SIGNATURE RESOURCES
CAPITAL MANAGEMENT

Commentary: August 2019

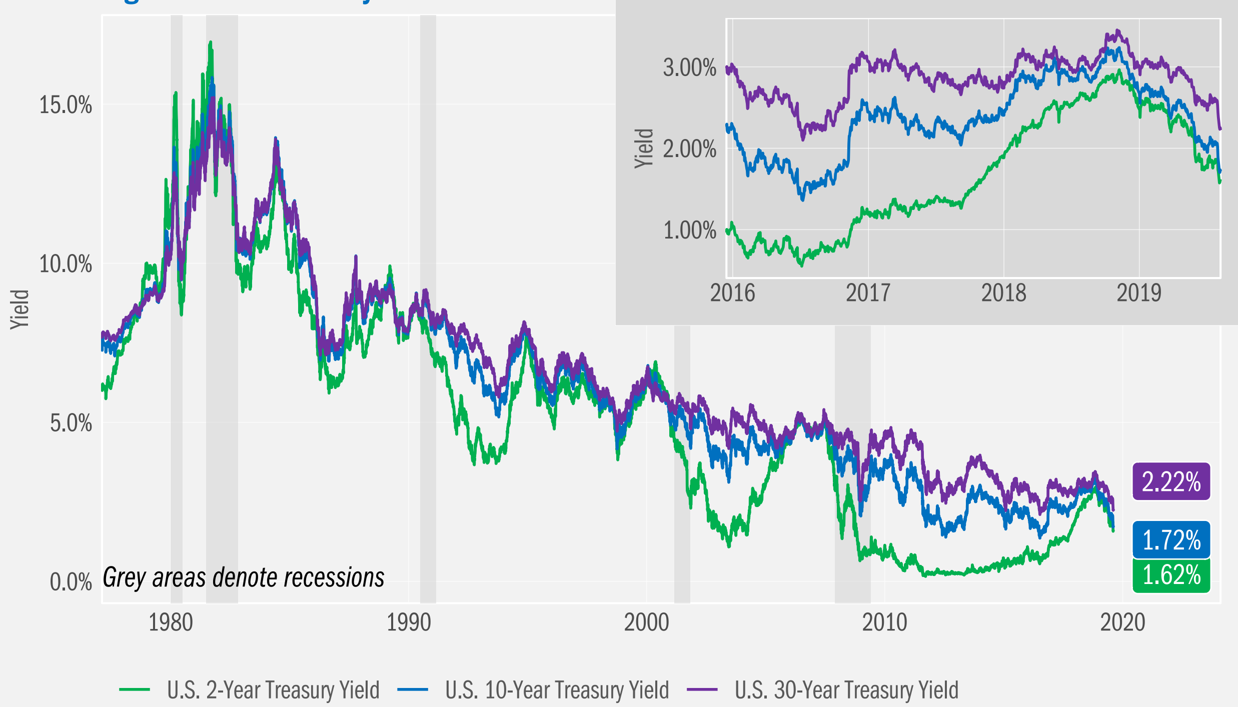
WITHERED YIELDS

Wasn't so long ago that we were applauding more generous yields among our fixed income exposures for the greater income over the longer term that they may provide. This despite the nearer term drag from the impact that rising rates had on bond prices, the movement of the latter being inverse to that of the former. So much for all that. A conspiracy of waning global growth, declining inflation expectations, rising geo-trade tensions and rather more perilous political turns of tone have seen interest rates near world-round sink on growing pessimism and uncertainty. Investors should be careful, we think, to respond by creeping up the risk curve, as bangs-for-buck remain historically weak among most of the riskier income-focused investment.

CLOSER TO WHERE WE STARTED

After seven years from December 2008 through December 2015 during which the Federal Reserve set its target for short-term inter-bank lending, the federal funds rate, at between 0% and 0.25%, the U.S. central bank began lifting rates in quarter-point (0.25% increments) to account for improving macroeconomic conditions. Three and a half years later, the Fed has changed course. A host of threats seem to have forced the Fed's hand, which just a few months ago may have been seen pointing toward additional hikes, not any manner of policy easing.

Figure 1: U.S. Treasury Yields

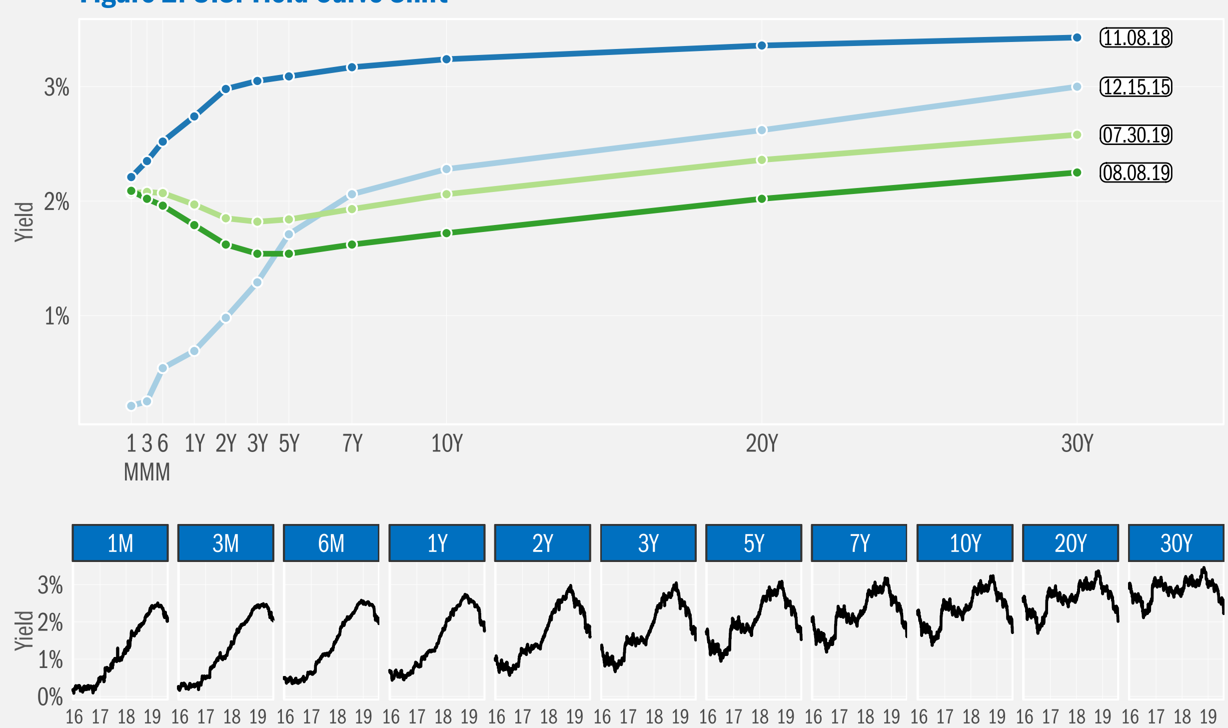


From 02.15.77 to 08.08.19. SOURCE: SRCM using data from Bloomberg

Among those threats are softening in corporate earnings growth, sharply increased protectionist trade rhetoric and policy implementation, a cooling in GDP growth here and abroad, relatively weaker gains in employment and stalled momentum in inflation. Outside of trade-related concerns, that none of those threats is all that dire may well keep the Fed from implementing additional cuts in the near term without sufficient change in depth or dynamic. Fed commentary regarding the cut suggested as much, focused on the Fed's desire to forestall any potential slowdown in growth through an "insurance" rate cut.

The initial reaction to the cut was mixed. It would seem many had hoped for a deeper cut, or at least a follow-on discussion that suggested more cuts were on the way. Longer-term yields, in fact, backed up as investors incorporated a rather less-accommodative stance than they had thought forthcoming. Almost on cue, however, trade-isolationist tit-for-tat reignited concerns over trade. This past week saw U.S. markets plunge nearly 5.6% (from the end of July before rebounding through today) after the U.S. chose to escalate tensions with China through an additional layer of tariffs, a move to which China responded by ceasing purchases of U.S. agricultural goods and allowing its currency, the yuan, to depreciate through a notionally important 7-per-dollar level. With stock investors cringing at the thought of further pressure on corporate earnings and macroeconomic growth, proceeds were heaved into the perceived relative safety of U.S. bonds.

Figure 2: U.S. Yield Curve Shift



As of 08.08.19. SOURCE: SRCM using data from Bloomberg

The effect of those flows along with a reversal of expectations for future Fed moves, saw much of the U.S. Treasury yield curve drop by 10 basis points (a basis point is 1/100th of a percent) or more on the week (light and dark green lines in Figure 2). More notable, however, is the fact that the entire curve with maturities of five years and beyond now rests below levels concurrent with the Fed's initial rate rise back in December

2015. These levels both confirm investor expectations for relatively dire circumstances going forward and provide the basis for ensuring relatively meager returns come what may.

Generous No More

Over and above the far more pessimistic tone such low absolute rates suggest, we find the extreme lack of future income reflected by the present yield environment not particularly comforting. With most Treasury bonds maintaining yields at or below 2%, expectations for future total returns within fixed income are back near crisis-era levels (just without the corresponding crisis…yet). Even more, though monetary policy—historically extreme as it has been—has failed to sustain inflation at the Fed's target 2% per year, year-over-year rises in domestic prices have not been so far off that mark. Very long-term rates now rest just a tick above recent inflation metrics (and all-time lows), and much of the middle portion of the curve now sits at or even below actual inflation. And that means real yields—the value of income received after inflation is considered—are zero or thereabout.

Careful if Creeping into Risk

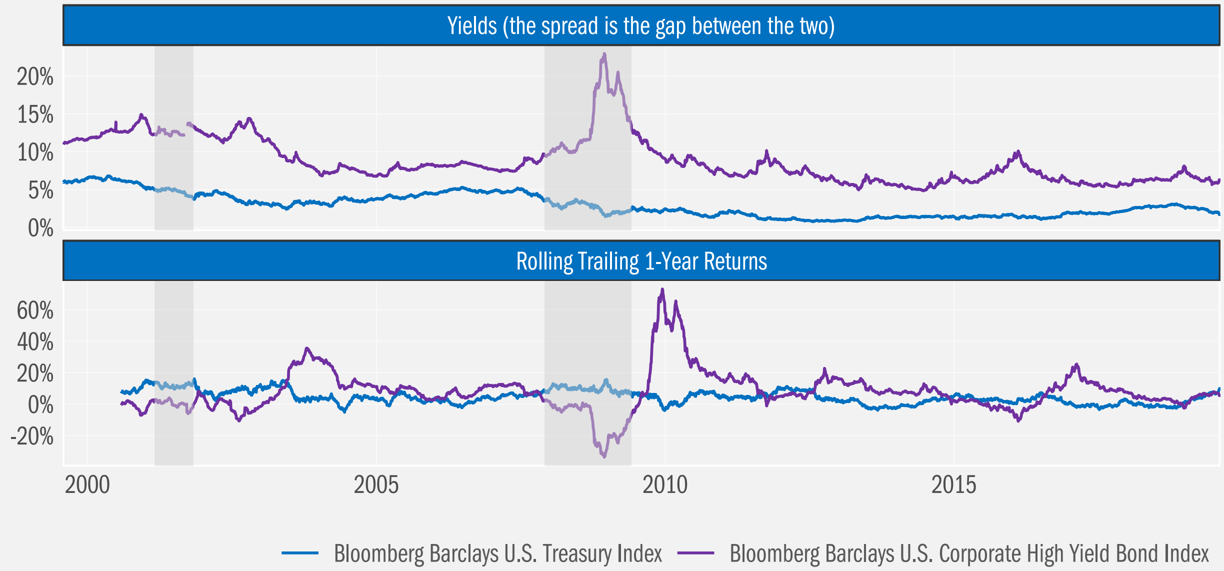
So, what's to be done about it? Quickly re-emerging, we imagine, are desires to find as much yield as possible in this revisit to income austerity. But, such thinking may find quick troubles, especially as one considers the potentially weaker future growth that's behind the plunge in rates. Generally speaking, outside of taking on the risk of holding bonds for longer periods of time, two additional factors can generate variations in bond returns. The first, exposure to credit quality, normally sees bonds with more potential for default (e.g., corporate bonds and those of countries with weaker macroeconomic underpinnings) pay higher yields. That's generally still the case, but the extra yield one should now expect to earn for taking on that risk (the "spread" over risk-free Treasury bonds) remains at historically low levels.

Take U.S. high-yield bonds, for example. In Figure 3, we chart the spread between high yield bonds and U.S. Treasuries of the same maturity over the last 15 years. Note that high-yield bond yields are always higher than U.S. Treasuries, reflecting the desire for incremental income for taking on credit risk. That gap evolves over time, however, generally expanding leading up to and during periods of macroeconomic distress and narrowing as those stresses abate. Readers will recall that bond prices move in the opposite direction of yields, so as yields rise, prices fall and vice versa. Similarly, as the spread widens, returns for the riskier bonds may trail those for Treasuries, so long as the extra income received from the riskier bonds (from their higher yields) fails to make up for the shortfalls on price.

As we suggested earlier, the latest plunge in stocks was reflective of investor concern regarding increased trade tensions and the potential for even weaker trends in global macroeconomic growth. Those concerns did not only affect stocks. High yield bonds, too, saw strong selling and the high-yield spread widened—yields on high yield bonds rose, even as Treasury yields fell—from about 3.9% at the end of July to 4.3% on August 8. So, while the U.S. Treasury index jumped 2.2% over those few days, the high-yield bond market fell 0.6%. Yet another reminder that excess return generally comes with risky strings attached.

Figure 3: Domestic High-Yield Historical Yield and Spread

The gap (spread) in yields between risker-bonds and Treasuries tends to widen during macroeconomic distress (grey shaded areas denote recession), with consequently weaker performance among the risker exposures.



From 08.02.99 to 08.08.19. Comparison makes no considerations for differences in aggreagte duration for the indexes. The Bloomberg Barclays U.S. Treasury Index measures the performance of the U.S. Treasury bond market. The Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the performance of the U.S. high-yield corporate bond market. SOURCE: SRCM using data from Bloomberg

Tipping Toward...?

What's next? It's the question everyone wants answered. While there certainly were signs that global growth was slowing even before U.S.-China trade skirmish began, we think the answer depends greatly on whether these initial volleys will turn into something more substantial. Near surely, some manner of incremental damage has been done to C-suite psyche, with the resulting uncertainty likely peeling back intentions for substantial nearer-term investment in productive assets. And while executives await greater clarity on American and Chinese intentions for their ongoing trade relationship, that lack of investment, along with likely stronger consumer retrenchment that may come with all the doomy chatter that surrounds the rift, may see further weakening in corporate earnings growth. We can add to that growing fears that the UK will rather messily fall out of the European Union, increasing political malaise in Italy, substantially increased tensions between India and Pakistan, and deteriorating geopolitical dynamics on, around and about the Korean Peninsula. Further stock declines thus seem well within the realm of possibility. And, then again, we may see a quick resolution to the trade disconnect, and perhaps each of the other ills, and as that weight lifts from investor psyche, we may retrace ground recently lost.

All that is to suggest we must get our minds right about expectations for reasonable levels of going-forward market volatility and potential return. To aid in that effort, we recommend readers reach out to an advisor to discuss how their portfolios are exposed to market risk and their level of comfort with those exposures.

Important Information

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