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Daily Observations

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Central Banks Are Paying Investors to Lock In the Huge Spread Between Cash Flows and Bond Yields

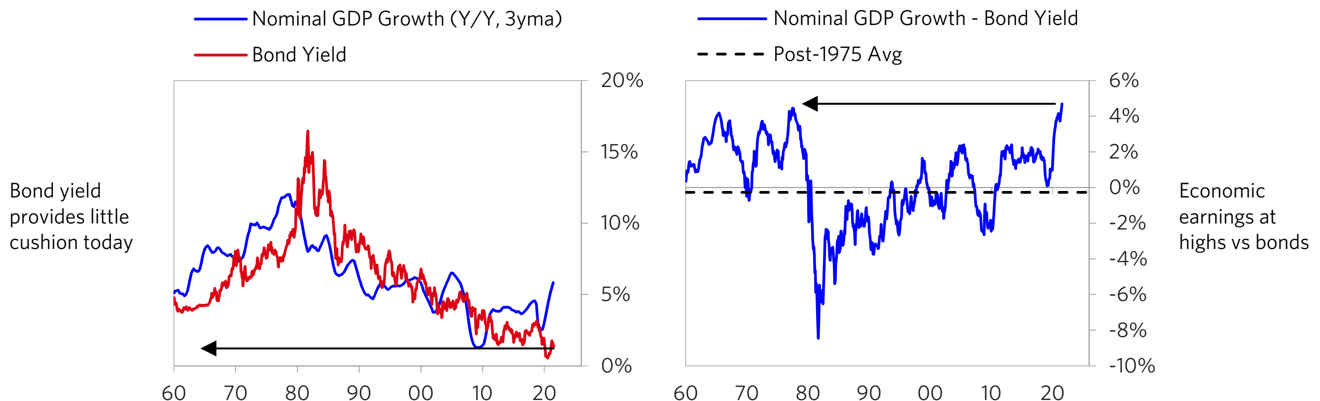
Bond shorts are likely to be diversifying in an MP3 world.

The gap between the bond yield and what can be earned, on average, by participating in economic activity (i.e., nominal GDP growth) is at its widest since the early 1950s. This is being engineered by central banks to achieve adequate economic outcomes while allowing the private sector to deleverage. The implication for investors is that they are getting paid by policy makers to earn these cash flows if they can. There are two legs to the trade. Harvesting cash flows (i.e., running a business or owning stocks) is obviously not risk-free. Changes in profitability, taxes, regulations, and how much capex you have to do to grow revenues all need to be accounted for. The amount you pay for the business or equity also matters, and the average spread to bond yields is wide, but not quite as wide as the gap between nominal GDP growth and yields. This is the hard part. The other leg of the trade is locking in the spread by shorting bonds. And here the skew/risk and reward look very different relative to history. Yields can still fall if the economy is weak, but the downside of being short bonds (or the benefit of being long) is capped by the low yield and by the fact that policy makers now have other tools to ease in order to support cash flows. The main risk facing investors today is a rise in inflation, as there is no easy policy response. The bond short ensures that cash flows are protected from rising inflation and a possible tightening cycle. By shorting bonds, investors can lock in the spread that is likely to narrow if policy makers are forced to pull liquidity to fight inflation, or if more investors move from bonds to equities.

For most of the last century, the reverse was true: being long bonds provided diversification to anyone exposed to growth-sensitive cash flows. Owning bonds provided a hedge to economic shocks and recessions because lowering rates was the primary tool used. Periods where holding bonds was harmful tended to be brief, as too much tightening led to weaker conditions and a reversal of policy. The most painful episodes occurred when inflation was high enough that a more significant tightening had to be sustained. But it has been many decades since investors would have been meaningfully hurt in this way by owning bonds.

The first charts below illustrate how wide the gap between nominal growth and bond yields currently stands. The gap is at its widest since the 1950s. They also show that yields today are likely to provide less of a cushion to recessions than ever.

USA Nominal GDP Growth vs Bond Yield



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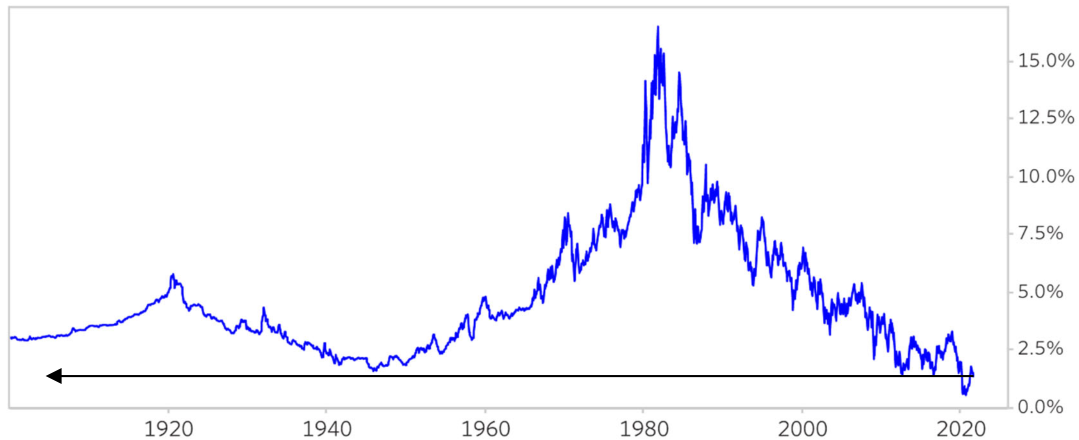
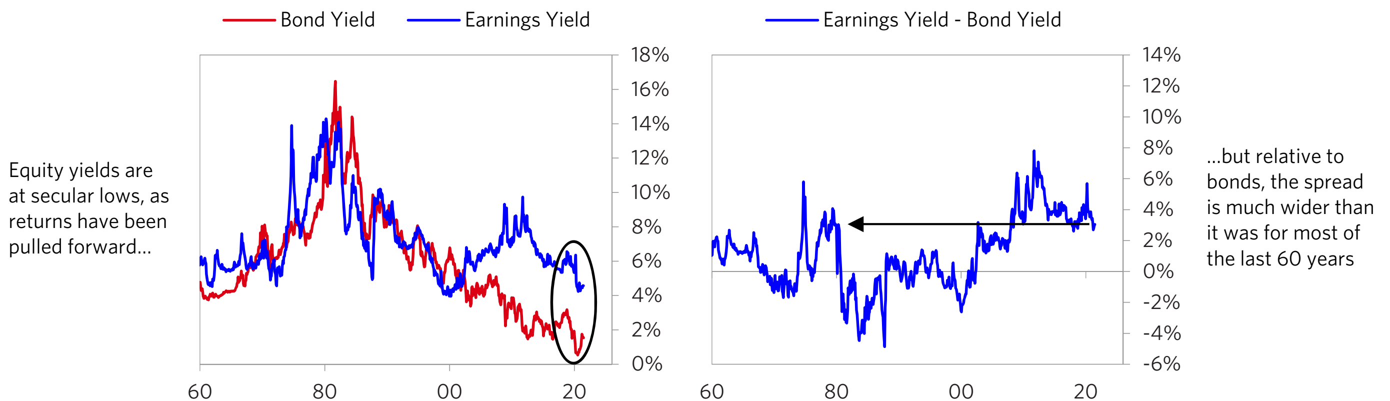
While rates gradually fell in the 1930s, were pegged at low levels during World War II, and took time to rise after that, it is useful to keep the perspective that rates today are quite a bit lower than they were in the 1930s, 1940s, and 1950s. Rates will provide a much smaller cushion to being long equities in the next downturn while offering a bigger hedge for when central banks pull back on liquidity.

USA Nominal Bond Yield

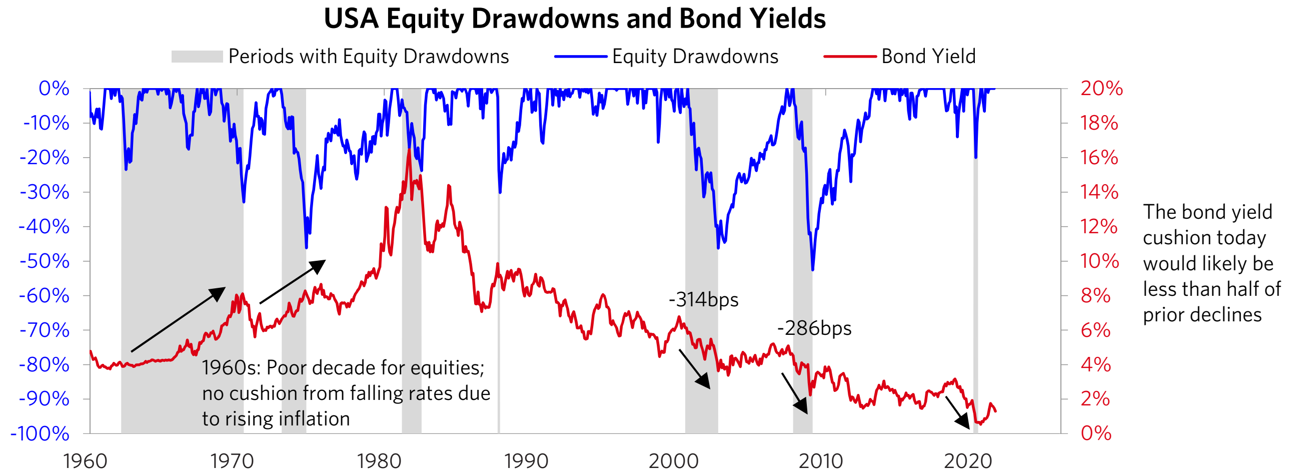


Nominal GDP is a proxy for what revenues can be earned in the real economy, while the earnings yield in equities represents a similar proxy for investing in stocks. Like nominal GDP growth, the earnings yield today is near secular lows (i.e., equity multiples are high), but yields are not low relative to bonds. If one can earn the yield (e.g., buy equities that don't experience margin contraction), the spread to bonds and the expected risk relative to return is actually quite a bit higher than the average in recent decades. In other words, equity returns may be low in absolute terms, but they are likely better than owning bonds. As noted above, we think this gap is likely to narrow (either by rates rising or by money moving out the risk curve and pushing yields down). And investors may get more protection from a tightening cycle and rising inflation by shorting bonds than they would from a recession by being long bonds.

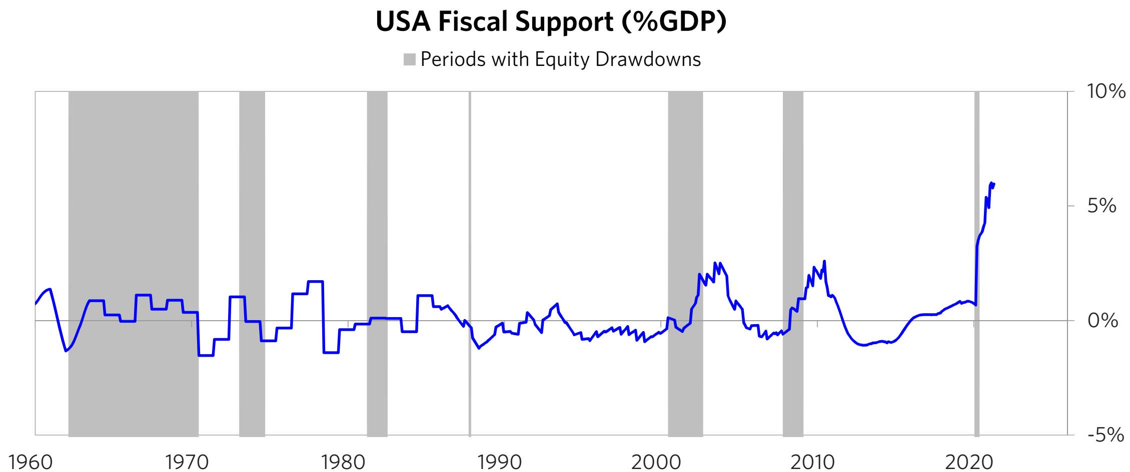
USA Bond Yield vs Earnings Yield



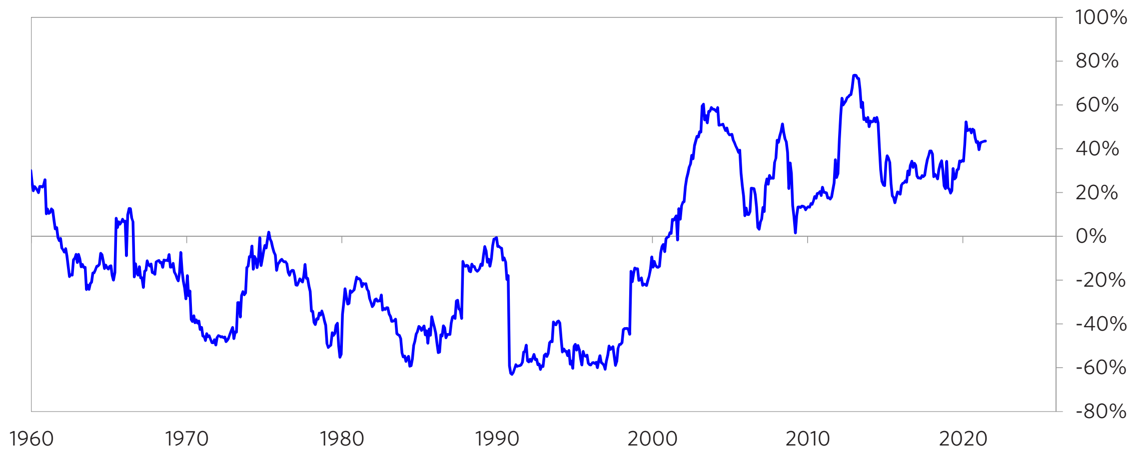
Since 1900, bonds have provided an important cushion to equities during big equity sell-offs. The yield decline not only helped to create an economic bottom, but it also supported equities through the discount rate. This support is likely to be much smaller going forward. Additionally, big bond sell-offs due to rising inflation or a tightening are obviously not positive for equities and are likely to be a more material risk going forward.



Fiscal policy has also played a much smaller role in prior downturns, and this is true even if you include the 1930s. Today, fiscal policy is a much more important tool in dealing with economic downturns. The cushion is likely to be targeted more directly at the economy. By preventing low yields from causing inadequate easings, fiscal policy (and QE) still provides some cushion to equity holders.

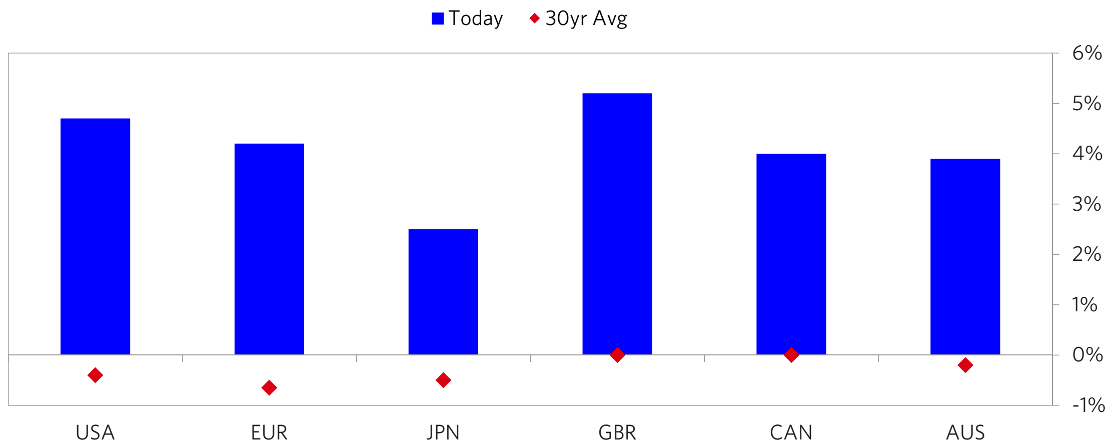


The correlation between bond yields and equities mostly stems from whether changes in growth, inflation, discount rates, and risk premiums are the main drivers of market action. The flip in correlation over the last 20 years from mostly negative to positive has come, in large part, because inflation has been stable and swings in growth have been the main driver. Prior to 2000, strong growth rates often led to expectations of preemptive tightening, leading to lower equity prices. As we look ahead, a short bond position would help in cases where the positive correlation actually matters (e.g., a material rise in discounted inflation, or a tightening cycle as MP3 reaches its limits).



Current Policy Intent and Pricing Are Similar Across the Developed World

While we see the risk of a rise in inflation and/or a tightening cycle being the largest in the US, the spread between bond pricing, economic conditions, and equity yields is similar in the rest of the developed world. If you can secure cash flows that are likely to grow in line with nominal GDP (once again, the harder part of the trade) and short bonds, the spread is wide. And the short hedges against the main risk of higher inflation and/or tightening. Likewise, the pricing of equities versus bonds is wide relative to history, but not quite as wide as the spread for bonds and nominal GDP growth.



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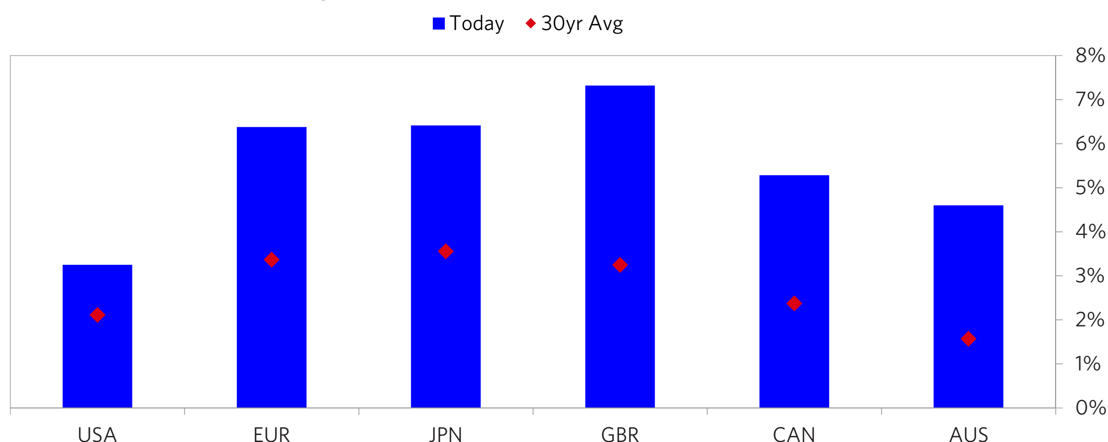

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