Buy bonds, not beta

FUTURE PROOFING FOR THE END OF AN ERA

The secular trends of the last 40 years are reaching their limits.
It’s time to prepare for uncertainty.
“Maturity of mind is the capacity to endure uncertainty”

JOHN FINLAY
The last 40 years are unlikely to reflect the next 10

1. Globalization is coming under pressure
2. Central banks have gone from trying to subdue inflation to trying to create it
3. Monetary policy stimulus is reaching its limits

History tells us Treasury yields can be range-bound for decades

Yields last reached a secular low in the late 1930s. For the following 20 years, they fluctuated within a range. Something similar can’t be ruled out today. The future is uncertain, meaning volatility and higher dispersion could create excellent opportunities for bond pickers, while passive strategies would be stuck on a rollercoaster.

Back to basics: buy bonds, not beta

We believe a bond-picking approach is the best way to counter uncertainty. Bond pickers maximize certainty and value by focusing on bottom-up research. They also tend to be opportunistic and can be contrarian in nature – so they can even turn volatility to their advantage.
End of an economic era

Since Adam Smith published “The Wealth of Nations” in 1776, we have witnessed three industrial economic eras. The latest began around 1980 and continues to the present day. It has been a great era for beta. Treasury yields have declined in almost a straight line from 16% to less than 2% over the period (Figure 1).

But can this trend really continue for another decade? It looks increasingly doubtful. For the first time in 40 years, signs are that the winds of change might be blowing again.

A quick recap of the last era

Here are three key developments that characterized the last era:

1 Globalization surged
Trade barriers fell and world trade soared. Global supply chains became more complex, particularly as China opened up its labor force to the world. Falling labor costs created disinflationary pressures in the West — helping Treasury yields fall (and markets rise).

2 Central banks started targeting inflation
The consensus on how to manage recessions changed. The post-war ideal of using fiscal policy stimulus to boost employment made way for using monetary policy to subdue inflation. Paul Volcker’s Federal Reserve (Fed) led the way in 1980 in its now-infamous fight against stagflation. Central bank inflation targets became the norm over the next decade. This has helped anchor inflation expectations and, by extension, bond yields.

3 QE joined the party
In order to stimulate markets, inflation and the economy following the 2008 financial crisis, the Fed and other central banks started buying government bonds, and other assets, directly pressuring yields down. Over $16 trillion of global bonds traded at negative yields for the first time in summer 2019.

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1 In the US, the Joint Economic Committee published a paper called “Plugging in the Supply Side,” the policy reforms of which were adopted by the Reagan administration. A watershed moment for the “neoliberal” or “neoclassical.” 2 Famously championed by John Maynard Keynes. 3 And unemployment and the economy by proxy. 4 The Reserve Bank of New Zealand became the first to adopt an explicit inflation target in 1989. The Bank of Canada followed in 1991 and the Bank of England in 1992. The Fed finally made its 2% inflation target explicit in 2012. 5 Bloomberg, August 2019.
Anti-globalization political movements are on the rise
Support for nationalist and populist political movements has been soaring globally. Many multilateral trade agreements have been questioned, including those involving the US.

Central banks have gone from controlling inflation to trying to create it
Since the 2008 financial crisis, inflation has been persistently low, partly due to long-term factors like aging demographics and technological disruption. Central banks have gone from trying to control inflation in the 80s, to trying to create it in recent years to meet their targets. The Fed\(^7\) and the European Central Bank\(^8\) are even pondering whether their current inflation targets still make sense in a low-inflation world.

Monetary policy stimulus is reaching its limits
Monetary policy has its limits. Negative rates squeeze banks’ profit margins, making it harder for central banks to keep easing.

Fiscal stimulus is therefore returning to national agendas — it’s a philosophy that actually unites many populist parties on both the left and the right.

Alternative schools of economic thought are also gaining traction. Some politicians are turning to ‘Modern Monetary Theorists,’ who propose a combination of fiscal and monetary policy.

We are merely a step away from a radical departure from the consensus of the last era.

BUY BONDS, NOT BETA

History tells us the end of an era could mean range-bound Treasury yields

If we’re looking for lessons from history, a good place to start might be the late 1930s and the 1940s, after the first economic era ended at the hands of The Great Depression (an event that has many parallels with the 2008 financial crisis). It was also the last time support for populist parties was so high (Figure 2).

Crucially, it’s also the last time that Treasury yields reached a long-term low (Figure 3).

So what can we learn? After the era ended, Treasury yields didn’t really rise or fall. Instead, they were range-bound for an entire 20-year spell.

Don’t rule out something similar for the next decade: as much as there is limited room for yields to fall, there is also limited room for yields to rise. Asset prices and the economy most likely couldn’t sustain higher yields.

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**FIGURE 2:**
Populism is having its best period since the 1930s

- Populism index (% vote share)
- Average

**FIGURE 3:**
Will yields become range-bound again?

Twenty years of range-bound Treasury yields when they last reached a low

For illustrative purposes only. Does not represent any BNY Mellon product. Past performance is not indicative of future results.

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9 Deutsche Bank, 2019 Countries included are US, UK, France, Italy, Germany, Japan and Spain. 10 Datastream and Insight, December 2018.
But, range-bound doesn’t mean stable. Uncertainty tends to go hand-in-hand with bouts of volatility, and volatility has often led to higher dispersion (Figure 4).

This paints a landscape full of opportunities for bond pickers — but not passive strategies.

“...as much as there is limited room for yields to fall, there is also limited room for yields to rise.”

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Buy bonds, not beta, to benefit from uncertainty

A back-to-basics, bond-picking approach will benefit from episodes of volatility in our view.

Security selectors focus on certainty of repayment and compensation for risks. They are also often contrarian and opportunistic. When sell-offs occur, they treat it like holiday sales and search out the best bargains. When markets rise and valuations become tighter, they tend to take profits to add ammunition for the next sell-off.

It’s a strategy ideally suited for range-bound and uncertain market conditions. We believe it has also been an attractive and effective strategy in recent years.

“This paints a landscape full of opportunities for bond pickers — but not passive strategies.”
‘Zombie’ companies are roaming the globe, and have been multiplying their numbers since the mid-2000s. These are companies that would probably not survive in more normal economic times, but record-low rates and QE have offered them a form of life support.

Zombies are a real problem for the global economy. The OECD\textsuperscript{12} cites their sheer prevalence as a major reason why labor productivity growth (a crucial long-term growth metric) has been so poor in recent years.

By definition,\textsuperscript{13} zombie companies are likely to struggle to meet their interest payments. Spotting and avoiding them has become all the more crucial today because corporate leverage has risen to record levels (Figure 5).

A passive or beta approach is most at risk of company-specific credit deterioration stories (we call them ‘landmines’ at Insight). Security selectors that do their credit work are better suited to countering the walking dead.

\textbf{FIGURE 5:}
\textbf{Beware of the zombies as corporate leverage rises}\textsuperscript{14}

\begin{tikzpicture}
\begin{axis}[
    width=\textwidth,
    height=0.4\textwidth,
    ylabel=Corporate debt-to-GDP (RHS),
    xmin=Mar-01, xmax=Mar-19,
    ymin=60, ymax=80
]\end{axis}
\end{tikzpicture}


\textsuperscript{13}The OECD defines zombie companies as having a history of at least 10 years and an interest coverage ratio of less than one in each of the last three.

\textsuperscript{14}Bloomberg, Q1 2019.
Broadening the opportunity set improves the power of bond picking

Bond pickers don’t ‘hug’ their benchmarks: they focus on the most attractive bonds.

Some lie in areas like structured credit, which can offer a premium, reflecting complexity rather than additional credit risk (Figure 6). The security and legal protections (a rarity in corporate bonds) also may offer protection against uncertainty.

It is important to note that it’s not easy to execute a bond-picking strategy. It requires extensive resources and analytical skills. It is also somewhat capacity-constrained making it harder to execute for strategies with very large pools of capital. Working within a nimble construct is paramount.

**FIGURE 6:**
Structured credit offers a premium despite being secured against collateral

- 1- to 3-year AAA corporate credit (swap spread)
- 2-year equipment large AAA (swap spread)
- 3-year prime auto AAA (1-month Libor spread)
- 3-year private credit AAA (1-month Libor spread)
- 3-year credit cards AAA (1-month Libor spread)

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The time to position for uncertainty is now

Traditional models have trained us to think of the economy as a mechanical system, but newer evidence shows that it is an evolutionary and adaptive ecosystem. Ecosystems tend to experience long periods of stability before a tipping point gives rise to a new regime.

Thinking of economies through this lens may be the best way to avoid the pain that has accompanied the end of past eras. The first era ended in the Great Depression and the second in the stagflation crisis of the 1970s and 1980s.

The environment is changing around us — it may be time for your fixed income strategy to evolve too. We think a back-to-basics bond-buying approach is the best way to strengthen your portfolio’s core.

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