PCM
PEAK CAPITAL MANAGEMENT

Professional Investment Management

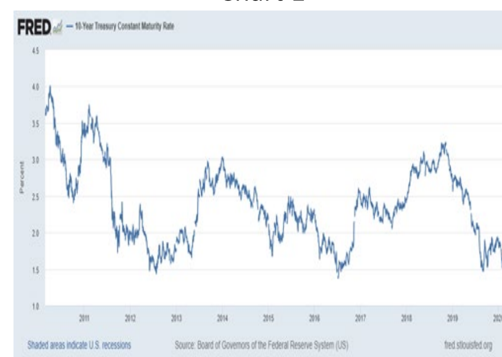
BLOG POST

Interest Rates Reach New Lows

3/23/2020

It wasn't long after the Great Recession back in 2009 and the peak of quantitative easing from the Federal Reserve in 2011 that the headline story was how interest rates were destined to rise. The consequences of such unprecedented quantitative easing would certainly lead to inflation and ultimately higher long-term interest rates. Anyone with bond portfolios that held long-duration maturities (e.g. fixed income securities with maturity dates beyond seven years) was at great risk of principal losses, as higher rates would send bond prices lower. The correct way to position portfolios was with TIPs, which have coupons that adjust with changes in the Consumer Price Index, and variable, floating-rate bonds that would shorten duration.

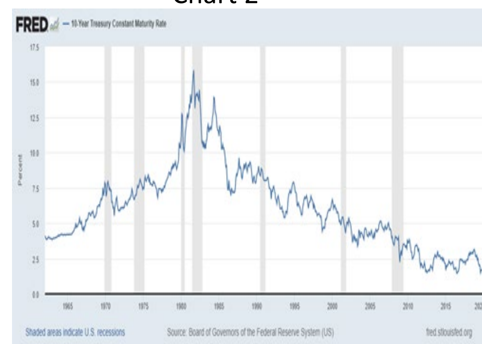
Chart 1



Indeed, higher interest rates and inflation might ultimately be the path forward over the next decade or so, and holding securities such as TIPs and floating-rate bonds might prove to be the correct portfolio allocation decision. But as of February 25th, 2020, the yield on the benchmark 10-year U.S. Treasury reached an all-time low of 1.31%. Over the past decade, the Barclay's 20+ Year Treasury Index is higher by roughly 120% on a cumulative basis, compared to a corresponding gain of roughly 44% for the Barclay's Aggregate Bond Index. Holding long duration has been the better investment. We've provided two charts to illustrate the more recent moves in yields over the past 10 years (Chart 1) and the longer-term change in yields (Chart 2).

Chart 1 begins in 2010 when the Fed was aggressively pursuing quantitative easing and operation twist to inject liquidity into the market. The 10-year yield began at roughly 4% and proceeded to collapse to roughly 1.5% in 2012 amid the Eurozone debt crisis. Then Fed chairman Bernenke made comments in 2013 that the central bank might taper their quantitative easing programs (the so-called "taper tantrum"), and yields soared back to 3%, but then subsided to new lows in 2016 as energy prices collapsed and market participants began questioning global growth potential.

Chart 2



Then, president Trump got the nomination on a platform of tax cuts and infrastructure spending, which sent rates higher based on inflation expectations. Fed Chairman Powell took a tightening stance and raised short-term rates. The 10-year ultimately rose to roughly 3.2% in 2018, but when market volatility hit, the Fed pivoted on policy and began lowering rates in 2019. Now, with the threat of the coronavirus and an economic slowdown in China, the 10-year sits at an all-time low. Chart 2 provides a longer-term view of the 10-year yield. Structurally, the benchmark rate has trended lower since the inflationary periods of the early 1980s, dropping from an all-time high of roughly 16% to 1.3% today.

Earlier this year, former Fed chairman Bernanke suggested that the central bank should not rule out using below-negative interest rates combined with direct asset purchases to combat the next financial crisis. This would suggest using a policy of keeping short-term rates at the lower end bound with longer-term rates near zero or negative. Another former Fed chairman, Alan Greenspan, commented that it's only a matter of time before we experience negative rates in the U.S. Current chairman Powell, however, has stated he would prefer to use direct asset purchases and forward guidance, but not negative rates. The bottom line is that rates seem to be on the "lower for longer" path, at least until the uncertainty of the coronavirus impact and the upcoming presidential election abates.