

# RIVERPOINT

CAPITAL MANAGEMENT

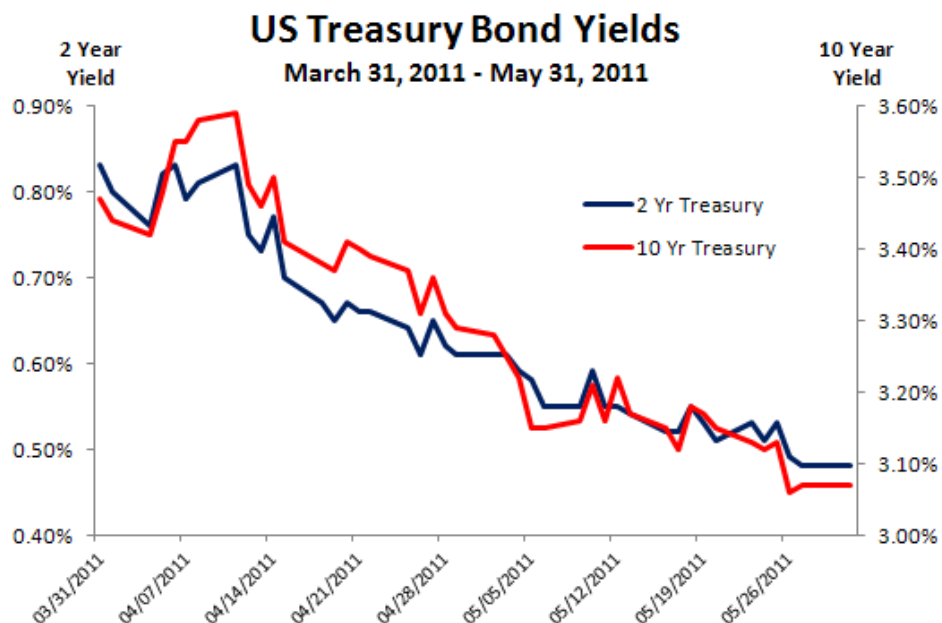
INVESTMENT ADVISORS

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## US TREASURY YIELDS – HOW LONG CAN THEY STAY THIS LOW?

*Inflationary pressures, cheap stocks, and strong corporate profits normally lead to higher rates.*

Weak macroeconomic data for May signals that the US economy may be experiencing an early summer slowdown, just as it did in 2010. The Federal Reserve is allowing its most recent stimulus effort (“QE2”) to come to an end. Commodity and food costs are rising, though these increases haven’t flowed through to overall price levels (according to the government). Stocks are performing fairly well (S&P 500 index returned 5.4% through 6/1), yet remain relatively cheap despite strong corporate earnings. And one more thing – the federal government has reached its “debt ceiling,” which could in theory lead to our country defaulting on its debts. Normally, all of the above would lead to higher interest rates.



Clearly, interest rates have gone nowhere but down over the past couple of months. So low, in fact, that \$1,000,000 invested in a three month government bond will pay the investor a whopping \$1,000,125 at maturity! How can this be?

### The RiverPoint Team

Valerie L. Newell, CPA  
 Leon H. Loewenstine, CPA  
 Victor R. Lassandro III  
 Pamela F. Schmitt, CFA  
 Ryan L. Brown  
 Casey D. Jones, CFA  
 Anthony Roberts III, CFA  
 Kirk M. Koppenhoefer, CFA

The answer to this question involves the increased globalization of the world's economies and financial markets, along with the scarcity of truly safe and liquid securities.

At the beginning of the millennium, global economies were in the early stages of an historic growth spurt. Technological advances and de-regulation in some emerging markets allowed for the free flow of investment capital across borders. All of a sudden, developed countries with relatively slow economic growth prospects could invest in emerging economies that promised much faster growth.

Emerging economies used these funds to invest in infrastructure and technology so that they could continue to grow. And grow they did – gross domestic product (or GDP – a measure of the size of a country's economy) averaged 10% annual growth for Brazil, Russia, India and China from 1995-2010. This investment and subsequent economic growth was a boon for these relatively small economies.

However, a problem soon developed. The economic growth was so robust and so fast that the emerging economies didn't have anywhere to invest their new capital surpluses. Their capital markets were still in their early stages and couldn't supply enough stocks and bonds to soak up the excess capital. Where did these emerging markets turn? Given a long history of "boom & bust" cycles – the reason why many "emerging economies" never fully emerge – these countries sought out the most liquid, safest securities in the world: US Treasury bonds. These countries weren't too concerned about the return that they were earning on these holdings; they just wanted a safe, stable investment that they could sell in a hurry if necessary. As the growth continued, these countries continued to park their reserves in Treasury securities. According to a paper by Federal Reserve Chairman Ben Bernanke, emerging economies purchased more than \$1 trillion worth of US government securities between 2003 and 2007.

These purchases have continued since 2007, and now these countries rank as some of the largest holders of US debt. So immense is the size of their holdings that if these countries were to try to sell, they would significantly hurt the value of their remaining holdings. Japan's Deputy Finance Minister recently said that selling US Treasuries would be "quite difficult... because selling Treasuries would hurt our own assets." Yet these governments don't see anything else as suitable. An Indian Central Bank official recently told *The Economist*: "There is no choice for (India) apart from investing in US Treasuries. We don't think about profitability. For us, first comes safety, then liquidity and lastly returns."

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*Worried investors are buying Treasuries in case the Euro Zone falters, or the Middle East deteriorates further.*

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This so-called “global savings glut” from emerging economies has had a significant impact on keeping US interest rates low. Another reason that rates have stayed low is that, in times of stress, investors engage in a “flight to safety.” We saw this during the financial crisis of 2008-2009, when US government bonds were in such great demand – again, due to their safety and liquidity – that interest rates touched historic lows. In mid-2011, the US economy has recovered, but many other parts of the world – namely the countries of the European Union – are still struggling with the fallout from the Great Recession. There remains a certain level of risk aversion in the marketplace, where investors just want safety. Adding to this nervousness are the events of the Arab Spring, throwing into question the tenuous stability of the Middle East region. Investors are parking their funds in Treasuries in case the Euro Zone is overburdened by its troubled members, or the Middle East deteriorates further, causing oil prices to spike and the global economy to grind to a halt.

Technical factors have also contributed to continued low US interest rates. The increased globalization of financial markets that has marked the past 15 years has also led to increased correlation across asset classes and across borders. In the past, it was common to see commodities move one way and stocks move the other way, or bond prices rise (lowering bond yields) and stock prices fall. As financial markets have become more globalized, these traditional relationships have crumbled. But why? One reason is the exponential growth in exchange-traded funds, or ETFs. ETFs provide investors with a low-cost way to gain exposure to an index, a sector, a commodity, or almost any other kind of security. Some offer “short” exposure, where an investor can bet on the decline in price. Others offer leveraged returns. Some even offer leveraged short exposure!

In essence, ETFs accept investor money, purchase the appropriate amount of the underlying security / commodity / etc and then issue shares to the new investor. When an investor sells their ETF position, the opposite occurs – the fund buys the investor’s shares and sells the underlying security on the open market to repay the investor. Assets controlled by ETFs have exploded to \$1 trillion from under \$70 billion in the past decade, driving up demand for assets across the spectrum and often at the same time. If an investor wants to buy an S&P 500 ETF, then the ETF will have to buy the appropriate amount of all the stocks in the S&P 500. As the amount invested in ETFs grows, the stocks in the S&P 500 will see increased demand. The same goes for commodities as assets in commodity ETFs rise, etc.

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For many investors, a portfolio is constructed using risky (stocks, commodities) and risk-free (US government debt) assets. As the investor gets more confident, they sell government bonds and buy risky assets (aka “risk on”). In uncertain times, investors sell risky assets (aka “risk off”) and buy more government bonds. Currently, US government bonds make up 60% of AAA-rated securities in the world, and are also the most liquid by far. Thus, when traders sell risky assets, there’s only one place to put the proceeds – US government bonds. This demand causes bond prices to rise (and rates to fall) and other asset classes to fall in concert. There’s an old saying: “in times of crisis, all correlations go to 1.0,” meaning that when investors sense trouble, they sell everything (a correlation of 1.0 means that prices move the same amount in the same direction). We saw this play out during 2008 and early 2009 – all risky assets declined in price.

At RiverPoint, we are proceeding under the assumption that interest rates could remain at low levels for a while longer. We may not see a return to the early 1950s and late 1960s, where the yield on the 10-year Treasury remained below 5% for fourteen consecutive years. But the need for liquidity and safety has left one of the world’s largest investor classes – sovereign governments – with no other choice but to invest in US Treasuries. We are confident that lawmakers in Washington will reach a compromise about the budget and debt ceiling before the country defaults on its debts, thereby maintaining the reputation that US government debt is the safest investment in the world. Under this scenario, it won’t really matter if the Federal Reserve stops its “Quantitative Easing” programs – the rest of the world will keep rates low in the US. For our client portfolios, we remain somewhat conservative with our asset allocation. We are focusing on high-quality, dividend-paying stocks as well as a mix of corporate bonds and higher-yielding securities in order to provide incremental yield in excess of US government bonds.

## **MORE INFORMATION AT THE FOLLOWING LINKS:**

An article from *The Economist* that discusses how safety is so important to sovereign investors:

[http://www.economist.com/node/18650928?story\\_id=18650928](http://www.economist.com/node/18650928?story_id=18650928)

A Reuters article that focuses on the same theme:

<http://www.reuters.com/article/2011/05/12/us-usa-debt-asia-idUSTRE74B0YE20110512>

For a more intense review of why growth in emerging markets has been partly responsible for keeping US interest rates low, see the article titled “International Capital Flows and the Returns to Safe Assets in the United States, 2003 – 2007” by Fed Chairman Ben Bernanke: [http://www.banque-france.fr/gb/publications/telechar/rsf/2011/rsf\\_1102.pdf](http://www.banque-france.fr/gb/publications/telechar/rsf/2011/rsf_1102.pdf)