Investment Management

Insights from Brett Wander

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Perspective on global economic and fixed income markets

Super low bond yields are everywhere, and here to stay

November 2019

As 2020 looms ever closer on the horizon, extremely low bond yields are pervasive throughout the global economy, as many longstanding investment "truisms" have been falling by the wayside. For example, common wisdom holds that bond yields could never be negative, that inflation rises as the labor market tightens, that the Federal Reserve (Fed) only cuts interest rates after the economy is stalling, and that an inverted yield curve signals a rapidly approaching recession. However, as the current market environment demonstrates, "Past performance doesn't guarantee future results."

The recent departure from historical norms may seem confusing to your clients, but we believe that the markets are acting quite rationally to the unprecedented conditions. From the ongoing trade war between the U.S. and China, to impeachment proceedings in Washington D.C., to the Fed's proactive approach to reducing interest rates, your clients are weathering an almost perfect storm for financial market volatility. In this environment, we wouldn't be overly surprised to see U.S. rates go even lower still, as we continue the "lower for longer" pattern that's been in place for years. In this edition of our recurring fixed income insights, we'll dive into this chaotic market backdrop, and touch upon one of the biggest assumptions in fixed income: that U.S. Treasury yields could never drop below zero percent.

Key takeaways

- Bond yields are extremely low globally, and we don't expect this to change anytime soon.
- The Fed has been uncharacteristically preemptive about cutting interest rates.
- Inflation can stay muted even with the U.S. unemployment rate around 50-year lows.
- Negative bond yields in Germany and Japan mean that negative U.S. Treasury yields are not inconceivable, but we think they're highly unlikely.
- We believe that high-quality U.S. bonds are as relevant as ever and should be an essential part of your clients' portfolios.

Negative rates have become a reality

One investment truism that has fallen by the wayside this year is that bond yields could *never* be negative. Global bond yields have plunged this year, as more than 30 central banks have eased their monetary policies in an effort to stimulate economic growth. Conditions have been so challenging internationally that yields on 10-year government bonds in Japan and Germany—some of the world's largest bond markets—are less than zero. In these markets, investors are essentially paying to park money in traditional safe-haven assets.

The chart below illustrates this point. As of mid-October, yields on 10-year U.S. Treasuries were on the high side of the G7 extreme at 1.77%, while 10-year German bunds were on the low side with yields of -0.42%. These negative yields underscore a significant degree of economic distress. Moreover, with overseas government bond yields well below U.S. Treasury yields, we expect that international demand for Treasuries will remain solid. Could U.S. rates head into negative territory in this environment? As negative rates overseas prove, it's not inconceivable, but we still think it's highly unlikely.

U.S. bond yields have fallen back down to historical lows, and they may fall even further.

The Fed's U-turn on interest rates

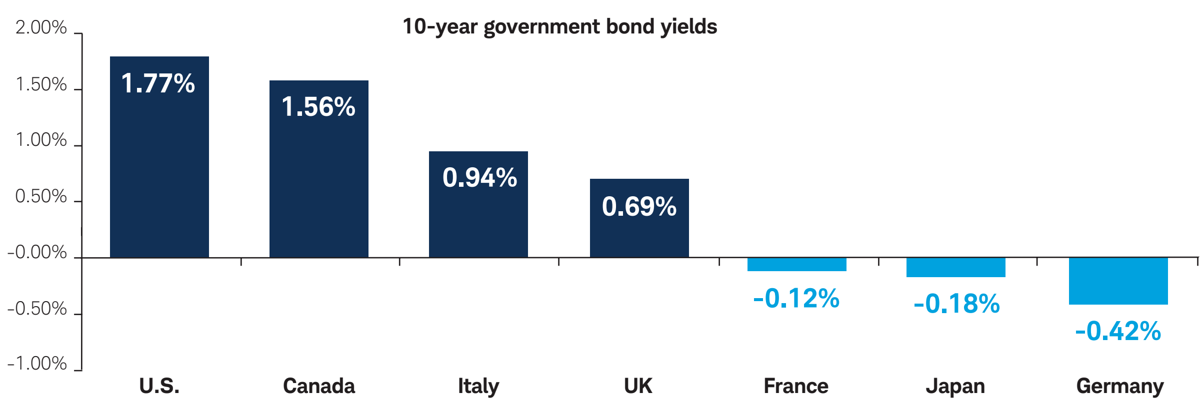
The Fed's quick shift from tightening to loosening its monetary policies this year is another broken investment truism. Historically, the Fed has lowered rates following signs of deteriorating U.S. economic growth in hopes of keeping the economy healthy and growing. This time is different. In July and September, the Fed cut short-term interest rates by 25 basis points (0.25%) each meeting, even as the U.S. economy continued to expand, and the unemployment rate hovered near 50-year lows. The Fed's proactive approach illustrates their intent to manage downside economic risks before "red lights" start flashing. As a result, U.S. bond yields have fallen back down to historical lows, and they may fall even further.

Global appeal of Treasuries

The chart shows yields on 10-year government bonds across G7 countries.

Think bond yields are low in the U.S.?

Compared with international equivalents, U.S. Treasury yields look quite compelling.



Sources: Charles Schwab Investment Management; Bloomberg. Data as of 10/15/19.

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Low U.S. inflation—here for the long term

The next investment truism no longer standing is that inflation rises as the unemployment rate falls below the natural level of full employment. Prior to the Great Recession, prices tended to rise alongside job growth. Economic theory explained this as the result of increased demand, fueled by greater spending, saving, and investing by job holders who started earning more thanks to upward pressures on wages. The government generally collected and spent more too, and all this translated into faster economic growth. The cost of goods and services eventually rose as firms recalibrated their pricing strategies to account for rising labor costs, equating to inflation. However, since the Great Recession, there has been little evidence that companies have been raising prices to due to wage pressures.

The chart below reflects this point, showing that inflation—as measured by the Consumer Price Index, minus food and energy components (core consumer prices)—has remained comfortably close to the Fed's 2.0% target since late 2011, in spite of the tightening labor market.

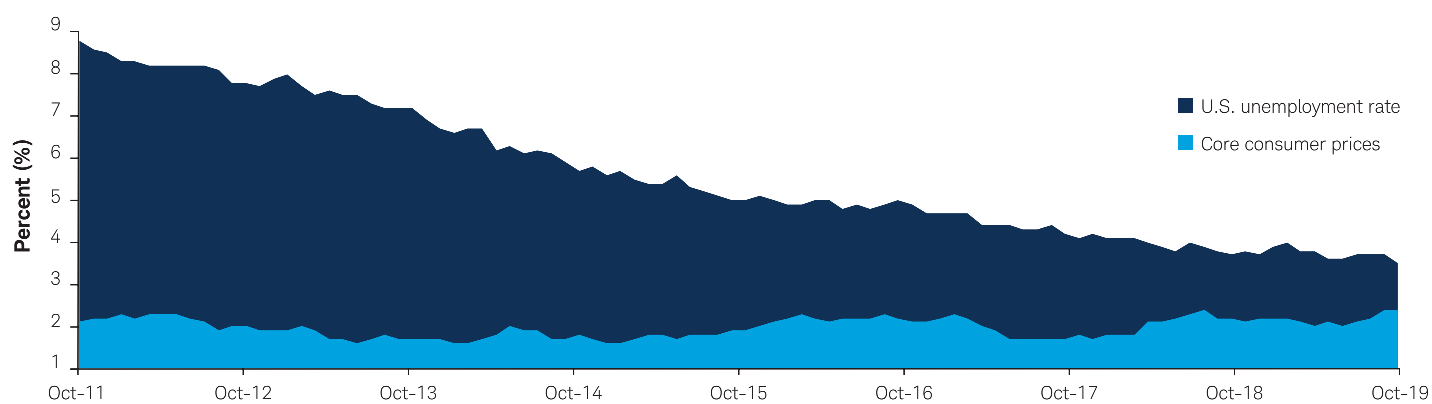
What does this mean for rates going forward? With inflation low not only in the U.S. but internationally as well, central banks like the Fed can keep rates accommodative for now without being overly concerned that inflation will accelerate. Viewed in this controlled-inflation context, rate cuts by central banks to stimulate economic growth in their local economies have not been a cause for alarm.

The inverted yield curve has not wreaked havoc

Another investment truism no longer holding up involves the "inverted" yield curve. Typically, longer-term bonds yield more than shorter-term bonds, reflecting a maturity premium that leads to a traditional upward-sloping yield curve. Yet in the current market, the U.S. yield curve is partially inverted, with yields on Treasuries maturing in one year or less higher than yields on many longer-term Treasuries. Historically, this has often served as a warning siren that a recession is approaching. Yet the 10-year U.S. equity bull market continues while weathering intermittent bouts of market volatility, with many major indexes hovering around all-time highs. Given this context, the partially inverted yield curve seems more of an academic point of interest by itself than a clear signal that a U.S. recession is imminent.

The tight U.S. labor market is having little impact on inflation

Core consumer prices have remained tame, even as the U.S. unemployment rate has dropped to 50-year lows.



Sources: Charles Schwab Investment Management; Bloomberg. U.S. unemployment rate and the Core Consumer Price Index. Data from 10/31/11 to 09/30/19.

Keep your clients focused on credit quality

Equities and fixed income alike have performed well so far in 2019. Market conditions have been volatile, with the political climate as electrified as we can remember amid impeachment proceedings. We think that 2020 is likely to hold more of the same, especially as we approach the next U.S. presidential election. Uncertainty surrounding Brexit, the U.S. trade war with China, negative yields for more than 25% of the world's investment-grade bond market, and slower economic growth overseas are additional factors. Fortunately, the market seems increasingly unfazed as investors are beginning to tune out the noisy political backdrop, and we suggest that your clients do the same.

From our perspective, the current investment climate underscores the benefits of a well-diversified portfolio that includes high-quality bonds like Treasuries. In addition, if your clients think they should wait before allocating more to bonds because of the low yield environment, consider pointing out how much higher Treasury yields are than overseas government bond yields. And, if your clients are wondering why allocations to longer-term bonds make sense when shorter-term securities yield about the same, consider reminding them about the higher total return potential of longer-term bonds when bond rates fall.

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About the author

Brett Wander is Chief Investment Officer (Fixed Income) of Charles Schwab Investment Management, Inc. (CSIM), a subsidiary of The Charles Schwab Corporation. Wander joined CSIM in 2011 and is responsible for all aspects of the firm's fixed income and money market portfolios, leading a team of more than a dozen investment professionals. Over his more than 20 years of investment management experience, Wander has been intimately involved in the design, development, and oversight of a wide range of active, indexed, and alternative fixed income strategies. His expertise spans a wide range of global and domestic markets and sectors. He is a frequent industry speaker, presenting at conferences and in various media forums.

He has taught MBA-level investment courses at the University of Southern California. Wander earned an MBA from the University of Chicago and a BS in system science engineering from the University of California, Los Angeles. He is a Chartered Financial Analyst® charterholder.

IAN (1119-9D24) MKT108974-00 (10/19)
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