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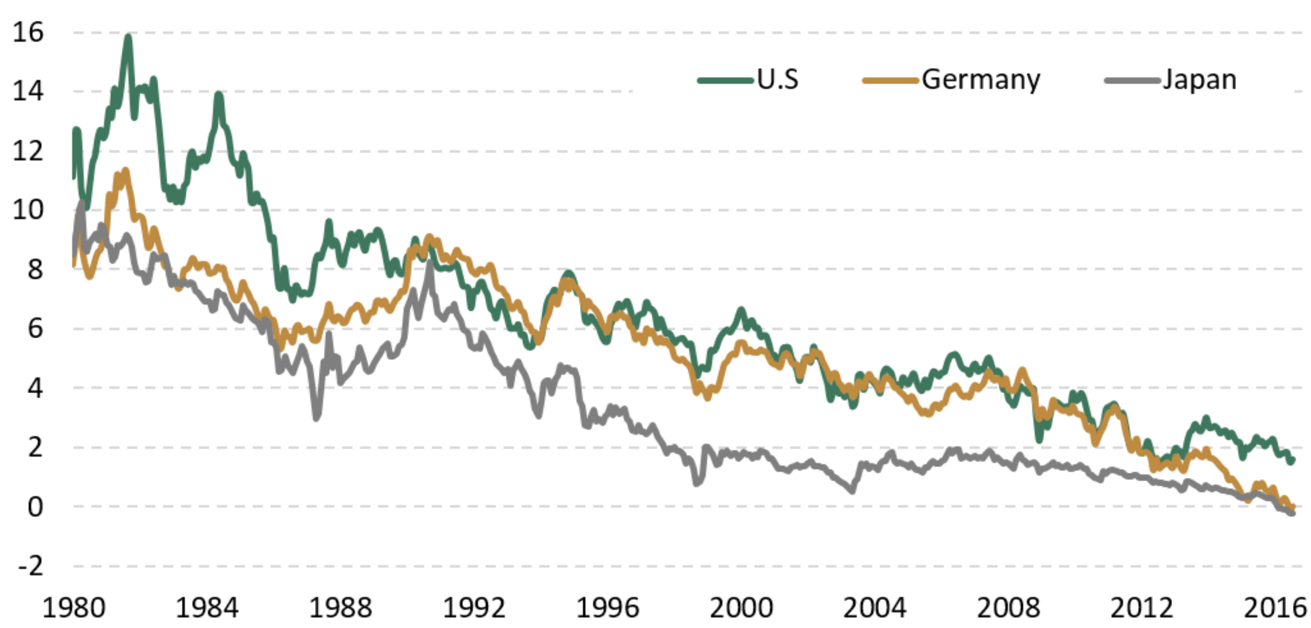
Featured G

The World Has Been Turned on Its Head

J. Patrick Bradley |

In today's topsy-turvy financial world, it seems that almost nothing should come as a surprise anymore. Yet, the U.K. managed to upend markets when it decided to go it alone and voted to exit the European Union. In the days leading up to the British referendum, long-term interest rates among developed market countries slid lower, including but not limited to U.S., German, and Japanese long-term interest rates. Even after the vote, German and Japanese yields continued to plumb negative levels (see Chart 1). More recent days saw these yields inch higher, as investors perhaps realized that June 23 (the date of the U.K. referendum) did not mark the end of the financial world. Nevertheless, with nearly $12 trillion in sovereign debt currently with negative yields, sanity has hardly returned. What are the possible reasons yields are either so low, or in many cases, negative?

Chart 1: Nominal 10-Year Bond Yields *Percent; As of 6/30/2016*

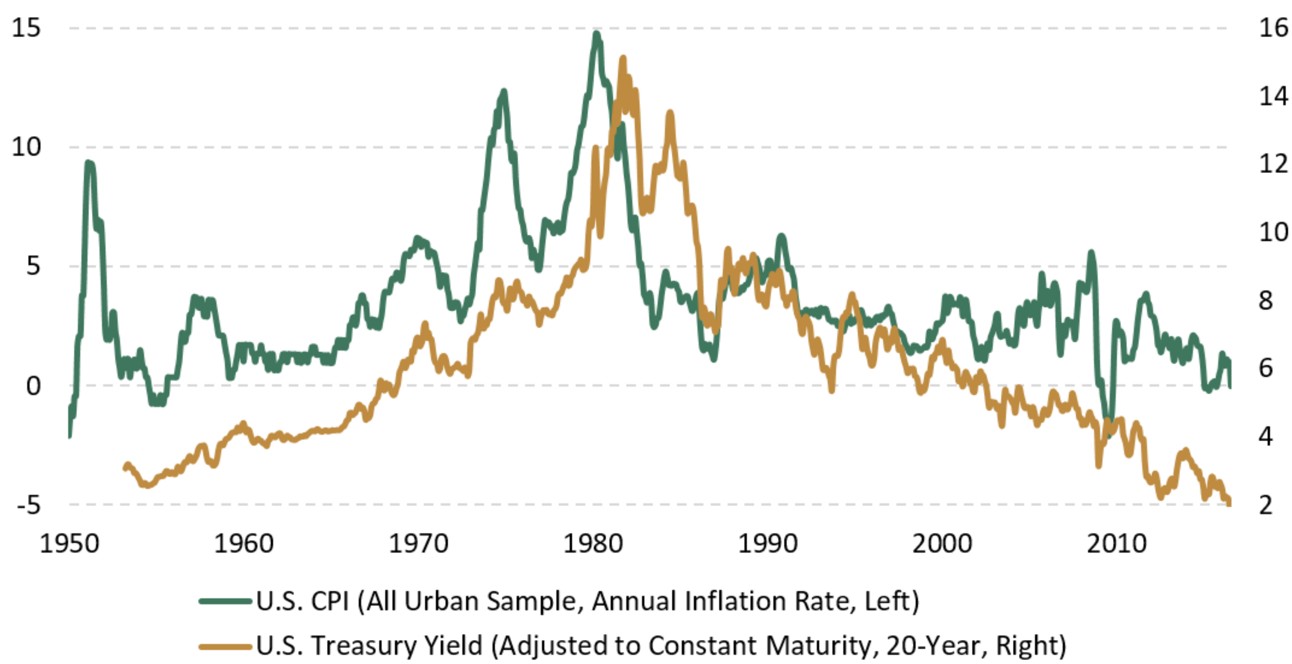


Source: Thomson Datastream

Using the case of the U.S. as an example, here are some observations that may help in understanding the current low rate environment and why certain relationships between interest rates and other factors have seemed to stop making sense:

- **The Long-Term Downtrend in Interest Rates. Interest rates in the United States peaked in August 1981 following the high point in U.S. inflation. The U.S. endured back-to-back recessions, as the Volcker-led Federal Reserve (Fed) aimed policy at reducing inflation and pushing the country out of the stagflationary environment. Inflation remained the primary objective on which the central bank directed its policy focus, adjusting interest rates to maintain a 2% inflation target. Historically, the relationship between inflation** and long-term interest rates has held up reasonably well over time (see Chart 2). However, more recently there appears to be a divergence as rates continued to slide even as headline consumer prices inched higher.

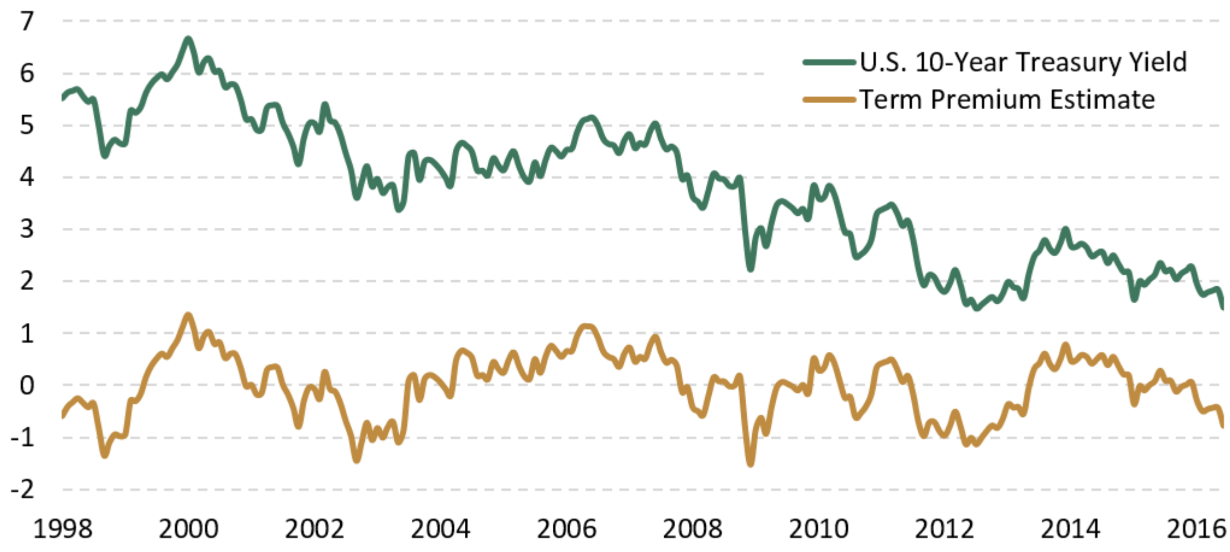
Chart 2: U.S. Inflation and Long-Term Interest Rates *Percent; As of 6/15/2016*



Source: Thomson Datastream

- The Savings Glut. In his blog (April 1, 2015), Ben Bernanke, former head of the U.S. Fed, countered economist Larry Summers' secular stagnation argument with a discussion on the global savings glut. According to Bernanke, the savings glut can be seen in the current account surpluses of many countries. Those surpluses represent a dearth of investment opportunities in a particular country. When a country saves more than it spends on domestic investment, it becomes an exporter of capital, the mirror image of a deficit country, which must borrow to consume. Bernanke's original hypothesis addressed the current account surpluses of the emerging countries prior to the 2008 Global Financial Crisis, which have since fallen. Nonetheless, current account surpluses have appeared in other areas, most notably in the eurozone, where Germany now has a current account surplus of over 8%. Exported capital from countries with a savings glut or surplus like Germany could be pushing yields lower.
- A Fall in the Term Premium. Bernanke's more recent analysis has suggested that the drop in interest rates is the by-product of a falling term premium. A long-term interest rate can be decomposed into three factors: a real, short-term yield; inflation expectations; and a term premium. In a simple sense, the term premium is merely the extra compensation an investor requires for accepting the additional uncertainties or risks of investing in a longer-dated security. For example, the term premium might be higher if investors became concerned that future inflation would be higher. As a result, investors might demand a higher risk premium to offset the perceived inflation risk. Chart 3 shows our estimate for the term premium, based on econometric modeling. Currently, investors are not factoring in a positive premium to compensate for future uncertainties. Indeed, the negative risk premium suggests risk aversion. Investors are apparently not worried about future inflation, or the future direction of interest rates. If the term premium rose to zero (indicating a risk neutral position), we estimate that interest rates could be 80 basis points higher. One might also interpret this negative risk premium as investors' willingness to pay for the "security" of investing in a relatively risk-free bond, like a U.S. Treasury bond. After all, in uncertain environments where the future is far from clear, it is often safety first.

Chart 3: U.S. Risk Premium Estimates and 10-Year Treasury Yield *Percent; As of 6/30/2016*



Source: Thomson Datastream

Conclusions

The most recent slide in U.S. interest rates coincides with a fall in the term premium, as investors' risk-off behavior draws them to higher-quality investments, like U.S. Treasury bonds. Can the term premium give us any future guidance? The term premium appears to exhibit cyclicality. For example, in periods of a weak economy and uncertainty, the premium is typically negative. Investors become risk averse, seek out quality, and avoid risk assets. A better economic climate would encourage investors to become risk seekers, searching out higher-yielding assets. That change in mindset would lead investors to eschew low-yielding Treasury bonds in favor of opportunities in higher-yielding markets, like emerging markets. A better economic climate could presently be unfolding in the U.S. Improving growth and inflation expectations, as well as Federal Reserve policy expectations, would tend to put upward pressure on interest rates. How? The term premium would likely increase. Improved growth expectations and higher inflation expectations could also push yields higher. At the same time, other factors could be at work that would temper how high interest rates might increase, including banks holding liquid Treasury securities to meet regulatory requirements. Overall, however, the future direction of interest rates likely could be higher from current levels.

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