INSIGHTS FROM CFA SOCIETY SINGAPORE

By Ezien Hoo

Why the low-rate environment should be of interest to investors

It has thrown up various challenges including lack of yield to cover future income needs and the threat of future inflation and rate rises

ON Aug 27, 2020, US Federal Reserve chairman Jerome Powell announced a significant policy shift that will allow inflation to overshoot the 2 per cent target. Historically, rates were raised to keep inflation in check. The change in policy stance reflects the Fed's concern that persistently low inflation may lead to a spiral of ever-lower inflation and inflation expectations.

The announcement also acknowledged the increased disconnect between employment and inflation, with Mr Powell highlighting that strong labour markets did not trigger a significant rise in inflation and that going forward, the Fed will allow employment to also run higher.

Against the recessionary backdrop, we think this means that the short-end rates are likelier to stay "lower for longer" even if employment markets start improving and inflation runs up. Rates at the short end barely budged, though investors reacted with long-dated bonds selling off, indicating concerns over inflation eating away at real returns. Despite the bear steepening of the US treasury curve since Mr Powell's announcement, UST 10Y yields are still low on an absolute basis. In the Singapore dollar space, swap rates were volatile in the immediate aftermath of the Covid-19 outbreak, though they are now similarly at a historical all-time low.

Pension funds and insurers must often juggle between managing liabilities and making enough returns on assets to pay for liabilities as they come due. PHOTO: PEXELS.COM

Lack of yield to cover future income needs

Pension funds and insurers must often juggle between managing liabilities and making enough returns on assets to pay for liabilities as they come due. With traditionally less risky assets having persistently low yields, this means such investors would find it harder to invest profitably to meet these liabilities without taking more risk.

The Organisation for Economic Co-operation and Development (OECD) in its 2019 annual survey of large pension funds and public pension reserve funds highlighted that the key trend since the survey was launched in 2011 was the gradual decrease in fixed income and cash and listed equities in terms of percentage of assets allocated while allocation to alternative investments has risen.

While there are multiple sub-asset classes and investment styles under the ambit of alternative investments, they are seen as riskier, with underlying returns boosted by leverage (eg private equity, infrastructure assets) while fund commitments may be locked in for years. We think the shift towards higher-risk assets would accelerate given the often-unpalatable alternative of asking members to contribute more money into pension schemes or cutting benefits.

For individual investors, a low-yield environment means that investors will either need to (1) lower current spending and set aside more for savings (2) contend with the lower returns, thereby opening up to the risk of insufficient income in the future or (3) take on higher investment risk. For bond investors, this means taking higher credit risk, taking duration risk or investing in subordinated securities. As a result of the low-rates environment and abundant liquidity in financial markets, major equities and commodity markets have rallied strongly from March 2020, despite a still uncertain recovery path for economies.

Threat of rates rising in the future and inflation

While inflation expectation for the real economy has been on the rise, a consensus has not been built on this matter, be it whether inflation will actually happen and the mechanism of how this would happen.

On an absolute level, rates are still the lowest they have been for at least the past 25 years. We have seen asset-price inflation happening though muted inflationary pressure in the real economy, with economists forecasting inflation in Singapore to be -0.5 per cent y/y for 2020 and +0.9 per cent for 2021. Existing high-grade bondholders would have benefitted from the recent rates rally, with prices of bonds recovering from the March 2020 lows.

However, unless one thinks longer-term interest rates will go into negative territory and stay there, a bond buyer entering the market now is subject to the possibility of future rising rates, even if this may take a few years to pan out. All things held equal, the price of a high-grade bond goes down as rates rise (and vice versa).

We observe that some high-grade bonds in SGD are already trading above pre-Covid-19 levels. A negative rate environment is not in our base case and hence we think this means that bond investors should be demanding higher credit spreads to compensate for the possibility of rates rising. Taking duration risk is one way to generate higher returns although the curve is still relatively flat.

How should investors deal with this conundrum?

There is no simple answer and as with all investments, this is dependent on investors' circumstances and risk appetite. However, in our view, holding cash or sovereign bonds alone would mean an investor would risk insufficient income in the future. Given today's starting point, an uptick in rates may also lead to capital losses on a solely low-risk bond portfolio, thus wiping out gains on a total returns basis.

Therefore, we think the right approach is to strike a diversified portfolio of different asset classes including those that provide an inflation hedge (such as financial stocks).

Within the bond component of the diversified portfolio, investors may consider a mix of bonds, including those that are lower on the credit curve. This though should be calibrated on an ongoing basis given changing macroeconomic and business operating circumstances of underlying issuers, especially as credit risks are heightened in a recession.

The writer, CFA, is a credit research analyst at OCBC Bank's Global Treasury Research & Strategy. This column has been adapted from content by OCBC Global Treasury Research & Strategy and is published with permission from OCBC Global Treasury Research & Strategy.