ERSTE Asset Management

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https://blog.en.erste-am.com/30-years-of-falling-interest-rates-what-is-ahead-of-us/

30 years of falling interest rates – what is ahead of us?

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Let's start with a trip down memory lane:

Do you remember the scenery 30 years ago – on the financial markets, and in our personal lives?

The 1980s – many of the older generation are still thinking back to the "good old times". There were no smartphones and no data kraken. Instead, we had shoulder pads in our jackets and wore peg-top jeans. No.1 in the German charts was an actor known from Knight Rider and Baywatch called David Hasselhoff with his song "I've been looking for freedom".

This was eerily in tune with the most important geopolitical event of that era, i.e. the fall of the Berlin Wall and the opening of the Eastern Bloc. On the financial markets, this set off a period of sharply falling yields on government bonds.

A chart is worth a thousand words

The following chart shows the long-term development of 10Y (remaining time to maturity) German and US government bond yields over the past 30 years. Let us discuss a number of remarkable findings and look at possible future scenarios.

Long-term development of 10Y German (blue) and US (red) government bond yields and interest rate differential (green)
Source: Datastream, 30 years as of 22 May 2018
Note: past performance is not indicative of the future development of an investment.

The chart depicts the yield of German government bonds in blue and that of US government bonds (i.e. treasury bonds) in red. The green area illustrates the yield differential. The long-term chart highlights several developments:

- Both US and German yields have fallen drastically
- The decline has occurred in waves
- For most of the time the US yield would exceed the German yield
- The yield differential (i.e. spread) between the two countries has fluctuated over time
- The German government bond yield turned negative at its low

What does this development mean for investors?

The bond yield reflects the inverted performance of the bond price. This means that German and US government bond prices have increased over the observation period, albeit with significant setbacks interspersed. Investors have thus not only received the ongoing coupon payments, but also benefited from rising bond prices. The optimum strategy has been to remain invested and ignore setbacks.

While future developments are unpredictable, this relationship holds: when yields are rising, the prices of existing bonds are falling. At the end of the 1980s, yields were above 8%. The falling interest rates made it easier to compensate for price fluctuations than today, with US yields of 3% vs. German yields of 0.5%.

The interest rate differential is currently as high as 30 years ago

German and US government bonds command high ratings. Defaults are unlikely. The spread (i.e. the green area in the chart above) can be explained by the underlying currency and the investment region. It constitutes an important criterion for the assessment by investors and at 2.5% in favour of the USA is currently as high as previously in 1989!

Rational investors will assess whether the volume of the spread can offset a possible depreciation in the underlying currency.

At a spread of 2.5% (per year) this means a surplus interest income of 25% over ten years for US bonds. Or in other words: if the US dollar were to depreciate by 25% in the coming ten years, euro investors would still earn the same return as they would on German government bonds.

The historically high spread is clearly making a case for US bonds at this point. Also, the US central bank (Fed) stopped its bond purchases back in 2014, whereas the ECB continues to buy aggressively and is expected to abandon its purchase regime only in autumn of 2018. This means that the Fed is about four years ahead of the ECB and has also communicated further interest rate hikes for 2018 and 2019 to the market. The ECB has not issued any statements about its possible future interest rate policy, except that rates will remain very low in the foreseeable future.

The last time the spread was of similar proportions (in favour of the USA) to today's scenario, the year was 1989. David Hasselhoff (known for his starring roles in Baywatch and Knight Rider) was topping the German charts with "I've been looking for freedom" at the time. By the way: Knight Rider has recently been rebooted, and Baywatch has been turned into a movie with a new cast. Is history repeating itself?

How to invest, and what asset allocation to maintain

As we pointed out above, the optimum strategy has been to remain invested. Investors will rightly ask how they can remain invested when the bond expires after ten years.

The solution: an investment fund will always remain invested. It automatically buys new bonds and thus provides investors with the chance to remain invested in the chosen markets without expiry date.

Conclusion: This is what we can learn from the long-term chart: in the past 30 years it has made sense to invest and remain invested in government bonds due to continuously falling yields. As far as the future is concerned, the experts of Erste Asset Management do not expect yields to continue falling for the coming 30 years. Investors should diversify their portfolios beyond credit-safe government bonds.

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Johann Griener

Johann Griener has worked at Erste Asset Management in Sales Retail since 1 January 2001. In this function he supported for example the Sparkasse banks in Austria, with a current focus on Upper Austria. His scope of duties includes the servicing, training, training and education of Sparkasse employees who work in the securities field. This means creating and holding presentations in the local branches and in Erste Asset Management for the purpose of promoting sales of Erste Asset Management GmbH and Erste Immobilien KAG funds. He also supports the Sparkasse banks (Austria-wide) in their own investments (nostro business). In addition, Griener is developing numerous publications for internal and external use. The "1x1 of Investment Funds" that he wrote is found in all of the branch offices of Erste Bank and the Sparkasse banks as basic reading and an introduction for customers on how investment funds work.

Griener began his career in 1988 as an employee at the bank counter in a local Sparkasse bank. There he learned the banking business, from a savings book to loans to investment operations. After a few years at the Sparkasse, he decided to continue his studies at the Vienna University of Economics and Business, with a focus on "banks" and "securities". After completing his master's degree, he remained loyal to the Sparkasse sector and has been working at Erste Asset Management since.

His motto: "Only a day with laughter is a good day"