

Yields, Liquidity and Asset Prices: Implications of Prolonged Central Bank Easing for Multi-Asset Portfolios

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Highlights

- Global equities have gained about 45% since their low point on March 23. While the speed of the rally has raised investor concerns, valuations have moved broadly in line with shifting fundamentals. With cash yields expected to remain at about zero for an extended period, equities provide an attractive long-term yield that support current valuations.
- Government bond yields are expected to remain low for a prolonged period, however they continue to provide a modest yield premium over exceptionally low cash rates.
- Unprecedented central bank easing has significantly improved liquidity conditions, motivating investors to unwind 'haven trades' by moving capital into other assets that offer relatively attractive yields. The decline in US interest rates has provided less support for the US dollar and a lower opportunity cost for holding gold versus interest-bearing bonds.

The aggressive policy response to the economic downturn this year has been a key factor driving financial markets. In response to the worst economic downturn since the 1930s, major central banks slashed policy interest rates to around zero. As both lenders and asset buyers of last resort, central banks also dramatically increased liquidity in the financial system through direct asset purchases and lending programs. Central bank easing has succeeded in preventing a more severe economic contraction, allowed credit markets to continue functioning and supported the rebound in asset prices from the distressed low point in March.

We expect central banks to continue the easing cycle for an extended period, which may have important implications for asset prices and multi-asset portfolios. From a macro policy lens, low interest rates and abundant liquidity provide a foundation to build the economic recovery, although the outlook remains clouded by the uncertain course of the pandemic. From a financial market lens, an extended period of short-term interest rates at about zero with low inflation are expected to support stock market valuations and keep downward pressure on bond yields. In this context, we focus on three asset allocation questions from an asset yield and liquidity perspective:

1. Have stock market valuations decoupled from the severe state of the economy?
2. Does an allocation to long-term government bonds still make sense with bond yields near historic lows?
3. Does the sharply declining US dollar and record gold price indicate inflation is making a comeback?

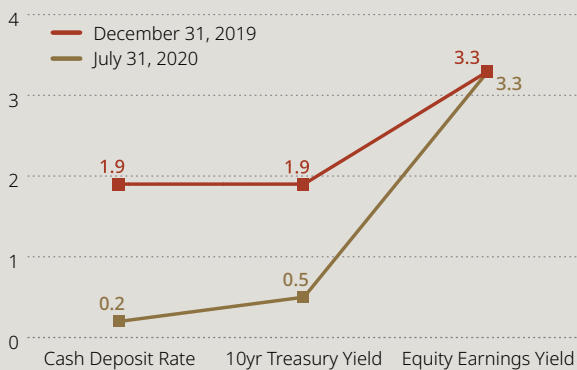
Have stock market valuations decoupled from the severe state of the economy?

Asset prices are simply the present value of future cash flows discounted at the asset yield. Falling yields imply that future cash flows are worth more today, corresponding to a higher asset price. For any asset, the yield is a combination of the risk-free interest rate ('cash yield') and a risk premium that compensates investors for forgoing the immediate liquidity benefit of holding cash. Central banks adjust cash yields and liquidity conditions to influence the business cycle and achieve their macro policy goals. In the process, asset prices tend to move in intuitive ways. When central banks cut cash yields to support an economic recovery, the opportunity cost of holding cash increases compared to higher yielding asset classes like equities. In this way, money begins to shift over time towards the assets with relatively attractive yields compared to normal. As asset prices gradually rise, or when central banks raise rates again, asset yields tend to return towards normal levels.

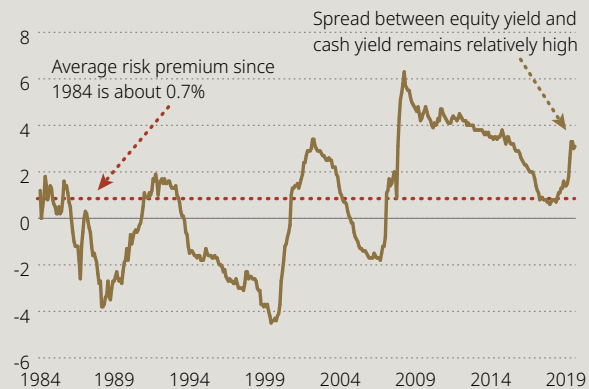
Figure 1 illustrates how the current easing cycle by major central banks reduced cash yields and encouraged a shift towards higher yielding stock markets. Entering 2020 before the pandemic, the US cash yield was about 1.85%. The Fed had been gradually reducing rates in 2019 to support stronger economic activity. Falling cash yields steadily pulled bond yields lower in 2019 and supported a rally in the US stock market. By the end of 2019, the US stock market provided a yield premium of about 1.4% compared to the cash yield. This compares to a historic average of about 0.7% since 1984 (Figure 1). By the end of July 2020, cash yields had been slashed to about zero as central banks aggressively responded to the 'Great Lockdown' with an unprecedented easing cycle. Low cash yields increased the opportunity cost of holding cash as the equity premium increased to about 3%. While US bond yields have declined since late 2019, they continue to offer a modest premium over lower cash yields. As cash yields are expected to remain low for an extended period, money is expected to continue moving towards higher yielding asset classes that offer relatively attractive premiums.

Figure 1. | Asset Yields and Long-Term Yield Premiums¹

SHIFTING US ASSET YIELDS: JUL 2020 VS. DEC 2019



STOCK MARKET EARNINGS YIELD VS CASH YIELD

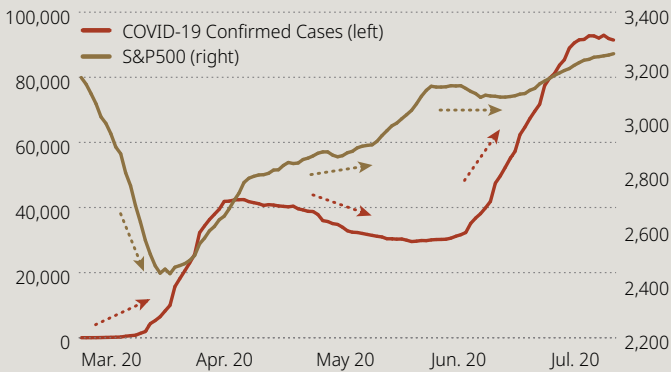


¹ Market data are provided via Bloomberg as of July 31, 2020. The cash yield is defined as the 3-month US deposit rate. The bond yield is defined as the yield to maturity for the 10-year US Treasury Note. The equity earnings yield is calculated as the cyclically-adjusted earnings yield using Shiller's online data as of June 30, 2020: <http://www.econ.yale.edu/~shiller/data.htm>. The slope of the frontier in the left panel is the difference between the US equity and cash yields, which we treat as a proxy for the long-term equity risk premium.

As the easing cycle is expected to continue for an extended period to support the economic recovery, relatively attractive equity yields will likely get pulled lower as stock market valuations get pushed higher. However, the extent and speed of the rally by about 45% since low point in March has raised investor concerns about valuations. With cash yields expected to remain at about zero for an extended period, equities still provide an attractive long-term yield that support current valuations. In that context, stock market valuations still appear reasonable. However, the economic recovery during 2020-21 is expected to be uneven and might disappoint in the near term. The shifting epicenter of the pandemic to US sunbelt states has heightened uncertainty about the speed and shape of the economic recovery. Figure 2 illustrates that swings in the US stock market since March have broadly coincided with shifts in new US cases of COVID-19. Similarly, 10-year interest rates after inflation have reached record low levels in July, pointing to a subdued growth outlook. While the growth trajectory in 2020-21 remains uncertain, the extended central bank easing cycle has increased the long-term equity premium to attractive levels, rewarding investors with a long horizon and tolerance for a potentially bumpy road in the recovery.

Figure 2. | Growth Expectations Remain Subdued¹

SECONDARY INFECTIONS IN US SUNBELT STATES HEIGHTEN UNCERTAINTY ABOUT GROWTH OUTLOOK



10-YEAR US YIELD AFTER INFLATION REACHED A LOW POINT IN JULY



¹ Market data are provided via Bloomberg as of July 31, 2020. Confirmed US cases of COVID-19 calculated as a 10-day moving average using Bloomberg data. The US 10-year interest rate after inflation is provided by the Federal Reserve as the 10-year constant maturity real yield based on inflation-indexed bonds.

Does an allocation to long-term government bonds still make sense with bond yields close to historic lows?

While long-term bond yields have declined sharply, they continue to provide a premium over cash rates. Based on swaps pricing as of July 31, investors do not anticipate a hike in cash yields by the US Federal Reserve until after 2023, keeping downward pressure on longer term bond yields. Fed policymakers have also provided 'forward guidance' to investors that cash yields will likely stay low for an extended period to support the fragile recovery. On top of these cyclical factors, secular forces, including demographic aging and low productivity, will continue to keep downward pressure on long-term bond yields. While investors may not like the low level of cash and bond yields on offer, low rates are likely to persist given current economic conditions. In this context, relative asset yields are the key consideration for long-term asset mix decisions and the US 10-year Treasury still provides a modest premium over cash yields.

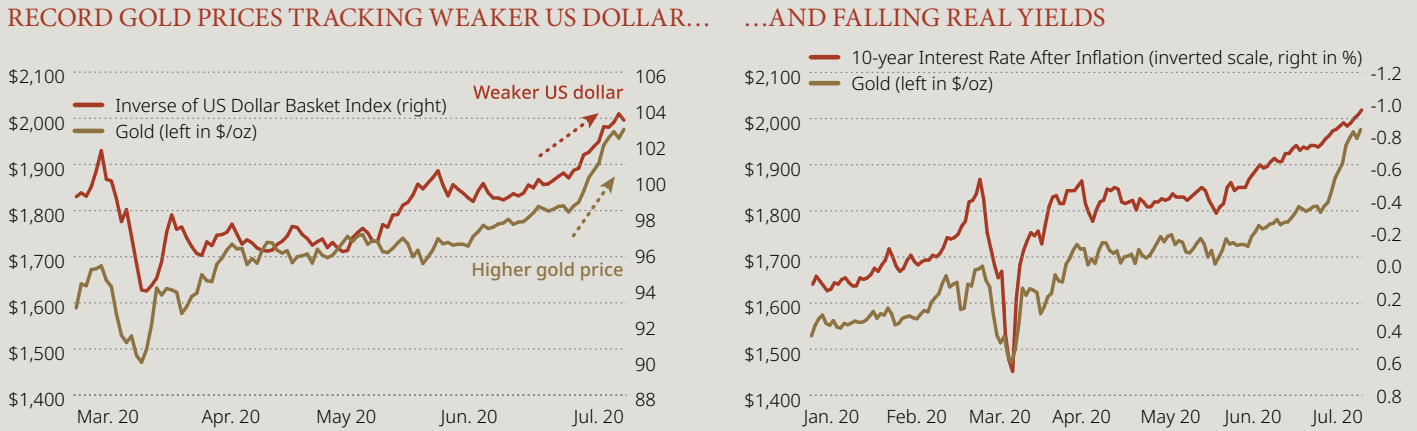
The main risks of a reversal in today's low bond yields include weakened confidence in high government debt and an increase in expected inflation. High government budget deficits to pay for pandemic relief and unprecedented money printing have increased sovereign credit and inflation risks. However, these risks do not appear to be imminent relative to the risks of a stalled recovery and low inflation as business insolvencies gain pace and the labour market recovery slows. The expected recovery in late 2020 and 2021 could be bumpy and gradual, keeping downward pressure on inflation. In terms of the high debt, governments will need to confront the challenge of stabilizing debt ratios when the economy recovers. This may require a mix of tax hikes and spending cuts, but fiscal austerity will likely be delayed until the economy recovers more firmly. Fortunately, private savings have surged in major economies, providing a large flow of savings to finance higher government deficits. In this context, long-term bond yields are expected to remain low but provide a premium over cash.

Does the sharply declining US dollar and record gold price indicate inflation is making a comeback?

Differences in cash yields and liquidity conditions across countries are key drivers of the sharp decline in the US dollar recently. Before the pandemic, the US dollar started from an over-valued position. Compared to other currency areas, the US dollar benefitted from relatively high cash yields and a stronger growth outlook. The US dollar strengthened further as illiquidity in March and April drove capital flows into havens during the lockdown as investors sought the security and relative liquidity of US dollar-denominated assets. As the Fed began its aggressive easing cycle, liquidity significantly improved in currency and money markets. This allowed for an unwinding of haven flows. With US cash yields cut to about zero, and real yields declining into negative territory, the US dollar provided little yield advantage over other G-10 and many emerging market currencies. However, as a multi-asset investor, it is important to recognize that the Canadian dollar tends to trade with global stock markets. Unhedged exposure to US dollar-denominated assets, such as US equity, can help to diversify equity risk for Canadian investors.

Gold prices have also surged higher in July, raising some investor concerns about higher expected inflation. The sharp rise in gold has been attributed to various factors, including a prelude to higher inflation, a debasement of national currencies by money printing and heightened geopolitical risk. However, higher gold prices can also be understood based on a framework of relative asset yields and liquidity. As gold does not provide a cash flow, holding gold as a long-term asset could be an expensive way to add inflation sensitivity in a portfolio compared to inflation-linked bonds. However, current bond yields after inflation are deeply negative, which reduces the opportunity cost of holding gold versus interest-bearing bonds. In addition, the weakening US dollar has passed through into higher gold prices (Figure 3). In an era of negative real yields, gold may represent an alternative inflation-sensitive asset. However, the average gold price since 1973 expressed in today's dollars is about US \$930 compared to US \$1,975 as of July 31, 2020. Consequently, investors interested in building a long-term strategic gold position should consider dollar cost averaging over time into desired positions.

Figure 3. | Weaker US Dollar and Higher Gold Price Reflect Falling Yields¹



¹ Market data are provided via Bloomberg as of July 31, 2020. The US dollar is a weighted basket of dollar exchange rates versus major currencies as constructed by Bloomberg ('DXY' index). The US 10-year interest rate after inflation is provided by the Federal Reserve as the 10-year constant maturity real yield based on inflation-indexed bonds.

Conclusion

Central banks are likely to continue easing for an extended period, supporting current valuations. The easing cycle is necessary to support demand, stabilize inflation, encourage job creation and prevent even greater business insolvencies. While higher inflation has increased as a risk factor, prolonged unemployment and a bumpy economic recovery is expected to keep inflationary pressures contained. In this context, a prolonged period of cash yields at about zero is expected to support equity valuations given relatively attractive yield premiums compared to history. In addition, we expect a prolonged period of "lower for longer" long-term bond yields. The weaker US dollar is a positive signal that illiquidity has been addressed by central bank easing as investors unwind haven trades and seek assets with higher yield. The sharp increase in gold prices also reflects the lower opportunity cost of holding gold versus risk-free assets that historically provided higher yields, such as government bonds.

We recommend that investors and their advisors strive for a well-balanced long-term asset mix to weather different possible economic conditions in the future. A balanced portfolio requires multiple asset classes to capture sensitivities to different macro conditions. Traditional stocks and government bonds remain key components of a diversified asset mix. As the Canadian dollar typically under-performs when global equities weaken, maintaining unhedged exposure to US dollar-denominated assets can help to hedge total equity risk in a portfolio. Gold has historically been a costly form of obtaining inflation sensitivity compared to inflation-linked bonds that provided positive real yields. However, in today's environment of negative real yields, gold could be an alternative asset class to obtain greater inflation sensitivity.

¹ Based on Bloomberg data as of May 29, 2020.

² See Paul Krugman: <https://www.bloomberg.com/opinion/articles/2020-05-27/paul-krugman-is-pretty-upbeat-about-coronavirus-economic-recovery>

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