cyclical instruments and their changes almost always reflect changes in the global cycle, on which we've been negative.

That said, we also are never holders of dogmatic views and are constantly looking for reasons that we could be wrong. Even the most dogmatic of bond bulls would have to acknowledge that there will be a day where bonds are fairly valued.

Truly nominal returns

To begin, our question is not whether we see a catalyst for a sharp repricing higher of yields similar to what we saw in 2013 (we don't), but whether there's a non-consensus argument for why the current bond rally could be running out of momentum.

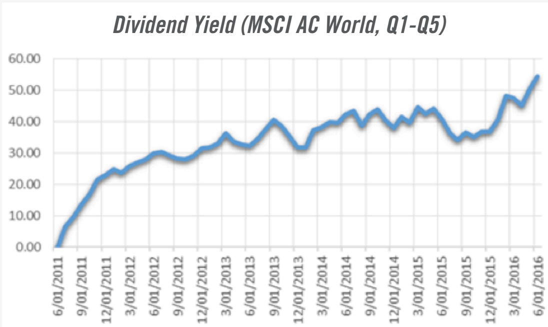
We see those as two distinct issues. First, we don't see the ingredients for a sharp repricing higher in rates. The volatility it would cause in financial markets and the real economy would once again make the move self-limiting.

Second, regardless of our views on tactical moves, we don't see the terminal fed funds rate in this cycle being much higher than 2%, so logically we do not expect the long bond significantly above that level. Despite that, we think that **even if nominal yields only stabilize and stop falling week after week, that in itself would be a very big change for allocators.**

It's no secret that equity market leadership has been highly related to the fall in bond yields. While quality stocks (defined by a company's superior profitability and earnings stability) have been strong for most of the post-crisis period, more recently ex-growth bond proxy sectors like utilities have taken over as market leaders. Effectively, this means that investors are buying solely on the assumption that the market will re-rate the stocks.

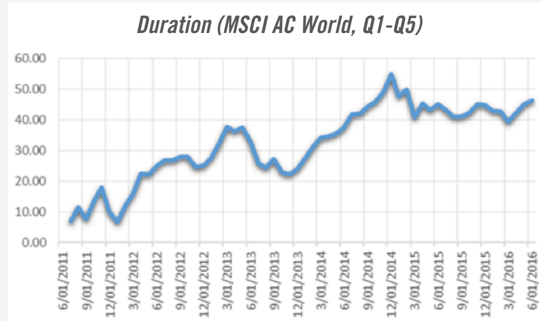
Of course, investing based solely on expectations of capital appreciation is a dangerous game. The highest quintile dividend payers have outperformed the lowest quintile payers by over 50% for the past five years—despite growth outperforming value over the same period (Exhibit 3).

EXHIBIT 3: The highest quintile dividend payers have outperformed low payers by more than 50% over the past five years



Source: Driehaus Capital Management

EXHIBIT 4: Our internal duration model for equities shows massive outperformance for 'long duration' stocks



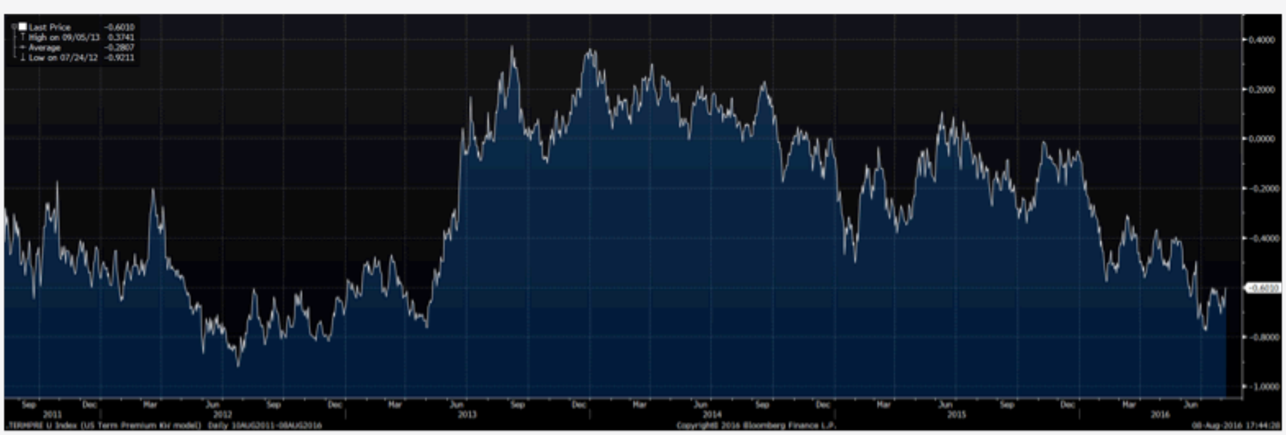
Source: Driehaus Capital Management

Similarly, our internal 'duration' model for equities, which aims to capture equities with higher sensitivity to bond yields and have longer duration cash flows, has outperformed by a similar amount the past five years (Exhibit 4). **The overarching point is simply that the move lower in bond yields has completely dominated every other factor in stock selection for the past five years.** If that changes, so will equity market dynamics. **It also means that investors probably have a lot more 'duration' exposure in their total allocation than they realize.** As such, assets that are effectively short duration, like financials, should at minimum have a diversifying place in most portfolios at these valuations.

Three points on bond levels

Of the three main components of yields—expectations for trajectory of policy rates, inflation compensation, and term premium—we find the last of these to be the most important. Term premium, the compensation investors receive for taking duration risk, is very low at the moment. In fact, not only are investors not being well compensated for taking duration risk, they are paying for the opportunity. By our model, term premium in the US is negative to the tune of about 60 basis points, near an all-time low (Exhibit 5). We do think it's fair for duration risk compensation to be structurally lower given the likelihood of a much lower terminal fed funds rate and much lower inflation volatility, but at these levels we think term premium are more likely to push bond yields up than down.

EXHIBIT 5: Our calculation of term premium shows investors paying near record highs for duration risk



Source: Bloomberg

Secondly, we view the US long bond as much a global instrument as a local one, and it responds accordingly to changes in the global cycle as much as local factors. While the structural trend has been clearly for lower yields, tactically yields tend to rise when the global economy picks up. In this case, the global economy has been slowing for over a year and we think the 10-year US Treasury has largely already accounted for that (Exhibit 6).

We see many leading indicators stabilizing, and stabilization would fit into our preferred understanding of the global economy. Namely, the volatility of growth in developed markets has been very low the last few years and the main drivers of cycles are whether emerging markets are slowing or accelerating. We see the rebound of EM currencies against the dollar helping these economies to do better over the next year than they have the past few. **Emerging markets are liquidity starved markets broadly, and the heavy flows back into these markets will translate to better growth a year from now.**

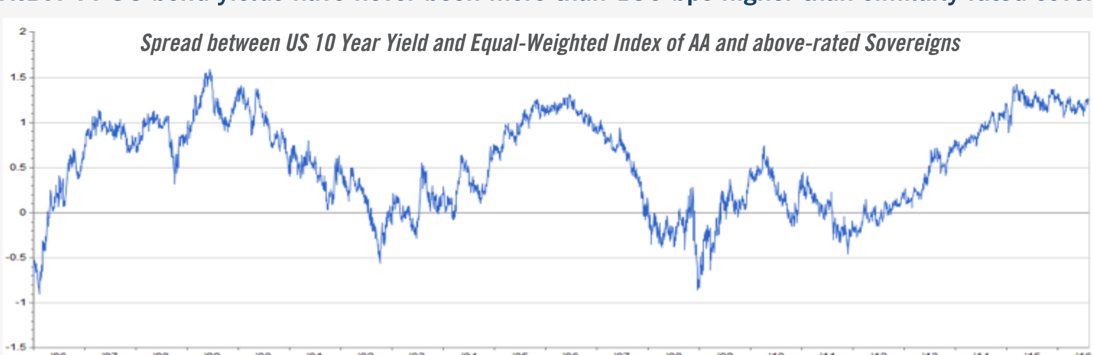
Adding to this second point is that we see fiscal policy becoming more supportive over the next year. Globally, policymakers are seeing the self-injurious nature of negative rate policies and have de-emphasized them in all the major central bank meetings over the past few quarters. The next leg of policy support will likely not be monetary but fiscal in nature, with Japanese, UK and American government spending likely to rise materially over the next year. This should increase issuance, provide a short-term boost to growth and upside risk to yields.

Finally, we believe that the levels of other developed market bonds are relevant and find no comfort there. Many investors have been buying European and Japanese sovereign bonds with the guarantee of nominal negative returns. Valuation measures look even more extreme abroad than they do in the US and betting on them to go even lower is not our base case. US bond spreads over developed peers have historically held around 150 basis points as an upper bound, in part because global investors can easily hedge these spreads (which you can witness in currency basis swap levels). We expect these ranges to hold once again (Exhibit 7).

EXHIBIT 6: The 10-year US Treasury tends to move tactically with the global economic cycle and is already discounting a material slowdown in growth

Source: Bloomberg

EXHIBIT 7: US bond yields have never been more than 150 bps higher than similarly rated sovereigns



Source: Bloomberg

What about inflation?

The outlook for inflation has two major implications as it pertains to this discussion. First, how will breakeven inflation compensation influence nominal bond yields? And second, how will inflation's trajectory affect real yields and thereby influence relative asset preferences?

To answer the first question, we will avoid a detailed breakdown of the inflation outlook and offer what we think are the two most important points. The first is that it seems clear to us that the economy has broken through full employment and genuine labor slack no longer remains. An economy that has been adding more jobs than supply for years would eventually reach this point. While the Fed wants to see more wage inflation to be absolutely, 100% sure, we are clearly below the natural rate of unemployment. It looks obvious to us given the behavior of wages broadly, wage growth in lower skilled areas, and falling unemployment levels for young workers (now equivalent to previous business cycle peaks). All three are suggestive of labor market tightness. When the economy passes through the natural rate as we have, wage inflation and services prices move up until disrupted by some other factor, like a recession. Secondly, if you (like us) do not believe in material dollar strength from here, then commodity prices and other input costs will start to rise.

The second point on inflation is that we see the risk of rising inflation as far higher than the risk of the Fed moving rates up in concert with that inflation. The world financial system is not well prepared for Fed hikes or dollar strength and it takes extraordinarily little to keep the central bank on hold. Conversely, the trend that will support rising prices is not easily paused. As such, the likelihood that real rates stay abnormally low is very high. As such, this should dictate relative asset preferences and currency valuations, supporting our allocation recommendations.

What about this TINA lady?

"One should always look for a possible alternative, and provide against it." — *Sherlock Holmes*

The conventional wisdom that there is no alternative (TINA) to buying equities with bond yields this low is a deeply flawed concept. First, a history of the relationship between equity valuations and bond yields shows that if anything, equity valuations are higher at times of higher yields given the superior growth outlook. While this is true over the long history of our markets (Exhibit 8), there has been basically no relationship between bond yields and valuations in more recent history (Exhibit 9). To believe that equities will go higher just because of nominal yield levels is to truly believe in a new world order.

As believers in the laws of mathematics, we understand that lower yields do mechanically make the future long duration cash flows of equities more valuable. We also understand, however, that equity risk premia have a far bigger effect than would another 25 basis points lower on the 10-year Treasury. If there is a world where investors become even less sanguine on growth (and take bond yields lower) but simultaneously also feel no change to their comfort with the same long duration equity risk, then undoubtedly multiples will go higher. For perspective, taking the 10-year to 1.00%, assuming no other changes and 4% EPS growth, equities would have a 9% implied rerating in the US. Conversely, if you take the 10-year to 1.00% but also increase the equity risk premium by 100 basis points, equities would have roughly 12% downside (Exhibit 10).

EXHIBIT 8: Fifty years of data show a positive relationship between equity valuations and bond yields

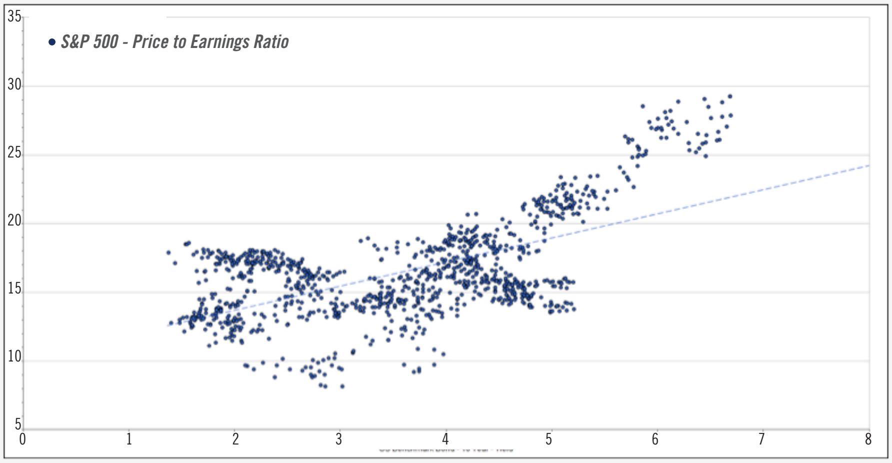


EXHIBIT 9: For the past five years, there has been no relationship between bond yields and equity valuations

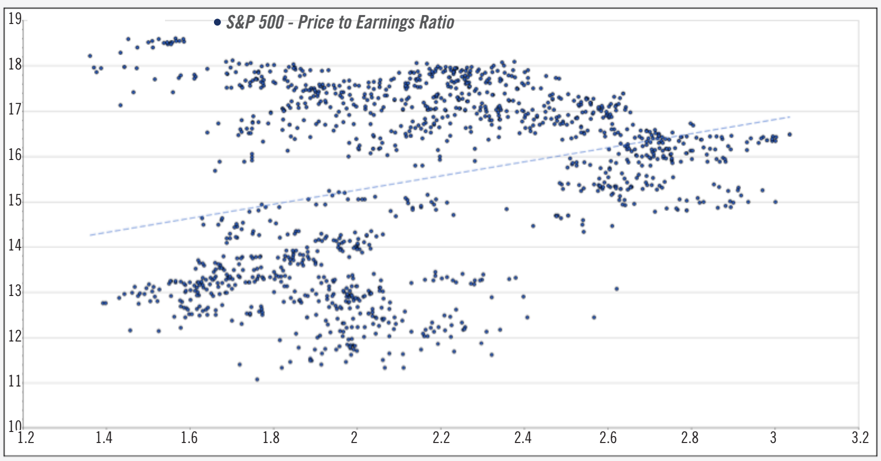
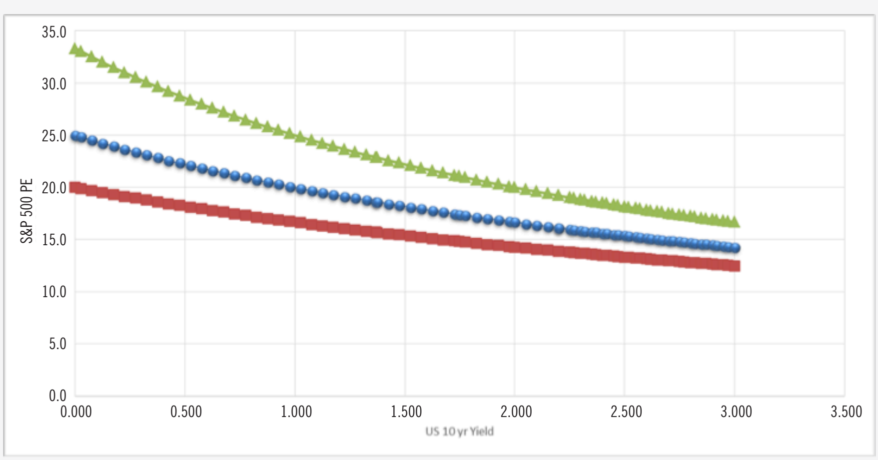


EXHIBIT 10: Implied fair P/E multiples of the S&P500 and different equity risk premium levels (Red – 5%, blue- 4%, green – 3%)



We see arguments on both sides of the equity risk premium outlook. On one hand, the extra return an investor requires to compensate for equity risk should be in some way related to the overall levels of return on offer to the investor and thus, should be lower with the low forward return outlook across assets. Similarly, contrary to popular belief, the volatility of our economic growth (which tends to be correlated to equity risk) has been extremely low. Nominal economic growth rates are low, but so is the volatility. On the other side, at its core, equity risk premium should reflect the underlying risk of the asset and given that private sector leverage has increased and increased well in excess of profits in recent years. Investors taking even less excess equity risk premium for an even riskier asset would not be a rational base case (Exhibit 11).

EXHIBIT 11: Corporate leverage has already risen significantly during this cycle, making it difficult to assume lower equity risk premia

Source: FactSet, Driehaus Capital Management

About the Author

Richard Thies is a portfolio manager. In addition to his portfolio management responsibilities, he provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. He also conducts in-depth analyses of specific events and potential scenarios at the region, country and sector levels.

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