



Revisiting Yields

March 2016

In our September 2015 Issue Brief, *Considering Central Bank Influence on Yields*, we discussed how difficult it is for investors to consistently and reliably predict the future path of interest rates. We also looked at several historical periods when the US Federal Reserve began to tighten monetary policy. Our analysis showed that changes in the federal funds target rate are not perfectly correlated with changes in short- and long-term rates, which are often driven by market forces.

The Fed, after a long period of anticipation (and some mistimed calls by a few prognosticators), raised the fed funds target rate on December 16, 2015—the first increase since 2006. Some market commentators believed that it signaled the beginning of an era of higher interest rates led by a Fed tightening cycle.

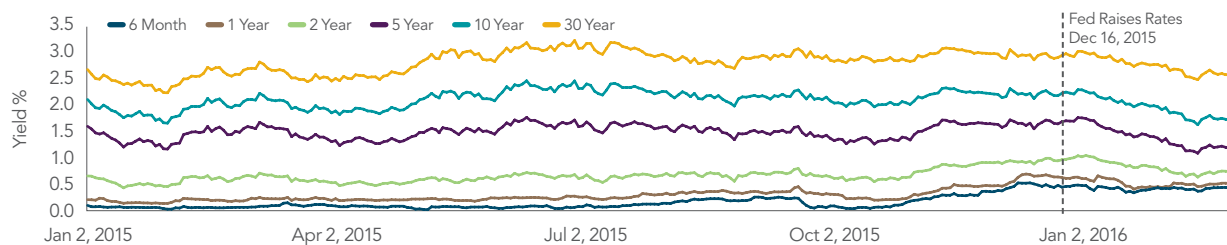
Looking at interest rates over the past several weeks, it may surprise many that the five-year US Treasury note fell to its lowest yield since June 2013. The 10-year US Treasury note fell to its lowest yield in over a year.

Recent actions of the Fed and subsequent changes in yields show how difficult it is to predict the future path of interest rates.

It is interesting that, in their late January meeting, the Federal Reserve decided not to raise the federal funds target rate. We can ask ourselves again, is the market leading the Fed or is the Fed leading the market in setting interest rates?

In February, yields on some bonds in the US fell to levels we have not seen in more than a year. Yields then increased, to further demonstrate the difficulty of predicting the path of interest rates. In mid-February the five-year US Treasury note was as low as 1.10%. Today it yields 1.23%. At the same

Exhibit 1: US Treasury Yields



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time, the yield on the 10-year US Treasury note fell as low as 1.64%, while today it yields 1.76%.¹

Although some investors may view US interest rates as low, the interest rates in other developed markets are even lower than their long-term historical averages. For example, the yield on 10-year government bonds from Germany (0.15%), Canada (1.18%), UK (1.40%), and Japan (-0.07%) are all below their long-term average.²

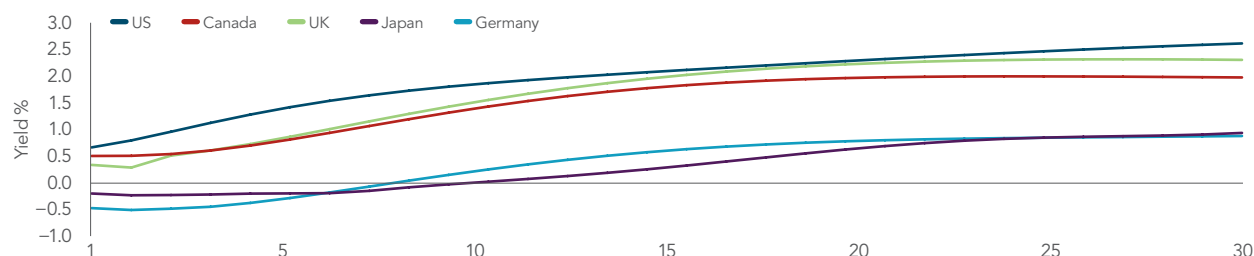
TAKING A BROADER PERSPECTIVE

Given interest rate levels in developed markets globally, what then are the benefits of global diversification? Yield curves globally have not moved in lockstep with each other. For example, interest rate changes in Germany have not always coincided with analogous interest rate changes in the US. Because of this, global diversification across yield curves can help reduce the expected volatility of a bond portfolio.

Further, yield curves globally have different shapes. This implies expected term premiums (the expected premium for holding a longer-term bond over a shorter-term bond) vary from market to market and provide opportunities to increase expected returns by pursuing term premiums globally. Thus, when compared to a domestic-only portfolio, global diversification can help reduce expected volatility as well as enhance expected returns.

What about volatility due to currency movements? By hedging the currency exposure of the non-domestic bonds in a global strategy, investors can benefit from this larger opportunity set without incurring increased volatility from currency movements. Hedging currency exposure also equalizes the short-term rate of interest between foreign and domestic markets but preserves the shape of the foreign yield curves. This implies, for a currency hedged global bond strategy, the shape of yield curves globally is a more important consideration than their level.

Exhibit 2: Global Government Bond Yields



Source: BofA Merrill Lynch indices are used with permission; copyright 2016 Merrill Lynch, Pierce, Fenner & Smith Incorporated; all rights reserved. Past performance is no guarantee of future results. Indices are not available for direct investment.

1. Current yields as of February 26, 2016.
 2. 10-year yields as of February 26, 2016.

SUMMARY

The recent actions of the Fed and subsequent changes in yields highlight just how difficult it is to consistently predict the future path of interest rates in one market, let alone across markets globally. A more prudent strategy that may increase expected returns and enhance diversification is one that uses information in yield curves globally and applies a variable country and variable maturity approach. A strategy should thus increase its allocation to yield curves where current prices indicate higher expected term premiums and lengthen its duration in those yield curves that are positively

sloped. This can be done in a systematic and controlled way to manage the tradeoffs among expected returns, expected volatility, and global diversification.

As we have mentioned before, the market's ability to reflect the probability of different outcomes and events in security prices reinforces the importance of focusing on asset allocation, diversification, and information in security prices as opposed to parsing information from news in an attempt to forecast future market activity.

Source: Dimensional Fund Advisors

Diversification does not eliminate the risk of market loss. Fixed income securities are subject to increased loss of principal during periods of rising interest rates and may be subject to various other risks, including changes in credit quality, liquidity, prepayments, and other factors. Sector-specific investments can increase these risks. International investing involves special risks such as currency fluctuation and political instability.

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