Investment insight

Resetting expectations: income from bonds may not be what it used to

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"It's easy to think that bond yields are simply at a low point in their cycle and will quickly move back to around the 6% level. However, that's not likely to be the case in the next three years or so."

While it's not something they'll want to hear, investors who are holding bonds for income will probably need to adjust their expectation of what bonds will deliver in the near future. In the short term, the healthy bond yields investors have come to expect over the last few decades aren't likely to return.

In this article, I look at why, until very recently, investors have relied on bonds as a solid source of income; why these factors aren't likely to deliver in the next three years; and what the options are for bond investors.

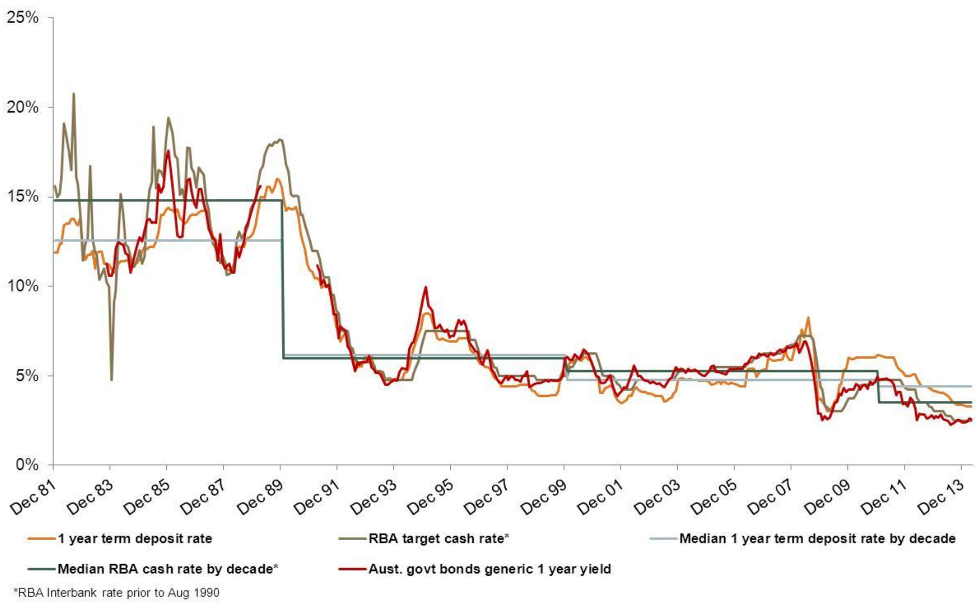
Why investors expect healthy bond yields

Although bond yields dived in 2008, and are now at historically low levels, they delivered good yields for a very long time before that. The 20 or so years before the global financial crisis (GFC) were an extraordinary time for bond owners. Not only did they benefit from solid yields, but also remarkable capital appreciation as yields gradually declined (as bond prices and yields move in opposite directions).

Many Australian investors consider a rate of 6% a natural floor for income from "safe" investments like bank accounts, term deposits and government bonds. They generally expect that even if income dips below that rate, it will soon rebound to this level.

Chart 1 shows why this belief is widespread. In the late 1980s, the Reserve Bank of Australia's cash rate (a key driver of short-term bond yields) and term deposit rates dropped from very high levels, and bond yields fell along with them. However, for the next 20 years, until the GFC hit, each of them hovered around 6%. Even after 2008 they rebounded for a few years, but have since had a slow decline.

Chart 1: Around 6% has been the norm for cash and term deposit rates and short-term bond yields for a long time

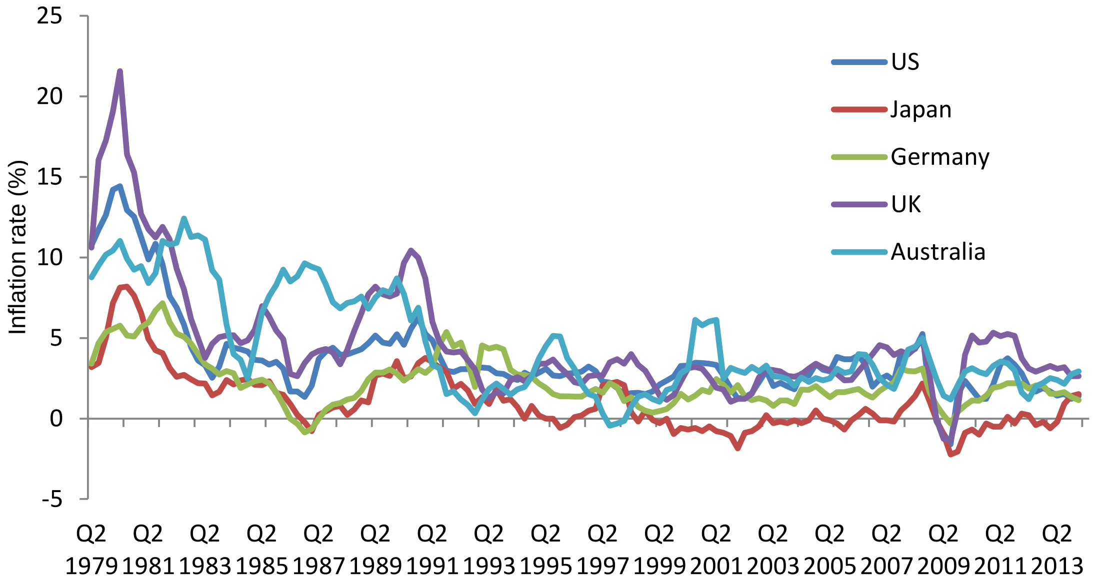


Source: MLC
Cash rates and term deposit rates 1981-2014.
1 year Australian government bond yields 1983-2014.

What have been the main drivers of bond yields?

The key influence on the cash rate, and therefore on bond yields, in the last three decades has been the dramatic fall in inflation (see chart 2). In the early 1980s, the US Federal Reserve (the Fed) began a campaign to fight inflation, which was stubbornly high. Other central banks in the developed world joined in. Over the next two and a half decades, inflation declined not just due to the actions of central bankers, but also the increasingly de-unionised workforce, which forced wages down, and the opening up of China, which created a huge pool of cheap labour. This eventually enabled central banks to lower interest rates.

Chart 2: Inflation in key developed economies has dropped over the last few decades



Source: MLC.
Inflation rates June 1979-Dec 2013.

As interest rates fell, bond yields declined. Despite this fall, bonds continued to provide a healthy income of around 6% until the GFC. And because increases in the cost of living were falling with inflation rates, investors had some insulation from the decline in yields.

For example, in mid-1982, the US 30-year Treasury yield was 14.2% and the three-month Treasury yield was 13.5%.In 2007, they were still at 5.2% and 4.8% respectively. They've now dropped to 3.4% and zero.

In Australia, bond yields followed a similar path. The yield on 10 year Treasury bonds fell from 16% in 1982 to 6.7% in 2007. It's currently at 3.7%, the lowest level on record.

Another factor that impacted bond yields was that for the "baby boomer" generation, the last three decades have been their peak period for accumulating savings. To achieve maximum growth, their investments and superannuation portfolios have usually been biased towards shares, with less exposure to bonds. This meant bonds had to offer reasonable yields in order to attract investors.

Why won't bond yields bounce back fast?

Given the experience of the past 30 years, it's easy to think that bond yields are simply at a low point in their cycle and will quickly move back to around the 6% level. However, that's not likely to be the case in the next three years or so, as the outlook for inflation and interest rates are currently very different to the last few decades. There are also some emerging factors which may well keep bond yields low.

Inflation and interest rates are likely to stay low

Inflation is too low in many countries (and particularly in Europe). If it falls any further, deflation would be a serious threat, and could stifle any economic recovery. Many central banks in mature economies aim for an inflation level of around 2% pa. To try to stimulate the economy, and light the fire under inflation, governments in these countries are considering steps such as increasing the minimum wage, engaging in quantitative easing (increasing the supply of money) and encouraging businesses to invest.

However, measures such as these are likely to take time to have an impact, especially as many economists believe demand remains weak and consumer confidence fragile in mature economies.

In terms of interest rates, it's frequently said that when short-term interest rates are at zero or at all-time lows (such as in Australia), there is only one way for them to go. While this is true, the market may well be overestimating the speed and strength with which central banks will raise them. After all, raising interest rates has the effect of dampening economic growth, which is the opposite of what policy makers want to achieve.

All of this means that (unless there's a general move into deflation), it's quite likely inflation, and therefore interest rates and bond yields, will increase from their current low levels. But it won't happen quickly and the rise is likely to be gradual. What we can't expect is a dramatic rebound of bond yields to pre-GFC levels. So income from bonds is likely to continue to be poor for the next few years.

Banks' regulatory requirements are tougher

More stringent regulatory requirements for banks are also likely to contribute to keeping bond yields low. The Basel Committee on Banking Supervision, which sets voluntary global banking standards, will require banks to hold more top-graded debt as a cushion against potential losses to ensure they can survive another crisis like the GFC. For example, the liquidity coverage ratio in the third Basel Accord (Basel III) requires the largest banks to hold enough high quality liquid assets (such as cash and Treasury bonds) to cover net cash outflows for 30 days.

This big new demand for bonds may lower bond yields by increasing their prices.

According to analysis by Bloomberg, based on US Federal Reserve data, US banks now own $1.85 trillion of US government bonds (within 2% of the record amount held at the end of 2012).[1]

Bank of America, one of the largest US banks, confirmed in an April market update that they have increased their holdings of short-dated US Treasuries and mortgage-backed bonds to help meet the liquidity ratios.

An ageing population may increase demand for "safe" investments

Finally, the retirement of the baby boomers may also impact bonds in ways that aren't yet fully appreciated. Most baby boomers are likely to follow the usual asset allocation pattern of those moving into retirement: shifting from growth assets, like shares, into defensive assets that have lower capital risk and can also provide a regular income, like traditional bonds. This could create huge extra demand for bonds in every major developed country, raising bond prices and lowering the yields on offer.

What can investors do?

Unfortunately, the market isn't going to deliver a 6% return to investors just because they expect or need it. So investors who want to continue investing in bonds for income have two choices.

First, they can accept that income from bonds is likely to be lower in future. They can continue investing in the type of traditional bond portfolio that has provided solid returns over the last 25 years and, for the next few years, adjust their lifestyle for an income stream that may well be lower than they expected.

Second, they can invest with a specialist fixed income investment manager who can help them achieve a better outcome in a difficult market, while still keeping a close eye on the level of risk of their investments. This approach is likely to involve the manager finding investment opportunities beyond traditional bonds, such as in high yield bonds, inflation-linked bonds, global bank loans and emerging market bonds. As investment managers are only able to generate returns from what's available in the market, investors will still need to adjust their income expectations downwards, but probably less than if they simply invest in a traditional bond portfolio.

Investors who aren't prepared to re-set their expectations of the yields bonds can deliver for the next few years will probably need to consider investing in other assets for income. However, their options may be limited at present, as prices of both real estate investments and shares have risen strongly in recent years and therefore yields on offer have declined.

[1] 'Treasuries irresistible to America's banks awash with cash', Susanne Walker, 29 April 2014, Bloomberg.com