The New Yield Paradigm

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Equity markets are stuck in a narrow trading band, with high volatility and a palatable degree of uncertainty. Bond yields across the globe have turned negative; in fact Switzerland bond yields are negative from the shortest maturity through thirty years. Imagine paying the government to hold your money for thirty years instead of them paying you! If this isn't a sign of extreme overvaluation in the bond market then I've never seen one. US treasuries, even at the current anemic levels look like a bargain to global investors when you factor in security and a high degree of liquidity. It's important to keep in mind that institutional investors have very different objectives than retail investors. Retail investors seldom have to be concerned with the problem of moving billions of dollars through the financial system and where negative rates might be acceptable for an institution looking to park funds short term, it is unlikely they will be acceptable to all but the most pessimistic retail investor. Retail buyers have been replacing low fixed income yields with dividends, one of the reasons why higher yielding dividend stocks like utilities and telecoms, as well as other dividend-oriented products, have been doing so well recently. While dividend stocks are expensive by historical measures, they look positively cheap when you compare the yields to fixed income.

Observation # 1

As return expectations and investment yields ratchet down, the amount of money it takes to generate a living retirement income increases. In other words, if you need to generate $100,000 in income per year, you would need $2 million of investment assets generating 5%. With a yield of 1% you would need $10 million to generate the same income. Whether we recognize it or not, these calculations become part of our collective psyche and instill a sense of caution when spending or investing. It encourages one to save rather than spend which in and of itself is not bad thing, but we live in an economy that is 70% consumption-based and that doesn't help to promote general economic growth.

Observation # 2

The cost of debt as compared to the risk-free rate of return on money market funds, CD's or treasury bills is higher. If you have an outstanding debt such as an auto loan, mortgage or equity credit line, paying off that debt represents a rate of return that is equally comparable to an investment. For instance, if you have an auto loan at 5% and you're sitting with $20,000 in the bank at 0%, paying off your auto loan effectively generates a 5% rate of return on your money, something that anyone in this market would jump at. Debt repayment, like savings ultimately creates a healthier economic environment but the money doesn't work its way back into the economy. Debt repayment is typically a sign of caution, not optimism. This deleveraging trend has gone for quite some time but has been offset by the attractiveness of ever plunging rates. At some point individuals will have reduced debt either to zero or to a point where they are comfortable and will begin to seek other investment options. One observation that I will share as an advisor is that money won't sit idle indefinitely, it will seek a home with the best risk/return characteristics and anticipating that next move is the key to generating returns. Asset allocation. While I'm all for reducing debt, it's important to keep an eye on the long game. When rates finally do begin to increase, a low cost mortgage may look more like an asset than a liability, something that will be the subject of cocktail party conversation and "remember when" recollections.