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Bond investors should expect continued low yields and low returns

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When fears of the new coronavirus seized hold of markets in early March, already low government-bond yields fell to record levels amid a historic "flight to quality". Given the impending global recession, government bonds will likely continue to be attractive for now – although their yields will be low and liquidity concerns will make them volatile. But over the long term, we favour spread products such as investment-grade and high-yield corporate bonds.

As the extent of the global coronavirus crisis became clear in recent months, we made some adjustments to our outlook for global bond markets. However, our core convictions remain the same: (1) interest rates will likely remain low in the near term; (2) bond returns are set to stay low for years; and (3) we still prefer spread products to government bonds in the long run.

1 Interest rates seem likely to stay low for the foreseeable future

There are compelling reasons for us to think interest rates will remain at or near their current very low levels for some time. The trend was apparent over recent years, even before the coronavirus hit: central banks have repeatedly showed their willingness to loosen the reins in the face of economic headwinds. And indeed, with a coronavirus-triggered global recession looming, major central banks have lowered rates dramatically, increased their bond purchases and provided additional liquidity provisions to stabilise markets.

Even if the outlook for global economic growth improves – which is unlikely to happen in the

Key takeaways

- We expect the US fed funds rate to remain low and possibly move lower, but we don't think these official rates will reach negative territory. However, market forces could push Treasury yields below zero
- The coronavirus has added complexity to the economic outlook and made a global recession all but certain; in response, investors have flocked to the relative "safety" of government bonds
- Government bonds are more attractive than corporate bonds and other "spread products" in the immediate future; however, we prefer spread products over a longer time horizon

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near term – we don't anticipate any imminent change in the monetary policy of the two most important central banks (the US Federal Reserve and the European Central Bank). If anything, we expect them to make additional rate cuts or extend their bond-purchase programmes further. As central banks and investors alike buy up government debt, their yields could fall even more.

When considering the future direction of bond yields, it's also important to note the relationship between high debt levels and low rates. Decades of "loose" monetary policy – including low rates – have lifted public and private debt levels close to record highs globally (see charts). One reason this has happened is the financial appeal of taking on cheap debt – including when corporations use it as leverage to buy back their own stocks. High levels of debt have historically curbed countries' longer-term economic growth, while making their central banks reluctant to raise interest rates to a "normal" level for fear of hurting a private sector dependent on low financing costs. Clearly, the environment that central banks helped create is not going away anytime soon.

2 We expect low bond returns over the long term

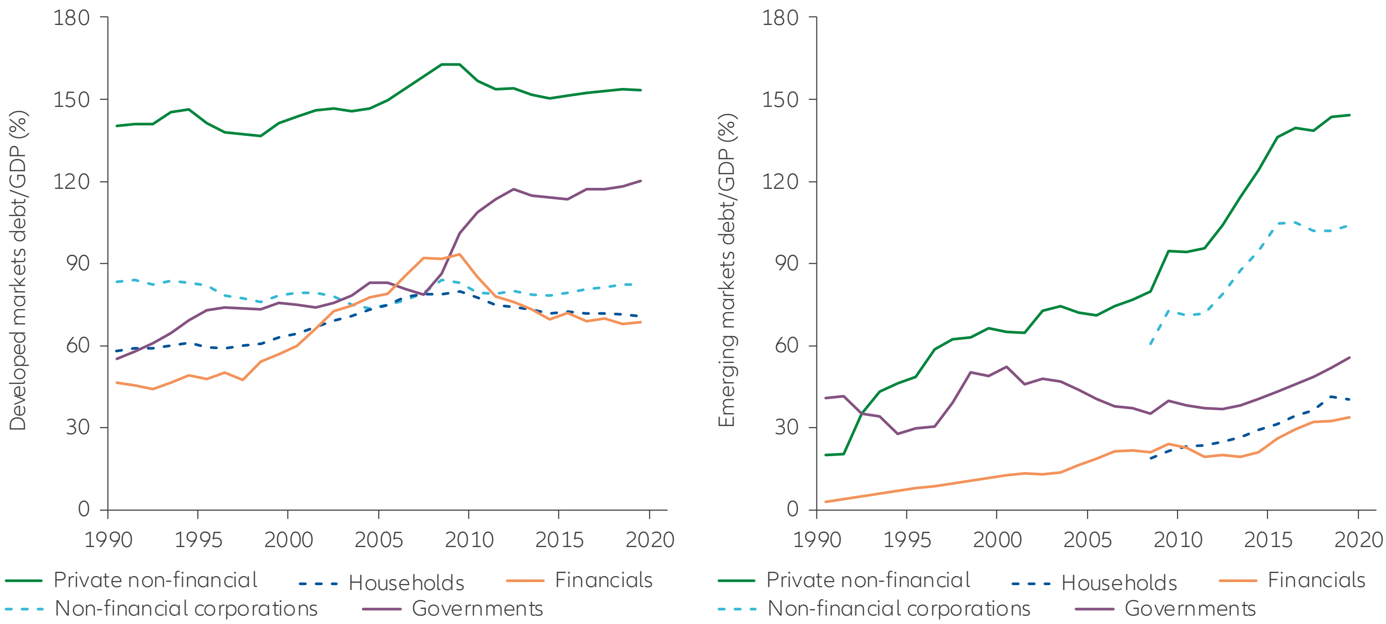
In our view, there are two reasonable outlooks for bonds: yields will fall even lower, or yields will rise slightly but still stay low.

- Given fears of the growing "Japanification" of the government bond markets in Europe and ultimately the US – a reference to the low-growth, low-yield, low-inflation environment seen in Japan since the 1990s – some wonder if the Fed would even push rates into negative territory. (Interest rates are already negative in Japan and the euro zone.) We don't think US policy rates will turn negative, but Treasury yields may be different: they could be forced by market pressures into negative territory despite the Fed adhering to its "zero lower bound". However, with short-term rates having reached the lower bound, the downside for bond yields – and, therefore, the upside for bond prices – seems to be limited.
- It is possible that bond yields could rise slightly in the long run while staying relatively low. For example, prolonged trade disputes can be inflationary (though the current trade war hasn't increased inflation significantly) and bond investors could start pricing in the risk of higher inflation as a consequence of ultra-easy monetary policy. This would result in higher yields and lower returns, since bond prices move inversely to yields.

Either way, we expect annualised returns on government-bond markets to be in the low single digits. Even in a climate of "normal" interest rates – and we are nowhere near such an environment – central-bank rates would likely rise to only about 3% in the US, 2% in the euro zone and less than 1% in Japan due to low trend growth. At these levels, US debt would likely be more attractive than that of other nations, but it's unlikely that these low yields would meet most investors' long-term obligations.

Non-financial and government debt levels are near record highs

Debt/GDP in % (developed markets on left, emerging markets on right)



Source: Allianz Global Investors, BIS, Refinitiv. Data as at 31 March 2019.

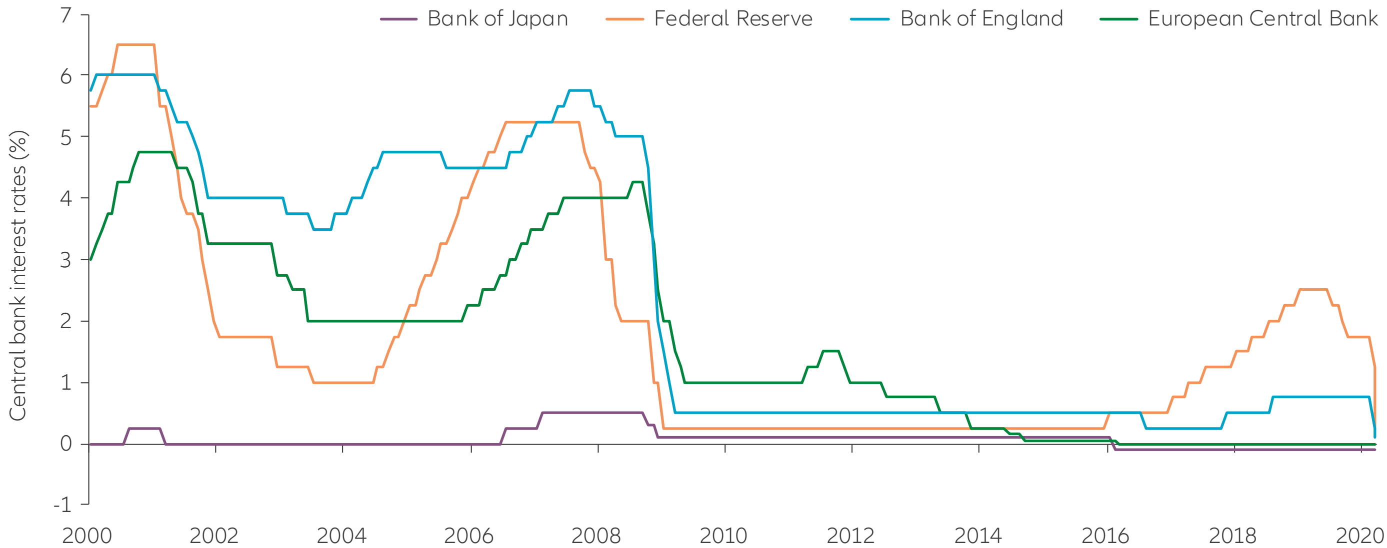
3 We prefer spread products to government bonds in the long run

When yields are low and the economy is not entering a recession, the more attractive segments of the bond market tend to be the ones that offer additional income potential over government bonds in exchange for taking on additional risk. Spread products are a good example: their extra yield potential (or "spread") is meant to compensate investors for taking that risk.

These are not normal times, however, and spread products as a category may not generate enough income to compensate investors for taking more risks (though proprietary credit research may help mitigate them). However, over the long term, we find credit and illiquidity risk to be worth taking. We estimate that compared with a government bond index, investment-grade corporate bonds could offer additional return potential of around 70 basis points, and high-yield bonds could offer an extra return of 200 basis points. (A basis point is 1/100 of a percentage point.)

The current environment is challenging. Growth prospects are unclear, the coronavirus outbreak is continuing to spread around the world and central banks could still change their monetary-policy approaches. We have seen several bouts of ambitious valuations hit the bond market as investors drove up prices and pushed yields further down. Portfolio decisions should be adapted actively in response to these difficult conditions.

Policy rates set by major central banks are at low or negative levels



Source: Refinitiv Datastream. Data as at 31 March 2020.

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Data as at 30 September 2019