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Yields end deep hibernation

Key take aways

- Along with rising inflation and growth expectations, yields have been increasing of late.
- This creates challenges as well as opportunities for investors both in equities and fixed income instruments.
- The recent uptick in nominal yields has been attributed to a rise in real yields, which is usually associated with higher economic growth expectations.
- If economic growth does indeed pick up, investors in risky assets – be they in equity or credit – should benefit, everything else being equal. If dynamics change, however, investors may have to adjust portfolios.

01 Introduction

Yields have been on a structural decline since the global financial crisis (GFC) with central banks around the globe embracing unconventional monetary policy tools. Accompanied by the reopening of the economy and low year-ago comparables, inflation expectations (Figure 1) as well as yields have increased of late. In the months to come we should expect more volatility and temporary spikes in inflation (and expectations) as a reopening economy finds its balance. Oil prices and other raw materials remain much higher than a year ago, add global supply-chain disruptions along with a fade out of temporary stimulus measures such as the temporary VAT cut in Germany, then pricing pressures will be surely felt as global economic activity reawakens. Lastly, markets are already starting to anticipate a shift to less-expansionary monetary policy (Figure 2).

The rise in yields has been felt on both sides of the Atlantic but more so in the U.S. in particular, with the curve steepening most evident between 2 and 10-year tenures. Furthermore, the most recent increase in nominal yields has been attributed to a rise in real yields, which can be historically associated with higher growth expectations. In such an environment, investors in risky assets – be it equity or credit – should benefit, everything else being equal. However, markets may struggle to digest the swift move in rates and bear in mind too that rates have been at unprecedentedly lows, and conversely, equity multiples remain elevated. Nevertheless, as long as there is no extraordinary swift rise in (real) yields or if real yields turn positive, then any volatility is likely to be temporary.

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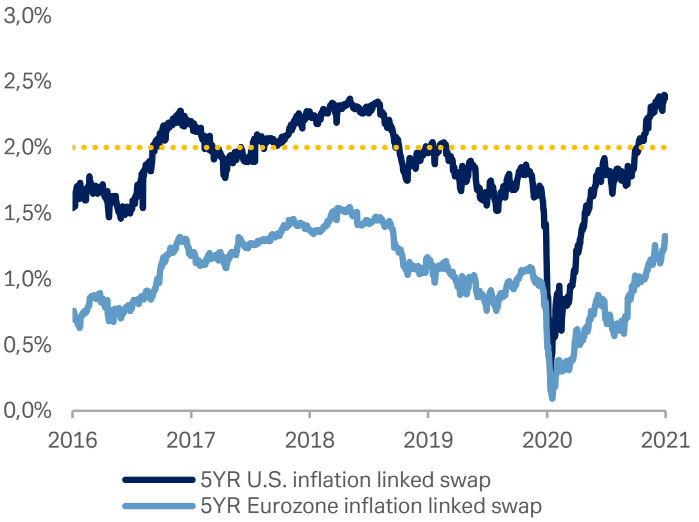
Figure 1: Inflation expectations are moving up



Source: Datastream, Deutsche Bank AG.
Data as of March 9, 2021.

Figure 2: Fed funds futures anticipate further rises

Source: Bloomberg Finance L.P., Deutsche Bank AG.
Data as of March 9, 2021.

02 Fixed income implications

The return of a fixed income investor is the coupon (the regularly interest paid) plus the change in value of the corresponding bond. The issue with rising yields is that bond prices have to fall to adjust to the new yield environment. So while a rise in yields may attract new buyers, existing holders of bond positions face an immediate fall in the value of their existing investments. The two reasons for the negative price movements that accompany rising interest rates are duration (the number of years a bond would take to be repaid) and convexity (a measure of the curve linking bond prices and bond yields). Both duration and convexity matter much more than in the past, for reasons explained below.

Investors, governments, and corporate treasurers used the previous falling yield environment to their advantage. Investors tried to profit from security price appreciation over the last few years prolonging their duration (often called "riding the yield curve"). In addition to general profit seeking in a low-yield environment, professional investors who are bound by internal restrictions to invest only in high grade bonds (e.g. pension funds) have had no alternative as they need to take more risk in investing in longer-dated bonds to earn the required rate of return needed (for example: to match future liabilities).

On the other side, government and corporate treasurers took advantage of the low-yield environment and issued longer-dated bonds to lock in the favorable refinancing conditions for a longer period of time. This means that the interest rate sensitivity of bond investments (measured by duration) has risen significantly making bonds much more vulnerable to interest rate changes than in the past.

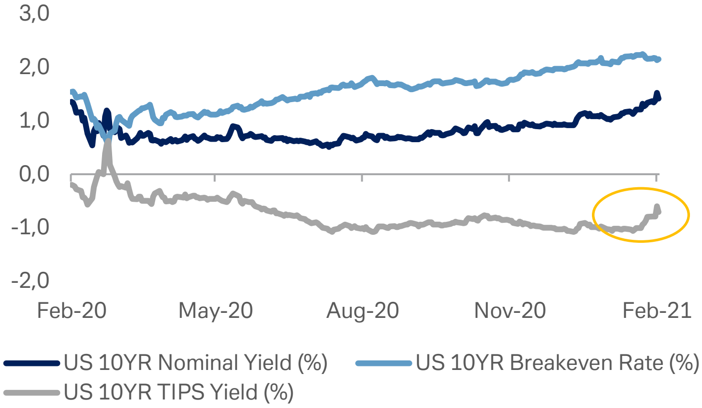
As both yields and coupons also remain close to historic lows there is little cushion even in case of small yield moves. Compared to the past, this implicates that price fluctuations are much higher because the convexity of bonds has risen drastically, meaning that small yield moves matter more compared to a high yields environment.

For corporate bonds, it is not only about the "what" it is also about the "why" – in this case, the fundamental reasons why yields are rising. When an increase in interest rates happens because an economy is expected to recover from a deep recession, this is associated with earnings growth and reflects a benign environment, meaning that spreads should not suffer. By contrast, when yields are rising because of an anticipated central bank policy shift (e. g. the prospect of less bond buying by central banks) they could come quickly under pressure as they also face the problems outlined above with historically higher duration and convexity. Another nuance must be made regarding the difference between nominal and real yields. In a highly indebted financial system, real yield increases are much more relevant compared to nominal yield increases that go in parallel with inflation rates.

Emerging market bonds face a specific threat when it comes to increasing yields. At the moment, U.S. Treasuries are at the forefront of global yield movements, and they are becoming relatively attractive for investors who have absolute return targets. The previous spread compression of emerging market bonds to their risk free counterparts (e.g. U.S. Treasuries) can be partially explained by the absence of comparable alternatives in terms of risk-return profiles. So, if risk-free bond yields were to rise further, emerging market bond investors might want to re-allocate their money to U.S. Treasuries, preferring to avoid taking idiosyncratic or currency risks.

Investors who anticipate rising inflation will be aware that inflation expectations have already risen quite strongly over the last 12 months – in the U.S. more than in the Eurozone, and already to above pre-crisis levels. These inflation expectations can be observed in the TIPS (Treasury Inflation Protected Securities) breakeven rate (Figure 3). This means that an investment in inflation-linked government bonds would be advantageous over nominal ones only if inflation turned out to be even higher than currently expected. In other words, the pricing in of higher inflation expectations means that there is now a higher hurdle for TIPS to outperform.

Figure 3: Recent uptick in yields was driven by rising real rates



Source: Bloomberg Finance L.P., Deutsche Bank AG.
Data as of March 9, 2021.

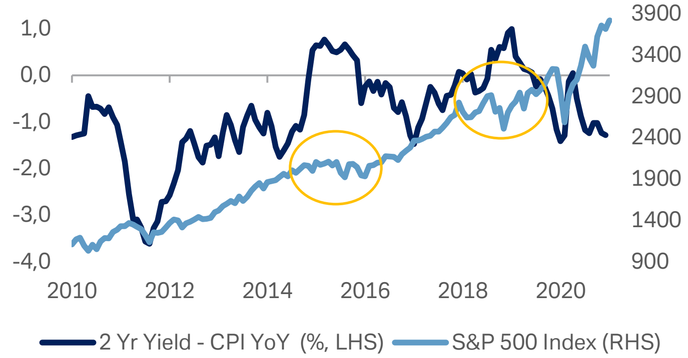
03 Equities implications

Two factors are important for the impact of higher yields on equities – the speed of the yields adjustment and their absolute levels.

Speed – In a normal environment, the correlation between equity prices and (real) rates is generally positive, as real rates signal that economic fundamentals are improving and growth is increasing. These conditions bode relatively well for optimistic equity risk takers, but less so for the generally more pessimistic sovereign bond holders (to simplify). This means that from a strategic standpoint, equity prices and real rates usually move directionally in tandem. However, there can be shorter-term shifts in this relationship that can signal difficulty for risky assets. These shifts usually occur after more dramatic or rapid increases in real-rates. We saw this happen at the start of 2016, when the Fed was entering an "auto-pilot" rate-hiking cycle, and also in 2013, following the infamous "taper tantrum". Another rather longer (or more persistent) period of negative correlation occurred from 2004-2007, just before the rate cutting cycle as we entered the Great Financial Crisis. Therefore, this phenomenon has happened around shifts to both simulative (lowering rates) and restrictive (raising rates) monetary policy regimes. Regardless, we should say that negative equity and rate correlations are shorter-term phenomena, which do not create very meaningful, or lasting, negative stock price performance. But as we approach the next monetary policy u-turn for the Fed (likely still some time away), we should expect another bout of increased rate volatility, creating some short-term headwinds and rebalancing opportunities for equities.

Levels – U.S. TIPS yields are not the only measure of "real rates" that investors should consider. Perhaps a more important gauge is the spread between the U.S. 2-year Treasury yield and headline-inflation (CPI). The absolute level of this rate has had historical significance for stock prices. During the last market cycle, the S&P 500 steadily increased so long as this spread between the 2-year Treasury yield and headline-inflation was negative. However, once this spread turns positive, equity momentum began to fade. In 2018, the S&P 500 index experienced a correction (i.e. it fell by more than 10%) shortly after real rates crossed into positive territory (Figure 4). Nonetheless, as the current spread between U.S. 2-year Treasury yields and inflation is still clearly negative, and given the Fed's more tolerant framework on inflation, we expect that the 2-year Treasury rate will stay low as prices (inflation) steadily edges higher.

Figure 4: Changing relationship between the S&P 500 and real U.S. 2-year yields



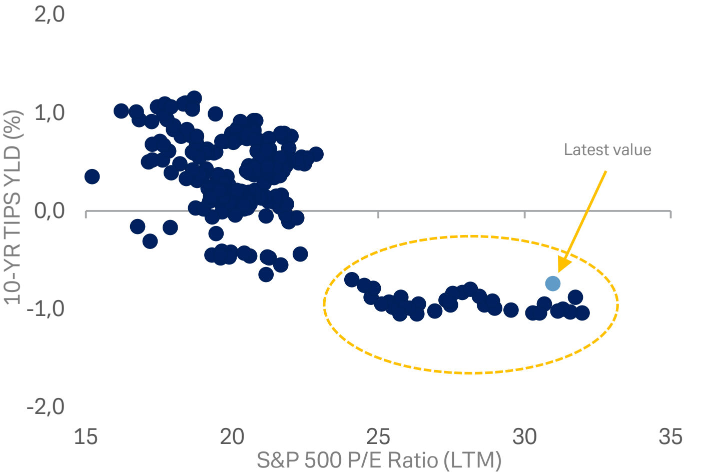
Source: Bloomberg Finance L.P., Deutsche Bank AG.
Data as of March 9, 2021.

Valuations – We have highlighted above how rising real-rates tend not to negatively impact equity prices in the longer term. But, by contrast, rising real rates have been shown to have lasting negative impacts to overall valuation levels. (Figure 5) In fact, over the past five years, the S&P 500 has never had a trailing 12-month price/earnings (P/E) ratio above 24 unless the 10-year TIPS yield was below -70bps (on a weekly basis). (Figure 6) As it currently stands, equity valuations remain relatively well supported despite the recent 40 bps rise in the 10-year TIPS rate. Over the next twelve months, we should expect multiple compression to occur against the background of a strong earnings recovery. This should allow for more flexibility for real rates to rise further and not derail overall equity market performance. In other words, the anticipated earnings recovery will remain paramount for equity markets, allowing them to absorb any additional increases in real rates.

Figure 5: High valuations associated with negative real yields

Source: Bloomberg Finance L.P., Deutsche Bank AG.
Data as of March 9, 2021.

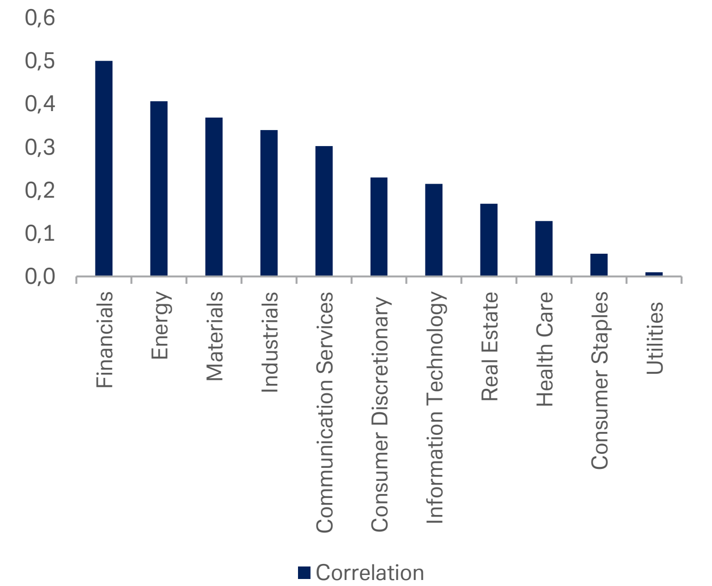
Figure 6: Relationship between TIPS yield and S&P 500 P/E (LTM)



Source: Bloomberg Finance L.P., Deutsche Bank AG.
Data as of March 3, 2021, past 5 years, weekly data.

Sector preferences – Increasing yields have typically provided a major impetus for rotating into "value" stocks (those seen as trading lower than justified by the underlying corporate fundamentals). Additionally, cyclical sectors are likely to benefit from a rise in yields stemming from a recovering economy. From a sector perspective, Financials, Energy, Materials, and Industrial names have had a high correlation to interest rate levels (Figure 7). Meanwhile, more defensive sectors such as Healthcare, Consumer Staples, and Utilities have the lowest. Globally, we see Financials as an overweight in this environment since the sector remains at a discount to others. Tactically adding exposure here would allow for upside participation in higher rates, without having to pay a premium for exposure to other sectors of markets that still have high overall valuations.

Figure 7: Financials show the highest correlation to yields (last 2-years)



Source: Bloomberg Finance L.P., Deutsche Bank AG.
Data as of March 9, 2021.

04 Where do we go from here?

The reasons why yields are moving have important implications for asset classes. Our base case is for nominal rates not to move much from here over the next twelve months. (Our end-March 2022 forecasts are as follows: U.S. Treasuries: 2-year 0.35%, 10-year 1.50%, Bunds: 2-year -0.70%, 10-year -0.30%). This outcome would reflect an improving economic environment and only slight policy tightening as the Fed may start to taper gently in Q1 2022 when also the Pandemic Emergency Purchase Program of the ECB is supposed to end at the earliest. Given that we also expect only modest increases in annual average rates of inflation (albeit with possible temporary spikes as mentioned earlier), real yields should also remain in negative territory. In such a scenario, credit spreads should be supported and the outlook for equites should be constructive. Valuation multiples in the equity market would be likely to contract further, mostly attributed to robust recovery in earnings.

If yields were to rise further than we expect, the consequences for other asset classes would depend on the speed as well as the level. Rising yields can be a reflection of a better economic environment, rising inflation or anticipation of rate hikes by the central bank. While the latter seems not very likely, markets may start to anticipate such rate hikes, particularly if inflation breaches the central bank's target for a significant period of time (in the U.S. and elsewhere the new symmetric inflation target will allow for a temporary overshoot). Steady but slow rises in yields should not harm the performance of risky assets. But fast rises in real yields could result in changing the correlation to stock prices to negative, creating a challenging environment for equities. As outlined above, these negative periods tend to be short-lived.

In addition, higher yields are a threat for the often repeated TINA ("there is no alternative") argument for equities. At a certain yield level, bonds could become an attractive alternative to equity investments again. First and foremost, higher yields challenge equity multiples which are still high in a historical context. But higher yields can also attract investors looking for steady income streams in particular. While this level cannot be forecasted with precision we would estimate that 10 year U.S. yields above 2.5% (a sufficient cushion above the Fed's defined long-term price stability goal and potentially positive real yields) or 2-year U.S. Treasury yields minus Headline CPI turns positive (Figure 4) could start changing the dynamics here. While this would imply more challenges ahead for equity investors, extracting performance would still be possible. Sectors, styles and earnings analysis would become more important in this alternative-scenario.

The third alternative, an environment of even lower yields (which we do not think is likely) can be seen from two angles. If inflation rates were to become very low, central banks would follow an expansionary path to stimulate higher prices. An extension of the TINA argument for equities mentioned earlier could be the consequence. Higher multiples in general and stronger performance of "growth" stocks (as lower interest rates increase the present value of future earnings) are obvious possible consequences. But if this lower yields environment came along with sluggish growth or (even worse) another economic crises, higher corporate spreads and challenges for the equity markets would follow.

Glossary

Bunds are longer-term bonds issued by the German government.

The consumer price index (CPI) measures the price of a basket of products and services that is based on the typical consumption of a private household.

An emerging market (EM) is a country that has some characteristics of a developed market in terms of market efficiency, liquidity and other factors, but does not meet all developed market criteria.

The European Central Bank (ECB) is the central bank for the Eurozone.

The Fed funds rate is the interest rate at which depository institutions lend overnight to other depository institutions.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

The Global Financial Crisis (GFC) refers to the crisis of 2007-2008.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

A spread is the difference in the quoted return on two investments, most commonly used in comparing bond yields.

Treasuries are bonds issued by the U.S. government.

Treasury Inflation Protection Securities (TIPS) index redemption values to the U.S. CPI.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

A value-added tax (VAT) is levied on the value added at each stage of the production process.

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