The Scarcity of Safety

After an especially volatile first quarter and despite a sharp initial reaction from the surprising Brexit referendum, the stock market managed to grind higher for the first half of the year. The S&P 500 and Dow Jones Industrial Average eked out respective gains of 2.69% and 2.90%, while the NASDAQ Composite registered a decline of -3.29%.

As the dust settles in our post-Brexit world, interest rates around the globe are plunging to new record lows. The yield on the U.S. 10-year Treasury recently reached a new all-time low of 1.36% and the U.S. 30-year Treasury bond now offers an unprecedented low yield of just 2.2%. Indeed, the current dividend yield for the S&P 500 is now higher than the yield on the 30-year Treasury bond for the first time since the Great Recession and only the second time in history.

While such a dramatic decline in yield might be historically associated with hints of an imminent recession, the economic evidence points to the contrary. Recent key indicators such as ISM Services and ISM Manufacturing clearly signal economic expansion. ISM Services Index grew in June for the 77th consecutive month, while ISM Manufacturing Index expanded for the 4th consecutive month. In addition, the June employment report was surprisingly strong with 287,000 new jobs created in June and unemployment stable at 4.9%. Representing 70% of GDP, consumer spending should receive a boost from the twin tailwinds of low interest rates, especially from this fresh drop, and energy costs which, while higher than the recent February low, remain 30% lower than levels from a year ago. Additionally, the housing market remains quite strong and refinancing activity is picking up once again in light of the recent drop in mortgage rates. Those looking to the U.S. economy to help explain this historic drop in interest rates will need to search elsewhere.

With central banks around the world having manipulated interest rates so that an amazing $13 trillion of sovereign bonds now have negative yields, the culprit for the conundrum can be found in European and Japanese quantitative easing programs. Indeed, nearly 80% of Japanese and German government bonds have negative yields. In Switzerland, the longest dated 50-year government paper now yields less than zero; and the yield on twenty-year bonds in Japan is now negative for the first time in history. With the 10-year bond yield in Germany at -0.12% and -0.28% in Japan, 1.36% in the U.S. suddenly looks attractive.

In the flight to safety that ensued after the Brexit vote, record sums have piled into bonds, exacerbating the situation. In the latest week, the $470 million inflow into equity mutual funds pales in comparison to the $14.4 billion invested in fixed income mutual funds.

In the wake of plummeting global interest rates, any income-seeking individual or institution is forced to either settle for "losing money safely" or climb the ladder of risk. To this latter point, fund inflows are spiking for emerging market bond funds and most bond proxy alternatives such as utilities and REITs. And at least some of the recent rise in the stock market can be attributed to the lack of yield available in otherwise historically safe fixed income markets. Shyam Rajan, the head of U.S. rates strategy at Bank of America Merrill Lynch summed it up well: "The world is running out of positive-yielding safe-haven bonds". Markets across the globe are signaling their own form of SOS - Scarcity of Safety!

For pension funds and life insurance companies who have promised a fixed rate of return for pensioners and owners of various "guaranteed" products such as annuities, SOS is clearly a call of distress. For example, the average rate of return assumption used for public state and local retirement systems in the

U.S. is 7.62%. The simple facts show that no safe fixed income security can even come close to this assumed rate of return, leaving these retirement plans with a substantial shortfall to make up. Across the worldwide institutional entitlement spectrum, whether it be corporate or public pension fund, endowment fund for charitable organizations or insurance company, there is a growing mismatch between expected and actual rate of return, looming funding gaps, increased pursuit of riskier investments and a great need to scale back future investment return assumptions.

Perhaps the greatest ticking entitlement bomb lies in the unfunded U.S. Social Security and Medicare gap which is now estimated at $42 trillion. While there is only one party currently talking about Federal entitlement reform, the challenges to the system may prove an unavoidable issue for the next U.S. President, regardless of party, to ignore. Some combination of lower benefits for future retirees, lower cost of living adjustments for current retirees, increased retirement age and even the possibility of investing in riskier assets could help alleviate the problem or at least kick the proverbial can down the road.

In a world where there is such scarcity for safe yield, it is no wonder that global investors are flooding into U.S. Treasury debt. Indeed, a record 70% of volume for the U.S. Treasury's latest auction went to non-U.S. investors. The highest volume bids and the most dramatic shifts in prices for US Treasuries have all come during European and Asian trading hours, offering yet another glimpse into the global thirst for yield. In such a world, we take great comfort knowing that our stable of core high-quality growth companies offers not only a higher dividend yield than the yield on the 30-year Treasury bond but consistent growth of income to boot. Companies that can offer reliable growth of income just may be the scarcest of all investments today and this scarcity will continue to support our client portfolios well.

A case in point, the SEC recently revealed that the Swiss National Bank's U.S. equity portfolio had climbed to a record allocation of over $54 billion in the previous year. Within the portfolio of treasures which the Swiss bank places in reserve for currency operations, the SEC reported a preference for higher quality names, including built-up stakes in Johnson & Johnson, Apple, and Microsoft. For perspective on the scarcity of high quality stocks, the entire Dividend Aristocrats Index, a group of 50 blue-chips that have raised their dividends consistently for at least twenty five years, represents just 27% of the market capitalization of the gargantuan $13 trillion sovereign debt pile currently paying negative rates. As long as central banks continue to manipulate rates to low and negative levels, investors will continue to seek refuge in high quality stocks that raise their dividend each and every year.

While it may be difficult to imagine rates moving higher in the immediate future, it would be dangerously naïve to believe that low/negative rates have been somehow ordained as permanent. What could go wrong? For starters, the ECB and Japanese Central Bank may decide to move policy back to neutral or zero percent rates, marking an important shift in sentiment as central banks realize the pitfalls of negative rates. In addition, it is very possible that the Federal Reserve decides to use its bully pulpit to jawbone rates higher with threatening language that warns of potential hikes in the coming quarters. Unexpectedly higher rates in the U.S. accompanied by a stronger dollar would cause ripple effects throughout the already fragile system. With current readings of 2% for CPI, inflation is hardly dead and could force a change in Federal Reserve strategy at any moment. It is estimated that for every 1% move higher in rates, investors stand to lose as much as $1 trillion in bond market losses. In this worldwide chase for yield, investors seem to have forgotten about potential risks. Let's hope that the bond markets don't end up exchanging one SOS call for the other.