

Between a Rock and a Hard Place

A gloomy outlook for bonds and hence bond proxies



Douglas Isles
Investment Specialist

In recent years, investors have crowded into predictable equities that look like bonds, be they defensive companies with stable cash flows or strong growth companies acting as long duration zero-coupon bonds. As bond yields fall, the logic goes that lower discount rates lead to higher equity valuations. While that strategy has worked this far, we would be very wary of its future outcomes.

COVID-19 has had a significant impact on economies and hence markets. US 10-year bond yields have fallen below 1%¹, which is the lowest nominal yield since 1871 (the earliest period for which data is available²). This phenomenon is not confined to the US, with 10-year bond yields in Canada, UK and Australia also below 1%, and negative in France, Germany, Japan and Switzerland. While they have fallen to a record low of 2.5% in China.³

With such low yields, the idea of nominal bond yields moving higher over the medium to longer term⁴ and/or the risk of negative real returns (i.e. after inflation) from bonds over a similar timeframe, is hard to argue against.

However, those who adhere to the alternate view that bond yields will remain low for this timeframe and that this will be good for equities, have perhaps not observed Japan in recent years, where a prolonged period of very low interest rates has had poor consequences for passive equity market investors.⁵

While rising bond yields does not mean high bond yields⁶, we conclude that at this juncture, we are between a rock and a hard place for bonds and hence for equities that look like bonds.

A more comprehensive analysis of bond and equity market returns over the very long term is provided as appendices for those interested in the background to, and history behind, the assertions above. However, in simple terms, our key observations are:

1. US 10-year bond yields have moved in very long cycles, whereby multi-decade peaks (troughs) in bond yields have coincided with troughs (peaks) in equity markets. Today, we have all-time low bond yields and close to all-time highs for the US equity market⁷, after a near 40-year fall in yields.
2. When we see negative real returns from bonds, the outlook for real returns from equities tends to be unfavourable. With nominal yields so low today, it will only take minor falls in bond prices or small amounts of inflation to turn positive real returns to negative real returns over the coming decade.
3. If you disagree that the above scenarios are plausible, we can look to Japan as an example of the impact of persistently low nominal rates. This has not been a boon for equities. Since 10-year Japanese government bond yields reached 2% in October 1997, the equity market total return has been an anaemic 1.8% p.a.⁸ While many cite high levels of debt or poor demographics for the reason behind this, interestingly, the rest of the world has these same features today. Persistently low bond yields are likely a sign of deeper problems that will ultimately plague equity returns, especially when starting valuations are high.

Taking into consideration the above observations, our flagship global equities portfolio, the Platinum International Fund, is currently tilted towards companies that may benefit from fiscal spending replacing monetary policy as a key driver of growth. We are also carrying short positions in expensive markets, specifically, stocks that may have been treated in the bond proxy category as defined above.

1 0.70% at the close on 26 May 2020. Source: FactSet.

2 Source: <http://www.econ.yale.edu/~shiller/data.htm>

3 As at 26 May 2020. Source: FactSet

4 Ahead of the COVID-19 outbreak, Platinum's CIO, Andrew Clifford, outlined reasons why he believes interest rates are no longer a one-way bet: <https://www.platinum.com.au/Insights-Tools/The-Journal/Macro-Overview-December-2019>

5 Refer to our article [Stock-Picking amid Chronic Low Rates - Lessons from Japan](#) by Platinum portfolio manager, Clay Smolinski, where he explains that investing in Japan has been a great market for active stock pickers.

6 <https://www.platinum.com.au/Insights-Tools/The-Journal/Interest-rates-to-be-lower-for-much-longer>

7 Encompassing all major US market indices including the S&P 500, Russell 2000, NASDAQ Composite and DJ 30 Industrial Average.

8 TOPIX total return in Japanese yen from the market high on 20 October 1997 to 31 March 2020. Source: FactSet.

APPENDICES:

A. The very long cycles of nominal US bond yields.

B. Equities in times of negative real bond returns.

C. Japanese case study – low bond yields do not necessarily mean great equity returns.

A. The very long cycles of nominal US bond yields

A long history of the US bond market⁹, allows us to clearly define long periods of rising or falling nominal bond yields.

Start Date	Start Yield	End Date	End Yield	Real Equity Returns p.a.
Jan 1873	5.58%	Dec 1900	3.10%	+8.4%
Dec 1900	3.10%	Jan 1921	5.09%	+0.9%
Jan 1921	5.09%	Jan 1941	1.95%	+9.3%
Jan 1941	1.95%	Sept 1981	15.32%	+5.9%
Sept 1981	15.32%	Mar 2020	0.87%	+8.2%

Past performance is not a reliable indicator of future returns.

In 1873, US 10-year bond yields fell slowly from 5.58% to a low of 3.10% in 1900. US equity markets hit a real peak (in price terms, not including dividends) in 1901, that was passed briefly in 1906, 1928-30, 1936-37 and finally exceeded in 1954.

Yields then rose to a peak of 5.09% in 1921 coincident with US equity markets troughing below 1871 levels in real terms, and a level only seen again since the absolute low of the 1932 depression.

Yields then fell to a low of 1.95% in 1941 and remained above that level until 2012. From the November 1938 real peak in US equities, the annual real price return to July 1982 was only 0.4%.

From 1941, yields moved higher to a peak in 1981 at 15.32%. The US equity market subsequently fell in 1982 to levels in real terms that were first reached in 1901.¹⁰ From 1981, yields moved almost continuously downward to today's lows of below 1%. US equity markets surpassed 1968's all-time real price highs by 1993.

By January 2000, US equity markets had returned 11% p.a. in real terms since the peak in yields. That month was coincident with the end of the fourth and final event to date (which started in January 1998), when yields rose by 2% or more during the equity markets' march southward.¹¹

⁹ Robert J Shiller, Sterling Professor of Economics at Yale University, has a comprehensive data set which can be found at: <http://www.econ.yale.edu/~shiller/data.htm>

¹⁰ Yields passed 4% on the way higher for the first time in 1959, and fell by at least 1% on four occasions, with equity returns positive each time. The first of which was from January 1960-May 1961 (the other occasions were May 1970-March 1971, August 1975-Dec 1976 and March-June 1980), by which point, equity real price returns had been 5.5% p.a. since the 1941 low in yields. For the remainder of the period, yields moved higher and equity real price returns were -2.7% p.a.

¹¹ The others were May 1983-June 1984, January-October 1987 (the month of the crash) and January 1993-November 1994.

From January 2000 to March 2009, US equity markets lost 9% p.a. and de-rated from a cyclically-adjusted price-to-earnings ratio (CAPE) all-time high of 44x to 13x. Bond yields contracted from 6.66% to 2.82%. As yields continued to fall to all-time lows, equity market real price returns were 12% p.a. from March 2009 to February 2020 ahead of the coronavirus-induced sell-off, with the CAPE at 31x at that time, a level only exceeded fleetingly in 1929 outside of the technology bubble and at various times since 2017.

US equities were at all-time highs in February 2020 ahead of the coronavirus situation, having surpassed their 2000 peak by 2014.

The case is made that generally periods of rising bond yields are unfavourable to real equity returns.

B. Equities in times of negative real bond returns

While Shiller's work above is helpful, it contrasts nominal bond yields with real equity market returns. If we see a long upward move in nominal yields, it is unlikely to be good for equity markets.

The work of Dimson, Marsh and Staunton at Credit Suisse in their excellent Global Investment Returns Yearbook¹² allows us to look at real bond returns around the world over the period 1900-2019.

Starting with the US, we can overlay the nominal cycles identified by Shiller and explore the real returns of equities and bonds through these periods. This is done crudely using a decade pattern of 20, 20, 40 and 40 years (which was closely in line with Shiller's approach), but the turning points are close enough for this to be valid.

Period	Environment	Real Bond Return	Real Equity Return
1900s/1910s	Rising bond yields	-1.9% p.a.	+3.3% p.a.
1920s/1930s	Falling bond yields	+6.6% p.a.	+7.9% p.a.
1940s-1970s	Rising bond yields	-1.8% p.a.	+5.9% p.a.
1980s-2010s	Falling bond yields	+5.6% p.a.	+8.1% p.a.

Past performance is not a reliable indicator of future returns.

The periods of falling nominal bond yields have been better for both equities and bonds. For most of us today, we have lived through a 40-year period that has been positive for asset prices, with above-trend returns for both bonds and equities.¹³

From 1900 to 2019 in the US, equities outperformed bonds in every decade except for the 1930s and 2000s, which both saw the bursting of valuation bubbles coincident with falling nominal bond yields.

When analysing individual decades, real bond returns in the US were negative in five of the 12 decades studied. In two of these, equity real returns were negative (the 1910s and 1970s). On a crude arithmetical average, equities averaged a

¹² The analysis in this paper uses the 2020 edition with data for the years 1900-2019 inclusive.

¹³ US bonds returned 2.0% real p.a. while equities returned 6.5% p.a. in real terms from 1900-2019.

4% p.a. real return in decades of negative bond real returns and 8% p.a. in decades of positive bond real returns, only during the 2000s did we see negative real equity returns when bond real returns were positive.

Using the same source data from the UK, bonds offered negative real returns in 54 of the last 120 years. In 31 of these 54 years, real equity returns were also negative (i.e. 57% of the time), while real equity returns were only negative in nine of the other 66 years (i.e. 14% of the time). In other words, what is bad for bonds, is not good for equities.

Credit Suisse provides a World ex-US series, which shows only two decades of negative real bond returns over the same period (i.e. 1900-2019), being the 1910s and 1940s. In both decades, equity real returns were negative. It is worth noting that these were periods of world wars.¹⁴ They also coincided with total losses in Russia (1917) and China (1949), when personal equity investments were confiscated during the revolutions. The 1920s and 1980s on the other hand, saw very strong real bond and real equity market returns as rate cycles turned downwards.

The 1950's post-war rebuild saw strong equity returns in a 'normal' bond environment. The 1990s, which saw the strongest real return decade for bonds, coincided with the unwinding of the Japan bubble and hence World ex-US equities, which were dominated by Japan, did not show great returns.¹⁵ The 2000s showed a similar pattern to the US as the technology-driven valuation bubble burst and bond yields fell.

The case is made that negative real returns from bonds do not always bode well for real equity returns.

C. Japanese case study – low bond yields do not necessarily mean great equity returns

The Japanese bubble of the late 1980s is well documented. Today¹⁶, the oft-quoted but mathematically imperfect Nikkei Index remains around half the level of its 1989 peak, as does

¹⁴ German real bond returns were -19.5% in the 1910s and -24.2% in the 1940s. Italian bonds lost 27.6% p.a. real in the 1940s and Japanese bonds returned -35.8% p.a. Equity market returns were -11.3% p.a. real in Germany in the 1910s, -12.4% in the 1940s, while in that same decade Italian equities lost -11.5% p.a. real and Japanese equities returned -26.4% p.a. In the rebuild after the war, in the 1950s, German equities (+30% p.a.) and Japanese equities (+27% p.a.) were phenomenal assets to own. Italian equities at 14% p.a. real delivered similar returns to the US in their bubble decades of the 1920s and 1990s. For comparison, the Japanese bubble of the 1980s delivered 18% p.a. real.

¹⁵ On the other hand, equity market real returns for the 1990s were 9% p.a. in Australia, 10% p.a. in Germany, 12% p.a. in France and the UK, 14% p.a. in Switzerland and 18% p.a. in the Netherlands, whilst Japan fell 5% p.a.

¹⁶ 26 May 2020.

the broader and more representative TOPIX¹⁷, which is used in this analysis.

Japanese 10-year bond yields hit a peak in September 1990 of just above 8%, not long after its equity market peaked. Aside from a rally in 1994, bond yields fell steadily, breaking below 2% in October 1997 and 1% in September 1998. Having climbed quickly to 2% by February 1999, yields reached new lows below 0.5% in May 2003. A rise in yields back to 2% by June 2006 preceded a long downward trend again, breaking below zero in February 2016. Yields have been as low as -0.3% in 2016 and 2019.

The long-term returns are revealing, though they conceal a market that has twice halved (2000-2003, 2007) and twice doubled (2002-2007, 2012-2017). The key periods of falling yields can be defined as September 1990-October 1997 (reaching 2%) and May 2006-February 2016 (falling to 0%).

Including the two periods where yields were more stable, we can look at the total return from the TOPIX index. The equity returns since bond yields hit 2% in October 1997 have only been a meagre 1.8% p.a.

Start Date	Start Yield	End Date	End Yield	TOPIX Total Return
28 Sep 1990	8.11%	20 Oct 1997	1.99%	-1.4% p.a.
20 Oct 1997	1.99%	10 May 2006	2.00%	+3.9% p.a.
10 May 2006	2.00%	24 Feb 2016	-0.05%	-0.3% p.a.
24 Feb 2016	-0.05%	31 Mar 2020	0.03%	+3.4% p.a.

Past performance is not a reliable indicator of future returns.

While US investors have become accustomed to double-digit returns, a Japanese-style experience, even in the flatter periods, would certainly be underwhelming relative to expectations.

As always, starting valuation plays a key part in returns. We have created our own Japanese CAPE, which was at 70x when the market peaked in 1989 and was still around 40x when bond yields hit 2% in 1997. (Today, the US market CAPE is also at elevated levels at around 30x, which it only exceeded at the 1929 and 2000 peaks.) It was near 50x at the top of the technology bubble (2000), before it fell away to a low of 9x post the global financial crisis and back to around 15x by March 2020.

The case is made that a prolonged period of low nominal rates is likely symptomatic of deeper issues, particularly around low economic growth. In Japan's case, this has commonly been seen as a function of both demographics and high levels of debt. Neither of these features are now unique to Japan.

¹⁷ Source: FactSet.

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