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FIXED INCOME | IN DEPTH

How investors can adapt to the negative real yield era

More than half of the bonds in the Bloomberg Barclays U.S. Aggregate Bond Index yield less than the current rate of inflation. We look at how investors can respond to this shrinking pool of opportunity.

Deeper analysis of investment trends and topics — October 29, 2020

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Key takeaways

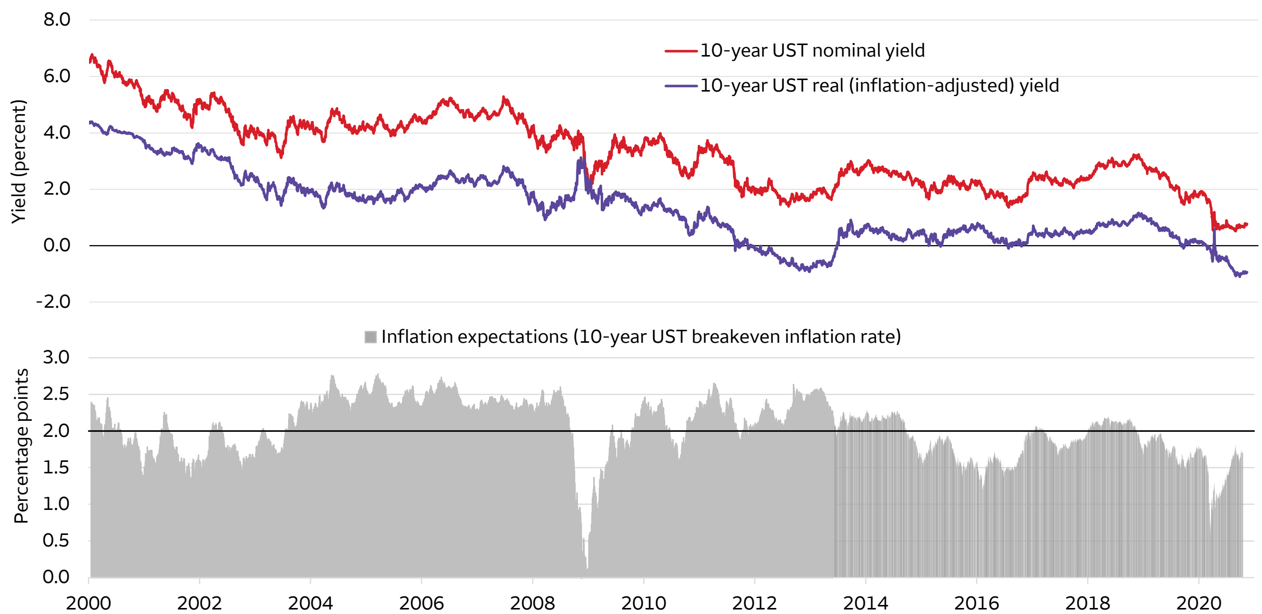
- The extraordinary policy changes made by the Federal Reserve (Fed) in response to the coronavirus pandemic have ingrained sub-inflation yields (that is, negative real yields) as an enduring feature of U.S. and global bond markets. We believe this negative real yield era could persist for some time.
- These policies have resulted in big changes to the yield distribution within U.S. bond markets, and a dramatic shrinking of the opportunity set for bond buyers seeking yields in excess of inflation. These changes may continue to have far-reaching ramifications for markets and investors.
- We list several potential implications for fixed-income investors, some of which are already evident in current markets.
  - Risk assets should continue to get a boost as negative real yields may be more successful in driving further asset-price appreciation than in achieving the Fed's goals of 2%-plus inflation and of stimulating the real economy.
  - More fixed-income investors may move further outside their traditional investment spheres, supporting credit markets.
  - Positive real yields available in emerging market bonds may find new buyers.
  - Gold may increasingly be seen both as a macro portfolio hedge for equities and as an alternative inflation hedge.
  - And the U.S. dollar may continue to be weak relative to the euro.

Extraordinary Fed policy brings negative real yields to the U.S.

The Fed's extraordinary policy response to the coronavirus pandemic has driven real yields (that is, yields adjusted for price inflation) deep into negative territory. The real (inflation-adjusted) yield on 10-year Treasury Inflation Protected Securities (TIPS) fell to -1%, as the Fed slashed the federal funds rate effectively to zero and 10-year nominal yields fell to around 50 basis points in the wake of the February-March coronavirus-driven equity market plunge.

The Fed's guidance around its new policy of "average inflation targeting" (AIT) shows that it has effectively committed to keep rates at rock-bottom levels not merely until observed inflation has reached its 2% target, but until it "is on track to moderately exceed 2 percent for some time." This has confirmed to the market that deeply negative real yields may be here for quite some while.

Chart 1. Fed policy brings deeply negative real yields to the U.S. bond market



Sources: Bloomberg, Wells Fargo Investment Institute. Latest data as of October 16, 2020. The 10-year UST breakeven inflation rate is the difference between the yield on the 10-year US Treasury note and the real yield on 10-year Treasury Inflation Protected Securities (TIPS). **Past performance is no guarantee of future results.** Current performance may be higher or lower than the performance quoted above. Yields and returns will fluctuate as market conditions change

Changing structure of the U.S. bond market

Yields below the prevailing rate of inflation (in other words, negative real yields) have been a feature of European bond markets for several years now. However, until 2020, the U.S. bond market could offer fixed-income investors relatively attractive yields in excess of inflation, in addition to its other attractions of breadth and depth of liquidity.

Table 1, an analysis of yields within the Bloomberg Barclays U.S. Aggregate Bond Index, shows the extent to which real yields have fallen and how the opportunity set of positive real-yielding bonds has diminished. Over the past year, the size of the index has increased by $1.4 trillion, to $24.4 trillion. However, the proportion of that index offering investors a yield in excess of prevailing inflation rates has shrunk significantly. The availability of bonds offering a positive real yield has fallen from $16.5 trillion, or more than 70% of the index, in September 2019, to just $9.5 trillion, less than 40% of the index, by September 2020. Negative real yields now make up more than 60% of this particular investible universe.

Table 1. Negative real yields in U.S. dollar-denominated debt markets

Barclays U.S. Aggregate Index Negative real yield assets (i.e. below zero)	30-Sep-19		30-Sep-20		1Y Change	
Total market cap	$23.0 trillion		$24.4 trillion		+$1.4 trillion	
Real yields < 0%	$6.5 trillion	28.1%	$14.9 trillion	61.0%	+$8.4 trillion	+32.8ppt
Real yields > 0%	$16.5 trillion	71.9%	$9.5 trillion	39.0%	-$7.0 trillion	-32.8ppt

Sources: Bloomberg Barclays indices, Bloomberg, Wells Fargo Investment Institute. Index data as of September 30, 2020. See disclosures for index definitions. Real yields are published bond yields discounted by the latest available data for Consumer Price Index inflation. Ppt = percentage points. Yields and returns will fluctuate as market conditions change

We believe the dramatic drying-up of the pool of opportunity and the reduction in achievable inflation-adjusted returns have multiple and far-reaching ramifications for investors. Here are the implications we expect and our guidance for fixed-income investors.

Negative real rates — a checklist for investors

1. **We expect equities and risk assets in general to benefit from negative real rates.**

We believe negative real rates should continue to be supportive of equity markets and risk assets in general, as what former Fed chair Ben Bernanke called the "portfolio rebalancing effect" takes effect and investors move into risker sectors in search of return. Asset price inflation continues to look more likely than goods and services price inflation. Furthermore, equities may appear more attractive from a valuation standpoint if extraordinary policy depresses real yields to deeply negative levels. Attractive earnings yields relative to real bond yields flatter stocks by making them appear cheap on that basis. We are favorable U.S. large-cap and mid-cap equities, and we believe investors should maintain our recommended allocations in these asset classes.

2. **We expect U.S.-dollar credit markets to continue to see inflows.**

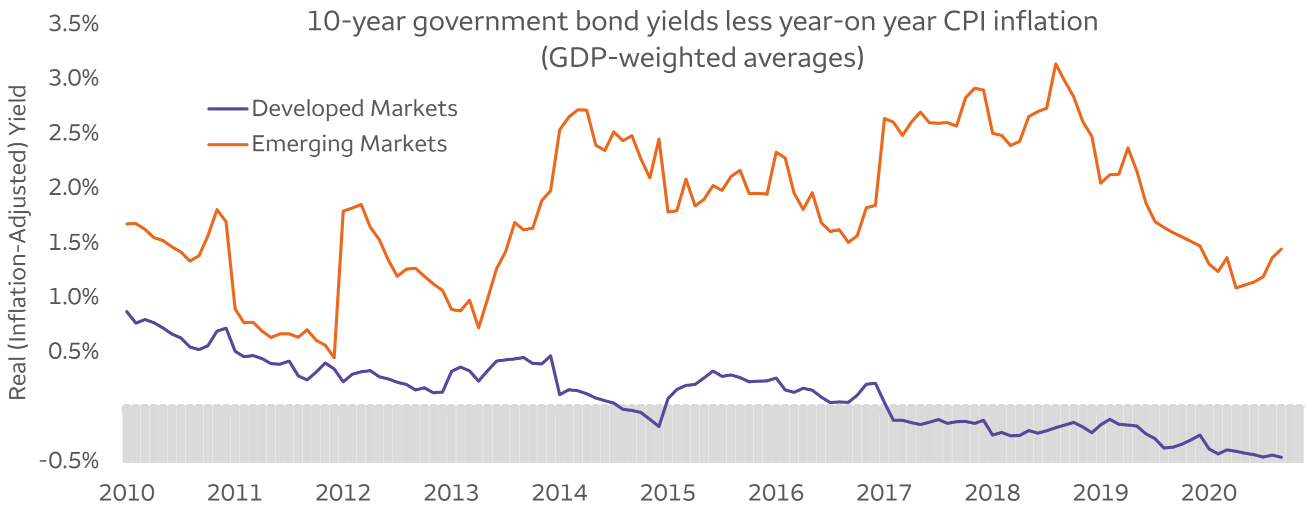
This is one theme with which fixed-income investors are already familiar. Vanishing nominal and real yields are driving a global hunt for yields, and this is moving investors into fixed-income holdings further down the credit curve. We expect this to continue, especially in U.S. markets, where Fed policies and rhetoric support credit positions of this type. In this context, we are favorable on Investment-Grade Credit and High Yield Taxable Fixed Income. We believe that in current markets, moving down the credit spectrum to increase yield is a viable strategy, but we advise doing so with caution. Selectivity remains important, and we recommend that investors use active management when purchasing lower quality investments.

3. **We look to emerging market debt as a source for positive real yields.**

Emerging Market (EM) Fixed Income is also seeing inflows, although, of course, this asset class is not directly supported by Fed purchasing policies. The dollar-denominated EM sovereign index[1] is currently yielding over 4.5% — more than 3 percentage points in excess of U.S. headline inflation. In local EM currencies, as Chart 2 shows, many emerging market countries offer bond yields 1% to 2% above still-subdued inflation rates, whereas a GDP-weighted basket of developed-market 10-year yields has been in negative territory since 2017 and is heading lower, in our opinion. While we are neutral on the Emerging Market Fixed Income asset class, investors looking for returns above inflation rates may consider adding to allocations. Again, as with other credit classes, we believe selectivity is key, and we favor using active management to manage risk.

[1] J.P. Morgan Emerging Markets Bond Index. See end of report for important index definitions.

Chart 2. Real yield dearth means more investors are considering EM debt



Sources: Bloomberg, International Monetary Fund, Wells Fargo Investment Institute. Monthly data, latest as of September 30, 2020. Developed markets represented by J.P. Morgan Emerging Markets Bond Index (EMBI Global); Emerging Markets represented by J.P. Morgan GBI Global ex-US Index (Unhedged). Real yields are 10-year government bond yields less the latest year-on-year rate of CPI inflation in each country. DM & EM real yields are GDP-weighted averages within each country group. The DM universe is the G7 countries: United States, Germany, United Kingdom, Japan, Canada, France and Italy. The EM universe here consists of: China, India, Indonesia, Brazil, Mexico, Turkey, South Africa, Russia and Poland. **Past performance is no guarantee of future results**. Current performance may be higher or lower than the performance quoted above. Yields and returns will fluctuate as market conditions change

4. We favor gold and alternative assets as a potential portfolio hedge.

With high-quality bonds at near zero nominal yields — and negative real yields — further drops in yields are unlikely unless the Fed espouses a negative nominal rate policy, which we do not expect to happen. In this context, the negative correlation between bond and equity prices that makes bonds a potentially efficient shock absorber and return stabilizer in balanced portfolios (60/40 being the archetypal allocation) is far less impactful. We suggest that alongside continuing allocations of high-quality and credit fixed income, investors consider alternative "portfolio hedges." Gold and alternative investments (such as hedge funds for qualified investors) are two possibilities.

5. We see other assets as potential inflation hedges.

Despite negative real yields, we are neutral on Treasury Inflation-Protected Securities (TIPS), as these remain the cleanest and most direct hedge against the erosion of portfolio value through an increase in inflation. However, investors can and should evaluate other portfolio assets as potential inflation hedges. Equities – given that they represent cash flows based on firms' growth and pricing power within the real economy – have historically kept pace with inflation over the long term and in aggregate, but of course, timing and selectivity are key risks to this hedge. Gold through the ages has been seen as an inflation hedge – that is, an asset with potential to preserve real wealth in times when money wealth may be eroded by inflation. This is one argument driving the rise in the gold price today. As much as a commodity, it seems gold these days is viewed as a currency – but the only currency beyond the reach of any central bank's ability to debase its domestic or external value via inflation.
Unsurprisingly, this narrative gains traction in an era of massive fiscal deficits and debt-to-GDP ratios, and of "average inflation targeting" and (perhaps in the future) "Modern Monetary Theory."

6. We expect further depreciation of the U.S. dollar against the euro.

The Fed's average inflation targeting policy means that it is now aiming at a rate of inflation higher than it was before. Previously, hitting (or maybe even just approaching) a 2% target was enough to warrant policy change; now, inflation must exceed 2% for an unspecified period. Given that the European Central Bank (ECB) inflation target is defined as "below, but close to, 2%," it is fair to say that the Fed is now clearly targeting a higher rate of inflation than the ECB. Many factors affect the U.S. dollar's value, of course, but over time, the country that inflates faster generally sees its currency fall against the country in which prices rise at a slower rate. We continue to expect further depreciation of the dollar versus the euro in 2021. At the margin, dollar depreciation improves foreign currency returns to the dollar-based investor, and therefore may brighten the outlook a bit for certain non-dollar asset classes. For example, although we do not hold a strategic weighting in this asset class, we recently upgraded our tactical (6 to 18-month) view on Developed Market (ex-U.S.) Fixed Income[2] to neutral, from unfavorable.

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Peter Wilson is a global fixed-income strategist for Wells Fargo Investment Institute. Mr. Wilson researches and analyzes economic and market trends to develop investment recommendations. He contributes to WFII publications including market updates, white papers, and special reports. Prior to joining Wells Fargo in 2012, Mr. Wilson worked for Nomura International Limited and Mitsubishi Securities in a variety of roles including multi-currency strategist and bond salesman. He has more than 25 years of experience in financial services.

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[2] J.P. Morgan GBI Global ex-US Index (Unhedged).

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. Although **Treasuries** are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. Investments in **gold** and gold-related investments tend to be more volatile than investments in traditional equity or debt securities. Such investments increase their vulnerability to international economic, monetary and political developments.

Treasury Inflation-Protected Securities (TIPS) are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the “inflation compensation” component of the principal. A holder of TIPS may be required to report this income annually although no income related to “inflation compensation” is received until maturity.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.
Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based measure of the investment grade, US dollar-denominated, fixed-rate taxable bond market.

Consumer Price Index (CPI) produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

J.P. Morgan Emerging Markets Bond Index (EMBI Global) currently covers more than 60 emerging market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

J.P. Morgan GBI Global ex-U.S. Index (Unhedged) in USD is an unmanaged index market representative of the total return performance in U.S. dollars on an unhedged basis of major non-U.S. bond markets.

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