economic climate change & the long-term view on yields

By Rick Harrell, Vice President, Macro Strategies

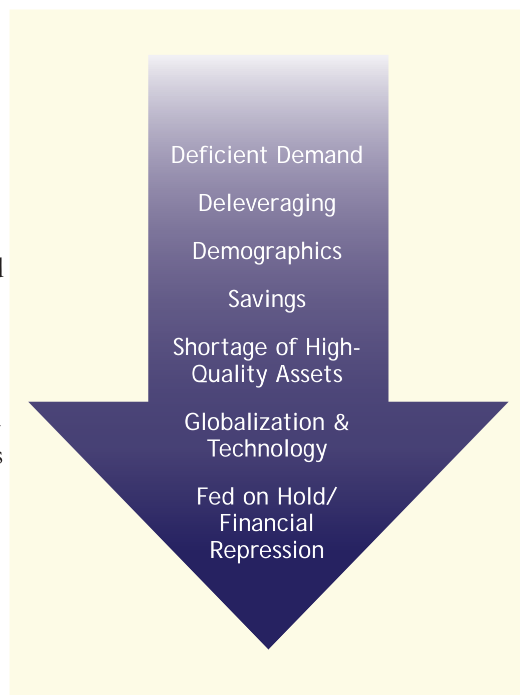
may
2013

Will rates rise? It's a logical question. US Treasury yields have been in a secular downward trend since the 1980s and almost frozen at historic lows for the last several months. While recent cyclical improvements suggest the US economy is heating up, we do not expect interest rates to start soaring to record highs. The interest rate environment will eventually undergo climate change, but the process will be gradual. There are secular headwinds cooling rates, and we expect them to persist for years to come.

Below, we discuss the secular deflationary and inflationary drivers that we think will simultaneously cool and heat interest rates during the next five years. As these drivers rebalance over time, they will shape various economic climates for yields. We go on to lay out three potential "climate zone" scenarios and describe how the 10-year Treasury yield might evolve in the years ahead.

FIRE VS. ICE: OUR VIEW OF THE SECULAR DRIVERS OF INTEREST RATES OVER THE NEXT FIVE YEARS

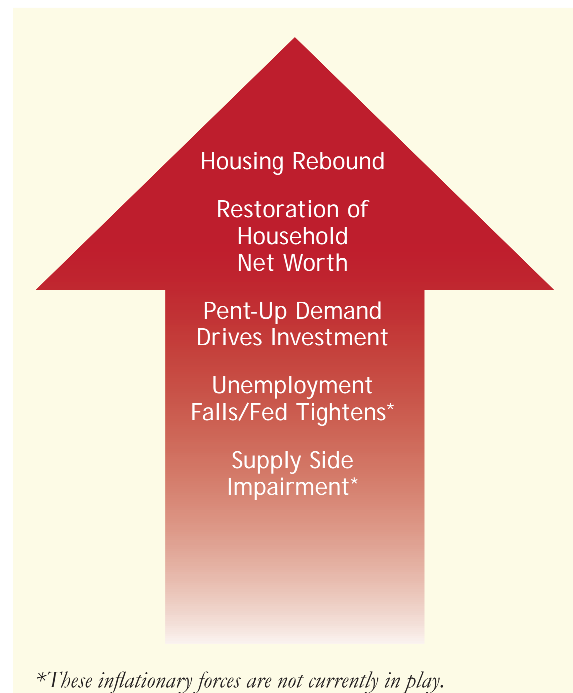
Deflationary Ice



- **Deficient Demand**: There is still too much slack in the developed world to warrant a meaningful pickup in inflation. The Organisation for Economic Co-operation and Development (OECD) forecasts a -3% output gap for advanced economies in 2013, a figure unchanged since 2010. The US employment-to-population ratio has stagnated at a 30-year low. Despite improvement in the headline unemployment rate, when adjusting for the drop in labor force participation, the unemployment rate is above 10%. In the euro zone, the unemployment rate reached a record high 12.1% as of April 30, 2013. We expect it will take three years or more for unemployment to fall meaningfully and for output gaps in the US and Europe to close.
- **Deleveraging**: In the US, total private and public debt as a share of GDP has risen from 150% in 1980 to more than 350% today.[i] The trend is similar in other advanced economies. Though household leverage has fallen since 2009, we believe deleveraging will continue. As households and governments pay down debt, this will constrain catalysts for growth that might otherwise be unlocked through investment.
- **Demographics**: Aging populations in advanced economies can affect growth in multiple ways. Most directly, this demographic trend translates into a declining supply of labor and hours worked, ultimately leading to lower growth potential.
- **Savings**: Increasing healthcare and entitlement costs will strain government finances and drag down growth. Governments will likely be forced to ration benefits, meaning households will need to save more. In emerging economies, governments have continued to stockpile savings through growing foreign reserves. All of these savings need a home, and the bond market is a common destination.

- **Shortage of High-Quality Assets**: The International Monetary Fund projects that by 2016, $9 trillion worth of sovereign debt will have been removed from the supply of high-quality assets.[ii] The shortage comes amid growing savings from households and international reserve portfolios, as mentioned previously. In addition, banks facing new regulations (Basel III) and higher capital ratio requirements are demanding high-quality assets. Much of this new regulatory capital will likely end up in highly rated government bonds. Even in the absence of overall market risk, the bid for Treasurys should endure.
- **Globalization & Technology**: Think about the price of a laptop today relative to five years ago. The competitive nature of our globalized marketplace helps ensure that production will continue to move to the most cost-effective location. We expect price deflation of manufactured goods and disinflation of wages to continue.
- **Fed on Hold/Financial Repression**: The Federal Reserve (the Fed) has indicated it will continue its loose monetary policy even as conditions improve to a point that would otherwise warrant less accommodation. We think the Fed will be on hold until 2016. Moreover, open-ended quantitative easing by major central banks, including the Bank of England and Bank of Japan, should weigh on longer-term rates globally.

Reflationary Fire



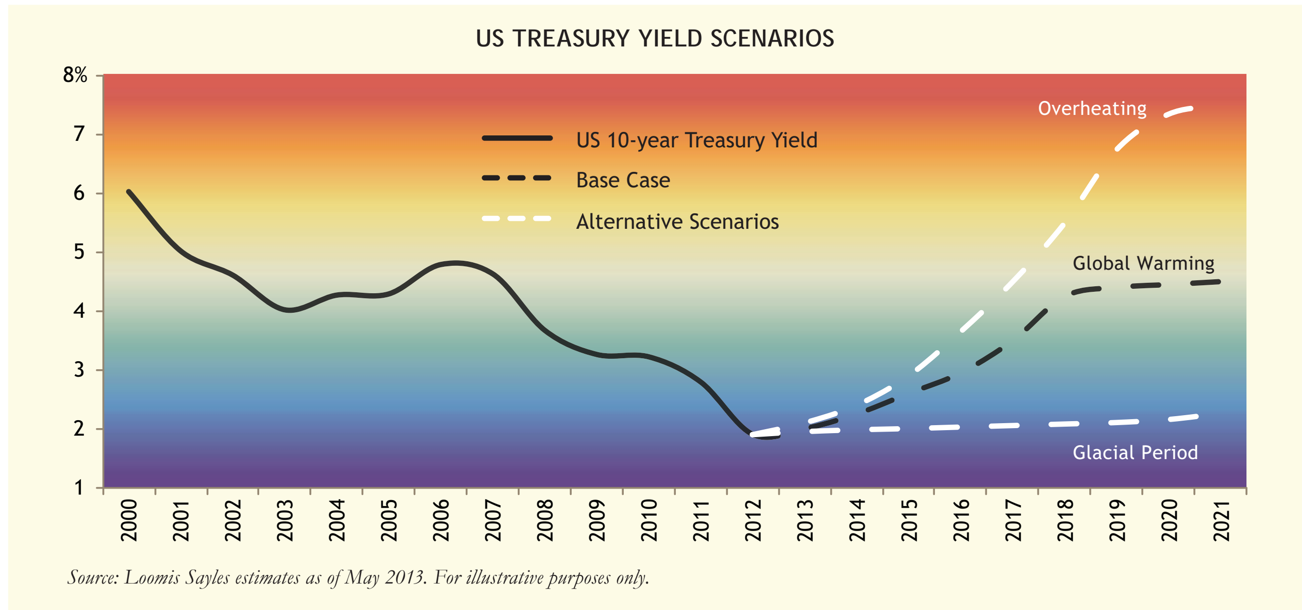
These inflationary forces are not currently in play.

- **Housing Rebound**: The housing sector is starting to pick up, and home prices are rising nearly 10% annually—the fastest pace since 2006.[iii] Economic recoveries in the US are typically led by housing, which until last year was largely missing.
- **Restoration of Household Net Worth**: As home and stock prices rebound, household balance sheets start to look better and deleveraging may cease being a priority. This should help restart the "borrow-and-spend" economy.
- **Pent-Up Demand Drives Investment**: Fixed investment as a share of GDP has fallen 25% since the crisis and is now lower than at any time in the last 60 years.[iv] Potentially trillions of dollars worth of capital projects may have been postponed or cancelled since the recession. If the recovery begins to evolve like previous ones, investment spending will come back, production will ramp up, and firms will accelerate hiring. The 1990s saw seven consecutive years of nearly 10% average growth in capital investment, leading the way for strong gains in employment and income.
- **Unemployment Falls/Fed Tightens***: Once the self-reinforcing process of investment spending, employment and demand is established, unemployment should fall rapidly, the output gap will close and wage pressures could begin to build. The Fed has indicated it will tighten policy when the employment picture improves, causing rates to rise.
- **Supply Side Impairment***: It is possible the recent recession and a slow-moving economic recovery have structurally altered parts of the US economy. Prolonged unemployment may have raised the economy's natural rate of unemployment, making higher joblessness the new normal. Additionally, the multiyear dearth of investment may have rendered a portion of the capital stock obsolete, causing the economy to hit capacity constraints sooner than expected. As the Fed relentlessly pursues a sub-6% unemployment rate, structural changes could cause wage and price pressures to mount more rapidly.

These inflationary forces are not currently in play.

CHANGING CLIMATE ZONES FOR YIELDS

The balance between deflationary ice and reflationary fire will change over time, creating different climates for yields. We set forth three potential scenarios—"Glacial Period," "Global Warming" and "Overheating"—to illustrate how the 10-year Treasury yield might evolve over the next five years and beyond.



Source: Loomis Sayles estimates as of May 2013. For illustrative purposes only.

BASE CASE: ARRIVE AT GLOBAL WARMING

We believe deflationary ice conditions will keep interest rates depressed until 2016. Fiscal policy will be tight, acting as a drag on growth and tempering reflationary fires, and slow profit growth will lumber along with subpar global demand—particularly from Europe. US economic growth should continue to average about 2% for another one to two years, and we think unemployment will decline slowly. We expect the 10-year Treasury yield to remain below 3%.

By 2016 and into 2017, reflationary fire conditions should begin to melt some of the ice, a thaw that will cause yields to enter Global Warming. During the transition to this phase, the economy can grow very quickly without alarming the Fed because of the large output gap. We believe once excess slack in the economy is removed and unemployment falls below 6.5%, a more typical interest rate setting should be in place, allowing for tighter Fed policy. At this stage, we believe the 10-year yield will begin to normalize toward 4%. Beyond 2017, we think real GDP growth will average around 2% with a 2% trend inflation rate, and long-run yields should track this trend rate of nominal GDP growth.

ALTERNATIVE SCENARIOS: GLACIAL PERIOD AND OVERHEATING

The first alternative is a Glacial Period in which deflationary forces persist beyond 2016 and the 10-year Treasury yield stays extremely low, potentially falling closer to 1%. If the private sector maintains an aversion to debt and delevers further, the "borrow-and-spend" recovery should stay on ice. Additionally, fiscal austerity could ramp up too quickly and short-circuit a recovery in private demand. Should deflation take hold, the US would experience an economic climate similar to the one Japan has been grappling with for the past 20 years.

The second alternative, Overheating, could result from policy error—fiscal, monetary or both. On the fiscal policy side, "crowding out" is a key risk. If the government fails to address entitlements and ramps up deficit spending in the face of strong private sector demand, the increased competition for capital will promote higher inflation and interest rates. In terms of monetary policy risk, the Fed may underestimate the extent of supply side impairment and continue to ease as the economy hits capacity constraints. Under such a scenario, we see the 10-year Treasury yielding above 6%.

In our view, Overheating is the most distant and least probable of the three scenarios. By definition, Overheating can only occur after the output gap has closed and Global Warming is in full swing. And, crowding out and supply constraints—the inflationary forces we see as necessary to ignite Overheating—are not likely to be considerations until 2018 at the earliest. The threat of fiscal dominance also makes Overheating a less likely outcome. History has shown that when governments are overly indebted, central banks can become hostage to the interests of the fiscal authority. If yields begin to spike, the Fed may face pressure to cap rates in order to contain government borrowing costs and inflate away the real value of mounting debts.

WHAT COMES DOWN MUST GO UP?

Following a 30-year secular downtrend in Treasury yields and recent months at historic lows, it is no surprise that many investors are concerned about rising interest rates. After a three-decade bull market in government bonds, we are unlikely to see the same generous returns from this asset class in the future; however, this by no means signals the beginning of a secular bear market. Brighter near-term growth prospects do not outweigh long-term demographic trends, declining potential growth, public and private sector balance sheet repair, savings needs, steady demand for high-quality assets and other secular forces. The deflationary ice weighing on yields today will likely dominate for a few more years.

ENDNOTES

[i] *Sources: Federal Reserve Board, US Bureau of Economic Analysis. Data as of fourth quarter 2012.*

[ii] *Source: International Monetary Fund Global Financial Stability Report. Data as of April 2012.*

[iii] *Source: CoreLogic National HP.*

[iv] *Source: US Bureau of Economic Analysis. Data as of fourth quarter 2012.*

This paper is provided for informational purposes only and should not be construed as investment advice. Any opinions or forecasts contained herein reflect the subjective judgments and assumptions of the authors only and do not necessarily reflect the views of Loomis, Sayles & Company, L.P. Investment recommendations may be inconsistent with these opinions. There can be no assurance that developments will transpire as forecasted and actual results will be different. Data and analysis does not represent the actual or expected future performance of any investment product. We believe the information, including that obtained from outside sources, to be correct, but we cannot guarantee its accuracy. The information is subject to change at any time without notice.

All indexes are unmanaged and do not incur fess. You cannot invest directly in an index.

Past market experience is no guarantee of future results.

LS Loomis | Sayles is a trademark of Loomis, Sayles & Company, L.P. registered in the US Patent and Trademark Office. *MALR010491*