INVESTMENT INSIGHTS

Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

July 25, 2016

IN BRIEF

- Developed market (DM) bond yields drifted higher last week but remain near decade lows. One-third of DM government bonds are trading with a negative yield to maturity.
- Early evidence suggests there is something inherent in negative yields that matters. First, negative yields pose a threat to the business model of banks, potentially limiting the efficacy of monetary policy. Second, to the extent that investors particularly abhor negative yields, demand would shift incrementally from negative- to positive-yielding markets, decreasing the spread between them.
- These factors create two-sided risks to our assessment that bond yields are likely to stay persistently low this year.
- More generally, negative bond yields and our cautious tactical positioning are both rooted in a challenging global growth environment that has been punctuated by frequent shocks. We continue to favor carry and quality across our multi-asset portfolios.

OPPORTUNITIES AND THREATS IN NEGATIVE BOND YIELDS

As bond yields sulked in the wake of the Brexit vote and then languished at low levels, fierce debate has sprung up around the question: What are ultra-low interest rates telling us? We explore this question at its outer limit by delineating implications of *negative* yields for the global economy and policy.

Roughly a third of global bonds are trading with negative yields, and that share has meandered upward since late-2014 (Exhibit 1). A confluence of global factors is driving bond yields lower, and some of them are likely to be persistent. Three adverse shocks to the global economy and financial markets have materialized over the past year, which have garnered an extra bid for safe assets, propelling low yields even lower. Policymakers have reacted to this environment with zealous pledges to head off downside risks via easier monetary stances which have, in turn, weighed on the term premium component of yields globally. Negative bond yields have played a supporting role by pushing the floor on palatable safe-asset returns ever lower.

This line of reasoning comes with an important caveat: The implications of negative yields—as opposed to low yields—remain poorly understood. As we discuss, they create two-sided risks to our assessment that the path of bond yields will likely remain subdued this year.

AUTHOR

Benjamin Mandel
Executive Director
Global Strategist
Multi-Asset Solutions

J.P.Morgan Asset Management

Why are bond yields so low?

DM yields drifted higher last week but remain near decade lows. The post-Brexit decline in U.S. Treasury yields underscores the international nature of today's bond markets. The contour of U.S. growth has been improving and inflation has been accelerating, both of which would tend to exert upward pressure on yields. If the U.S. was an island, economic conditions would be propelling yields upward.

The recent decline in U.S. yields also seems at odds with the idea that fixed income markets are pricing in substantially slower global growth. The broader constellation of markets—in which the S&P 500 is up and dollar moves have been moderate since Brexit—is not suggesting that growth expectations for the U.S. have declined. Analogous reasoning suggests that global growth prospects have not dimmed over the past few months.

The other major change in fixed income markets is the share of DM bonds trading with negative yield. The Brexit shock in Europe, combined with DM bonds' near-perfect correlation, formed the basis of a broad decline in yields. This process was facilitated by long bond yields' push into negative territory because it roundly refuted arguments that they had reached a binding lower limit.

Unintended consequences for banks

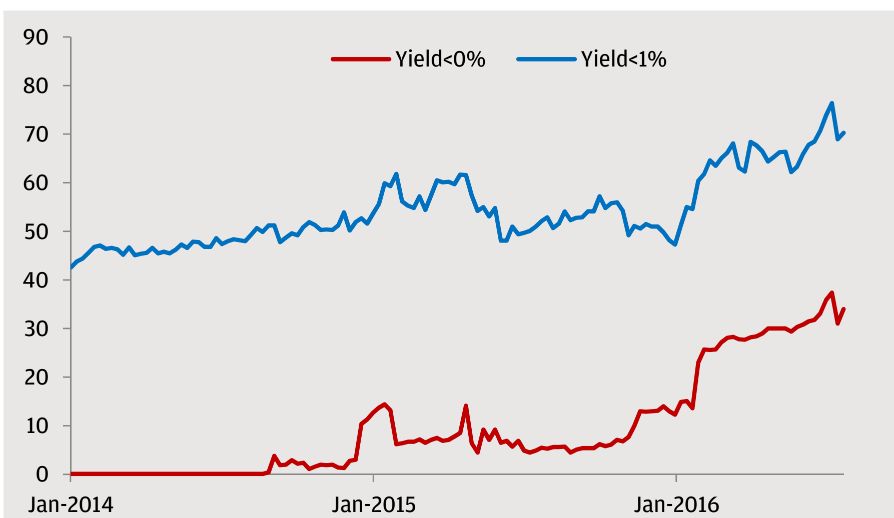
Of course, the share of negative yielding bonds is just a function of the level of global yields. Is there something inherent in negative yields—vs. low positive ones—that matters? Early evidence suggests that there is.

Bank profitability depends on the steepness of the yield curve. A flatter curve implies lower profits, since banks take short-term deposits and extend long-term loans. The floor dropping below zero has played a facilitating role in the recent flattening of DM yield curves and the related challenge to bank earnings.

There is an even more direct effect on banks' net interest margins to the extent that policy rates below zero are not passed through to retail depositors (due to cultural or political norms, or otherwise). The increasing share of negative yields signals a more persistently negative path for policy rates in the future and hence a longer-lasting challenge to bank earnings. Viewed through this lens, it is not surprising that significant bank stresses in Europe immediately followed the Brexit vote, given the confluence of more negative core European yields and expectations of further European Central Bank (ECB) action.

EXHIBIT 1: SHARE OF GLOBAL BOND MARKETS WITH LOW OR NEGATIVE YIELDS

The share of developed market bonds trading with negative yield has been rising since late 2014 and hit an all-time high of 37% in early July. This is part of a broader shift; over 70% of bonds are currently trading at a yield of less than 1% and the trend shows no signs of receding.



Source: Bank of America Merrill Lynch, Bloomberg; weekly data through July 22, 2016. For illustrative purposes only. Past performance is no guarantee of future results.

At best, these conditions set up a contrived outcome for policy, where rates sink ever lower and central banks bend over backwards to ensure a viable channel of credit transmission to the economy. The good news is that measures to bolster banks amid negative rates—including the ECB's latest round of targeted long-term refinancing operations offering funding to banks at negative rates—seem to be working. According the ECB's latest bank lending survey, a majority of euro area banks are now participating in the program.

In sum, from the perspective of banks, the proliferation of negative yields presents two-sided risks to our duration view. On one, the challenge to earnings could lead policymakers to be more timid about further easing. On the other, if accommodating banks proves successful, it may actually pave the way for even more deeply negative policy rates and bond yields.

Flight from negative yields

Another effect specific to negative yields arises from the possibility that some investors are fleeing from negative to positive yielding markets. To the extent that this behavior arises—as a result of behavioral biases, institutional constraints or otherwise—it would be tantamount to an increase in the relative demand for positive yield bonds, narrowing the spread between positive and negative yielding markets.

Indeed, we find an empirical relationship between the share of global bonds yielding less than zero and the subsequent narrowing of yield spreads. Across an array of DM markets, a 1% increase in the share of negative yielding bonds corresponds to a 1% to 3% decline in spread to Treasuries. Remarkably, this correlation disappears when we consider the share of bonds yielding less than 1%, rather than those with negative yields. Something inherent in negative yields seems to prompt some investors to flee.

Flight from negative yields implies that recent declines in U.S. yields have been amplified. But we note that this technical factor is likely to amplify movements in the other direction, too. As a case in point, over the last two weeks the share of DM government bonds with negative yields declined by 3 percentage points and spreads of Treasuries to Bunds and JGBs widened. The question also remains whether flight from negative yields will produce lasting effects on the path of Treasury yields; the answer depends largely on the persistence of the behavioral biases that caused it in the first place.

ASSET CLASS IMPLICATIONS

Like negative yields, our cautious tactical positioning is rooted in a challenging global growth environment marked by frequent shocks. We believe that market sensitivity to downside risks, and the response of policy, will be supportive of duration in the coming months, even as bond valuations have soared.

The resiliency of the current expansion in light of these challenges should also favor carry, including a preference for credit and higher yielding bond markets. We've noted that negative yields are a technical factor driving international spreads to compress, and may well continue to do so.

Within equity markets, we continue to favor the U.S. as the highest-quality option. And to the extent that lower bond yields reflect international factors rather than weaker domestic growth, they are an incremental positive for valuations.

Our current ambivalence toward European equities balances the impairment of a subset of banks with otherwise decent cyclical dynamics. But given European policymakers' high incentives to mitigate Brexit contagion, and to keep the credit channel of monetary policy alive, a decisive improvement in Italian banks' solvency represents a source of upside risk.

Global Multi-Asset Strategy:

John Bilton
Head of Global Multi-Asset Strategy
London

Thushka Maharaj
Global Strategist
London

Katrina Lee
Global Strategist
London

Michael Hood
Global Strategist
New York

Diego Gilsanz
Global Strategist
New York

Patrik Schöwitz
Global Strategist, Editor
New York

Mark Richards
Global Strategist
London

Timothy Lintern
Global Strategist
London

Michael Albrecht
Global Strategist
New York

Benjamin Mandel
Global Strategist
New York

NEXT STEPS

For more information, contact your J.P. Morgan representative.

II-AA-WEEKLY-072516 | 0903c02a815a3ab4