SPECIAL REPORT
WHY ARE GOVERNMENT BOND YIELDS FALLING?

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There has been a subtle shift in market psychology regarding the economic recovery. There appears to be a growing sense that the current economic boom is not sustainable and that the next several quarters of spectacular growth will be followed by a sharp slowdown during the first half of next year. There is also a belief that the peak growth rate of GDP experienced in the second quarter has passed and that an extended period of decelerating economic growth lies ahead.

- Although the US economy is in the middle of an economic boom — accompanied by a rising trend in inflation — long-term interest rates have been trending lower since the end of May and remain trapped at historically depressed levels. The current 1.32% yield to maturity on ten-year government bonds is near the lowest levels in the 250-year history of the US government bond market.

- Even more puzzling is the level of *inflation-adjusted yields*, which are currently at a *negative one percent*, the lowest level in history as measured in the market for Treasury-Inflation Protected Securities (TIPS). Real yields reflect market perceptions regarding the underlying strength, durability, and resiliency of the economy and its prospects for long-term growth.

- There are several possible explanations for this highly unusual phenomenon, the most obvious being the depressed level of central bank policy rates, currently at zero. However, the Fed held its policy rate at zero for seven years following the world financial crisis in 2008, during which time market yields on long-term US government bonds averaged 2.6%. The average nominal yield on Treasury bonds since the outbreak of the pandemic is 1%, while the overnight federal funds rate has been pegged at zero.

- At its most basic level, market interest rates — borrowing costs — are determined by the supply of and demand for loanable funds. There is currently a record level of savings within all sectors of the US economy — households, businesses, and the banking system. Consistent with this exceptionally high level of liquidity, the demand for credit is depressed. Excluding residential mortgage loans, commercial bank loans have not increased since the onset of the pandemic.

- Another explanation is the *relative* "attractiveness" of US bonds versus non-US sovereign debt. The average market yield on government bonds outside the USA is close to zero for ten-year maturities — slightly negative in Germany and Switzerland, zero in France and Japan, and slightly above zero in Spain and the UK. However, market yields on European and Japanese sovereign debt have been in negative territory for an extended period long before the onset of the pandemic.

- There is strong evidence that investor psychology has made an abrupt shift in recent weeks from risk-on to ***risk-off***. There are numerous indicators of this shift. The US dollar (USD) has strengthened considerably since the end of May, rising by nearly 5%. Equity market leadership has swung from cyclicals and value stocks to safe-haven growth and technology stocks. Except for crude oil, most industrial commodity prices have weakened since May. In this environment, it should not be surprising to see increased investor demand for government bonds, arguably the quintessential safe-haven asset.

- There has been a subtle shift in market psychology regarding the economic recovery, in two respects. There appears to be a growing sense that the current economic boom is not sustainable and that the next several quarters of spectacular growth will be followed by a sharp slowdown during the first half of next year. There is also a belief that the peak growth rate of GDP experienced in the second quarter has passed and that an extended period of decelerating economic growth lies ahead.

- It also appears that many investors have come to believe that the current boom is the result of several one-time factors and is therefore perceived as transitory. These factors include: A V-shaped recovery from the deepest recession since 1945; vaccination of a large percentage of the US adult population; massive pent-up demand in the aftermath of previous lockdowns; and unprecedented fiscal stimulus that will fade rapidly in 2022.

- Following a recent scare, financial markets also appear to be more relaxed with respect to the outlook for inflation. Indicators of inflationary expectations have moderated in recent weeks and investors appear confident that the Federal Reserve will be successful in conquering inflation when it becomes necessary.

- There is also an increased sense of confidence that the Federal Reserve will maintain a highly accommodative monetary position than previously assumed. It has become clear that Fed officials are more fearful of a stagnant and deflationary economy than an overheating economy with out-of-control inflation. This perception of the domestic economy has been widely adopted by investors.

- What are the catalysts that might reverse this downward trend in long-term interest rates? There are several plausible candidates:

    1. Evidence supporting the sustainability of the economic boom throughout 2022 and beyond

    2. Evidence that the recent surge in inflation is not transitory as claimed by the Federal Reserve and has begun to spill over into wage inflation

3. Indications that a new Fed tightening cycle will begin sooner than currently expected

4. Evidence that the COVID-19 pandemic has stabilized globally, and that the Delta variant is less threatening than currently perceived

5. An increased rate of vaccinations among those previously resistant to inoculation

6. Indications that President Biden's ambitious spending programs currently debated in Congress will be approved prior to yearend

7. Evidence of a sustained recovery in credit demand

8. A calming in geopolitical tensions, most notably those involving China

I expect some combination of these developments to become reality within the next six to nine months.

- I believe that the current level of interest rates is not sustainable in the long term. However, in the medium term, it is likely that the prevailing market psychology regarding the economy, long-term inflation, government policy initiatives, and the global pandemic will continue to exert downward pressure on bond market yields.

- My view is that the recent decline in interest rates is overdone and that bond yields will be considerably higher later this year and in 2022. Although GDP growth has peaked, the US and world economies will be growing at a rate well above trend for many quarters. Most importantly, the unemployment rate is heading lower and inflation is in a sustained upward trend. Bond yields should begin to trend higher once the market begins to discount a looming monetary tightening cycle.

- One can observe a very strong correlation between the direction of long-term interest rates and equity market leadership. Economically sensitive stock groups and value stocks tend to rise when interest rates are rising, while growth, technology, and defensive stocks tend to benefit from falling interest rates.

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Bloomberg Barclays US Aggregate Bond Index: is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market.

Bloomberg Barclays High-Yield Corporate Bond Index: measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

Dow Jones Industrial Average: is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

NASDAQ: is an American stock exchange at One Liberty Plaza in New York City. It is ranked second on the list of stock exchanges by market capitalization of shares traded, behind the New York Stock.

Russell 2000 Index: is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

Russell 3000 Growth Index: is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

Russell 3000 Value Index: : is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.