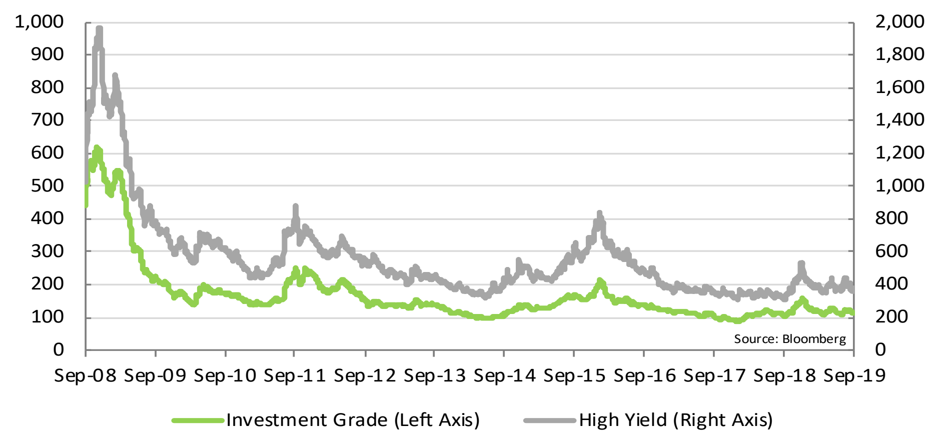
FIXED INCOME OUTLOOK

REGIONS
INVESTMENT MANAGEMENT

The Interest Rate Quandary

October 2019

Corporate Average Option-Adjusted Spreads (Basis Points)



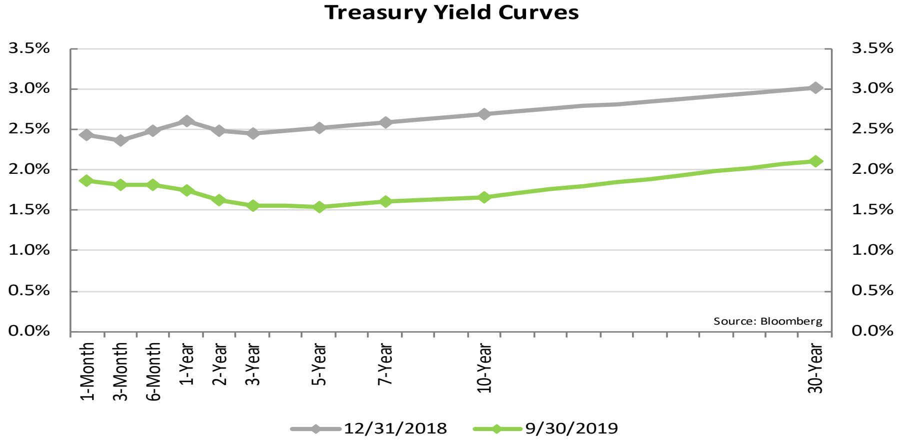
Interest rates are low and are likely headed lower as the markets adjust to a new reality: slowing global economic growth and the lack of monetary policy tools to do much about it. Trade disruption caused by the on-again, off-again negotiations with China is beginning to show up in domestic economic data points, most recently with poor ISM manufacturing numbers and a drop in ADP employment growth. Outside the U.S., Brexit continues to cause political and economic consternation, and who knows when the Middle East might disrupt the flow of oil or North Korea might test another missile. Albeit reluctantly, even the Federal Open Market Committee (FOMC) recognizes that times have changed and moved to lower the fed funds rate a second time this year by 25 basis points (bp) to a range of 1.75-2.00%. And the market expects at least another 25 bp cut later this year.

Longer term, the economic dilemma is much deeper and much harder to resolve than trade disputes. It's global demographics. Aging populations, lower birth rates, and immigration policies are hindering growth in mature economies. For the moment, the demographic problem is less severe in the U.S., but the trend is clear with few real solutions to solve it. Monetary policy tools won't address demographics, and while fiscal policies might help offset the decline in population growth, even sound legislative efforts are unlikely to solve this long-term problem. Trends in demographics are a reflection of cultural and societal changes that will be difficult to overcome. In contrast to a hundred plus years ago when the economy was largely agricultural based, children are viewed no longer as a cheap source of labor but rather as an expensive luxury.

Those countries already suffering from weak global economic growth and a serious deflationary threat have launched massive quantitative easing (bond buying) programs in a Hail Mary attempt to spur growth and inflation, with little results other than inflating financial assets. Across much of the economic base of Europe and Japan, $15 trillion—down from a peak of $17 trillion only a few weeks ago—in sovereign debt trade at negative yields, according to Bloomberg. The list consists of 14 individual countries including larger economic powers such as Japan, Germany, France, and the proverbial safe haven, Switzerland. But as one digs further, names like Slovakia, Latvia, and Slovenia emerge. The list of negative sovereign yields grows even more bizarre with Ireland, which is one of the original five PIIGS from the foreign debt crisis only a handful of years ago. In other words, investors are willing to pay these sovereigns to hold their money, perverting what would normally be the latter's cost of capital into . . . earnings? It gets even better. Of the remaining four PIIGS—Portugal, Italy, Greece, and Spain—all have ten year yields BELOW ten year U.S. treasury yields. Yes, even Greece.

It is our view that the global demand for yield will continue to drive yields lower and push global investors further into the U.S. bond markets. From a credit standpoint, the U.S. is the leading global economic and military power where a free society and the rule of law, well, rule. The U.S. dollar is the world's reserve currency in which a majority of global trade, unfortunately even illicit trade, is transacted. Yes, hedging costs offset the yield advantages of U.S Treasuries for many global investors, but money will always flow to safe havens in times of stress. Investors know and respect this and will pay up for the privilege. Coupled with slower U.S. economic growth, regardless of the reason, and the possibility of future rounds of FOMC bond buying, negative interest rates could even find their way into the U.S. markets.

Treasury Yield Curves



Lower and especially negative interest rates will present significant challenges to U.S. financial institutions, pension funds, endowments, investors, and savers alike. Financial institutions make their money on net interest margins, and as interest rates fall, margins become compressed. Life insurers and pension plans who tend to have very long investment horizons may not be able to earn previously assumed actuarial returns. The funding status of pension funds and endowments will become challenged requiring significantly more fund contributions to meet obligations as returns fall short. Endowments may be forced to cut back on distributions while individual investors may simply need to work longer and save more for retirement.

There are a few more possibilities worth mentioning. Sophisticated investors may find that their valuation models for options and other derivatives that are based upon a positive risk-free rate are no longer functioning properly and need to be reconfigured to generate accurate values. Growth stocks may outperform value stocks as the cost of capital drops for corporations. Yield-hungry investors may also chase high dividend paying stocks. For gold bugs, it may be heaven on earth as the opportunity cost of holding physical gold drops, thereby sending prices higher. And instead of paying someone to hold on to one's cash, demand for safes and other facilities providing secure physical storage could grow. Fixed annuities that "guarantee" a set cash flow may see a lift in demand but still leave investors with low returns.

So what should bond investors do? Expect interest rates to fall over time and position your portfolios accordingly. We recommend lengthening the duration—a fancy way of describing the life of a bond and its sensitivity to interest rate changes—of your bond portfolio to capture the price appreciation that is likely to occur in this scenario. The longer the duration, the greater the price upside (or downside) as interest rates fall (or rise). Essentially, higher bond prices pull forward returns from future coupon payments, leaving prospects for future returns even lower. Another way to think about this is that over time, bond math will always take investors back to par barring a default. And while we are on that topic, keep a close eye on credit quality. The temptation to chase yield among lower quality companies will be incredible, and investors need to remain vigilant. At ever lower yields/returns, the cushion against future bond defaults shrinks.

Sector Performance as of 9/30/2019

	QTD	YTD
Bloomberg Barclays US Aggregate Index	2.27%	8.52%
Bloomberg Barclays US Treasury Index	2.40%	7.71%
Bloomberg Barclays US MBS Index	1.37%	5.60%
Bloomberg Barclays US Corporate Index	3.05%	13.20%
Bloomberg Barclays US High Yield Index	1.33%	11.41%

Source: Bloomberg