

# Converging on zero



# Converging on zero



## FED POLICY SHIFT REINFORCES OUR PREFERENCE FOR INCOME GENERATION AND INFLATION PROTECTION STRATEGIES

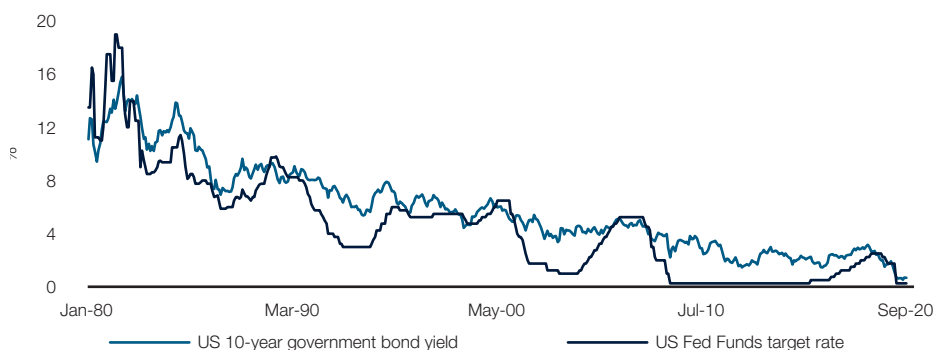
In August, the Fed confirmed its intention to do everything it can to support the US economy and push inflation higher by shifting its policy goals towards achieving an average 2% inflation target over the medium term. While Chair Powell did not specify how the Fed plans to achieve this, it will likely lead to downward pressure on all, not just government, bond yields towards 0%.

The global response to any significant economic slowdown since the 1980s has been to reduce the economy's funding costs. Initially this meant cutting interest rates sharply, but as interest rates approached zero, other measures were pursued. During the Global Financial Crisis, this involved quantitative easing, whereby the Fed printed money to buy US government bonds. In the recent crisis, the Fed has extended this to corporate bonds, not just those issued by highly rated, 'strong' companies, but also those with lesser ability to service their debt. Yields, as a result, have fallen sharply.

*Rising debt levels have gone hand in hand with lower interest rates and bond yields. The key question for investors is what is going to change this relationship in the coming months, and potentially years*

**Fig. 1 Anybody seen a trend around here?**

US 10y government bond yield and the Fed Funds target rate



Source: Thomson Reuters, Standard Chartered

These moves have arguably led to a vicious circle. Lower funding costs and economic stress, when combined, have increased the incentive for companies to borrow more to bolster near-term cash flows and ensure their short-term survival. Meanwhile, governments borrow more to fund tax relief and spending programmes.

Unless this debt is paid down when the economy is strong, this potentially makes the economy more sensitive to any rise in interest rates and bond yields, which increases the incentive for central banks to keep funding costs low (the alternative, of course, is to let the economy weaken significantly).

## UNINTENDED CONSEQUENCES

This vicious circle has potentially huge implications on how we invest. Historically, for income-seeking investors, it was conventional wisdom that one should increase the allocation to low-risk government bonds as you get older. When US government bonds offered a yield of 4-5%, this made sense as it would provide sufficient income at limited risk.

However, government bond yields around the world have fallen dramatically over the past 40 years. While this has generated very strong returns, the low yields are detrimental to income and returns one can expect from investing in bonds, going forward.

Falling bond yields have also had a knock-on impact on other asset classes, such as real estate and equities. While some investors have been confused by the recent strong performance of equities in the face of economic fragility, the strongest areas of the market have typically been those companies with strongest long-term growth outlooks.

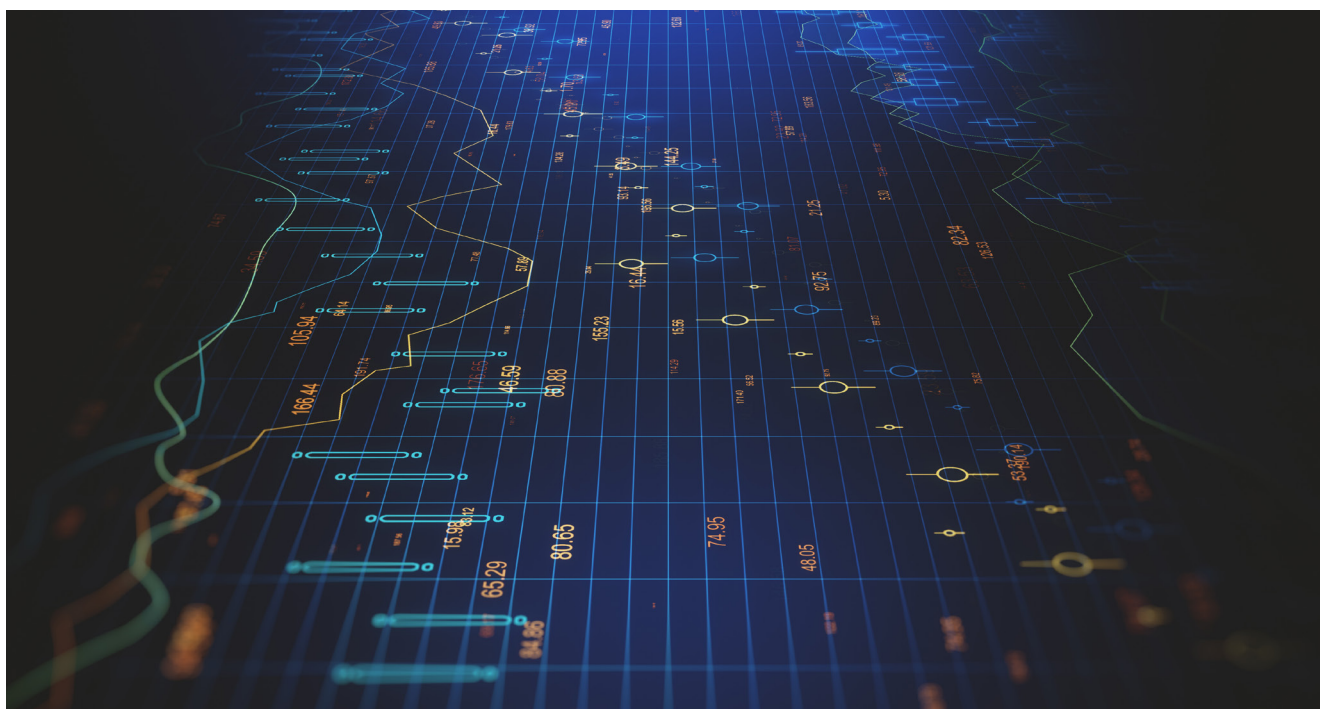
The outperformance of growth areas of the market can be at least partly explained by the fact that ultra-low interest rates mean equity investors can justify high valuations for these companies. To arrive at stock valuations, analysts take their expectations for future profits and then discount these using a discount rate, which is based on a measure of long-term interest rates. As interest rate expectations fall, this reduces the impact of this discounting, raising potential valuations even if the earnings outlook has not changed.

## WHAT DOES THIS MEAN FOR INVESTORS?

Against this backdrop, how do we assess the future implications of low rates? Many investors highlight that major asset classes, on traditional metrics, are overvalued and that focusing on relative valuations – for instance equities looking cheap relative to expensive bonds – is a recipe for disaster.

What are our alternatives as investors? In reality, the 2 obvious alternatives are pretty unpalatable: 1) spend all your money (ie. not save for retirement) or 2) keep it on deposit, which is an almost sure way to lose its real value (relative to things you may want to purchase in the future), given inflation is, in most economies, above the deposit rate.

Perhaps a better way of looking at the current predicament is to ask what is going to change. Are authorities likely to throw in the towel, let the economy weaken sharply and allow a default cycle to develop? Or is inflation going to rise sharply, requiring a significant tightening of policy? Of course, neither can be totally ruled out, but they do not appear likely, at least in the coming 12-18 months.



The Fed's latest policy pivot towards targeting an average 2% inflation rate over an extended period suggests that the US central bank is highly unlikely to throw in the towel. This is also true elsewhere in the world. Indeed, we are heading in the opposite direction of attempting to reflate the economy further to generate higher inflation over the medium term. That said, we believe inflation will take some time to rise given the huge excess capacity created by the COVID-19 crisis.

There is also the added dynamic that additional fiscal stimulus, which looks increasingly likely (at least) in the US, could encourage central banks to double down on simultaneous monetary stimulus to ensure that bond yields remain capped and secure a rise in inflation. This is the first time, at least in the Developed world, that additional fiscal stimulus could actually encourage (rather than discourage) monetary stimulus.

## RECIPE FOR HIGHER VALUATIONS

This interpretation suggests that asset valuations may get more expensive – higher-yielding corporate bond yields falling further and equity P/E ratios rising higher. While this would

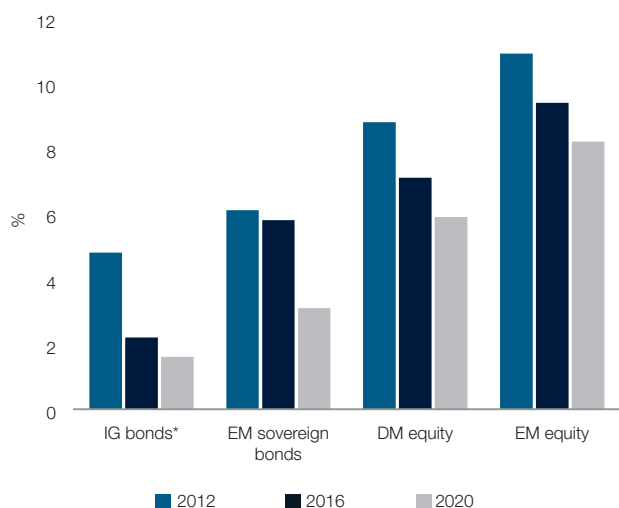
further reduce the forward-looking long-term return on assets (a trend that has been in play for several years – see Fig. 2), it suggests that these returns may be ‘front-loaded’ as has been the case in recent years (see Fig. 3). In turn, this means investors have to trade-off 1) being patient and waiting for cheaper valuations and 2) acknowledge the risk that this may not happen for the foreseeable future and, in the meantime, they miss out on attractive returns.

The reality is nobody knows exactly what the future has in store for us and therefore the ideal investing style is to try to prepare for different potential scenarios. Therefore, a prudent investor would still hold some high-grade bonds, despite their very low yields, in case the economy does falter in a meaningful way.

However, the Fed's policy shift increases the probability of inflation rising in the coming years. Therefore, increasing your allocation to assets that protect you against a modest rise in inflation probably makes sense. Such assets would include equities, assets with yields significantly above the level of inflation – for instance high yielding bonds – and income-generating assets which are inflation-protected.

**Fig. 2 Forward-looking returns are falling...**

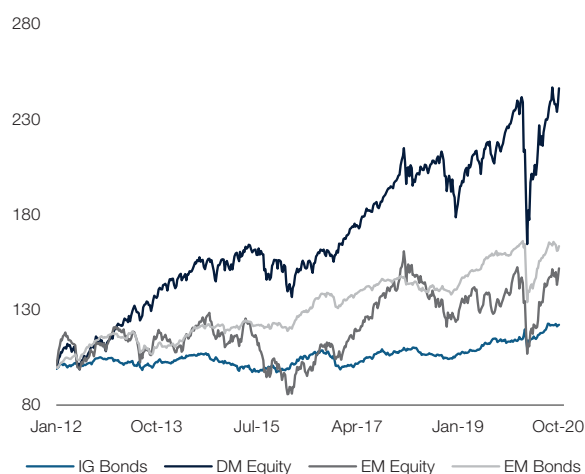
Potential seven-year forward-looking geometric returns for different asset classes



Source: Mercer, Standard Chartered

**Fig. 3 ...on the back of the front-loading of returns in recent years**

Cumulative performance for different asset classes; indexed to 100 as of January 2012



Source: Bloomberg, Standard Chartered  
Indices used: FTSE Non-Mortgage-backed Security World Big, JP Morgan EMBI Global Diversified Composite, MSCI World Net Total Return, MSCI Emerging Market Net Total Return



## Disclosures

This document is confidential and may also be privileged. If you are not the intended recipient, please destroy all copies and notify the sender immediately. This document is being distributed for general information only and is subject to the relevant disclaimers available at <https://www.sc.com/en/regulatory-disclosures/#market-commentary-disclaimer>. It is not and does not constitute research material, independent research, an offer, recommendation or solicitation to enter into any transaction or adopt any hedging, trading or investment strategy, in relation to any securities or other financial instruments. This document is for general evaluation only. It does not take into account the specific investment objectives, financial situation or particular needs of any particular person or class of persons and it has not been prepared for any particular person or class of persons. You should not rely on any contents of this document in making any investment decisions. Before making any investment, you should carefully read the relevant offering documents and seek independent legal, tax and regulatory advice. In particular, we recommend you to seek advice regarding the suitability of the investment product, taking into account your specific investment objectives, financial situation or particular needs, before you make a commitment to purchase the investment product. Opinions, projections and estimates are solely those of SCB at the date of this document and subject to change without notice. Past performance is not indicative of future results and no representation or warranty is made regarding future performance. Any forecast contained herein as to likely future movements in rates or prices or likely future events or occurrences constitutes an opinion only and is not indicative of actual future movements in rates or prices or actual future events or occurrences (as the case may be). This document must not be forwarded or otherwise made available to any other person without the express written consent of the Standard Chartered Group (as defined below). Standard Chartered Bank is incorporated in England with limited liability by Royal Charter 1853 Reference Number ZC18. The Principal Office of the Company is situated in England at 1 Basinghall Avenue, London, EC2V 5DD. Standard Chartered Bank is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority. Standard Chartered PLC, the ultimate parent company of Standard Chartered Bank, together with its subsidiaries and affiliates (including each branch or representative office), form the Standard Chartered Group. Standard Chartered Private Bank is the private banking division of Standard Chartered. Private banking activities may be carried out internationally by different legal entities and affiliates within the Standard Chartered Group (each an "SC Group Entity") according to local regulatory requirements. Not all products and services are provided by all branches, subsidiaries and affiliates within the Standard Chartered Group. Some of the SC Group Entities only act as representatives of Standard Chartered Private Bank, and may not be able to offer products and services, or offer advice to clients. They serve as points of contact only. ESG data has been provided by Refinitiv. Refer to <https://www.refinitiv.com/en/financial-data/company-data/esg-research-data>.

### Market Abuse Regulation (MAR) Disclaimer

Banking activities may be carried out internationally by different branches, subsidiaries and affiliates within the Standard Chartered Group according to local regulatory requirements. Opinions may contain outright "buy", "sell", "hold" or other opinions. The time horizon of this opinion is dependent on prevailing market conditions and there is no planned frequency for updates to the opinion. This opinion is not independent of Standard Chartered Group's trading strategies or positions. Standard Chartered Group and/or its affiliates or its respective officers, directors, employee benefit programmes or employees, including persons involved in the preparation or issuance of this document may at any time, to the extent permitted by applicable law and/or regulation, be long or short any securities or financial instruments referred to in this document or have material interest in any such securities or related investments. Therefore, it is possible, and you should assume, that Standard Chartered Group has a material interest in one or more of the financial instruments mentioned herein. Please refer to <https://www.sc.com/en/banking-services/market-disclaimer.html> for more detailed disclosures, including past opinions/recommendations in the last 12 months and conflict of interests, as well as disclaimers. A covering strategist may have a financial interest in the debt or equity securities of this company/issuer. This document must not be forwarded or otherwise made available to any other person without the express written consent of Standard Chartered Group.

### Country/Market Specific Disclosures

**Botswana:** This document is being distributed in Botswana by, and is attributable to, Standard Chartered Bank Botswana Limited which is a financial institution licensed under the Section 6 of the Banking Act CAP 46:04 and is listed in the Botswana Stock Exchange.

**Brunei Darussalam:** This document is being distributed in Brunei Darussalam by, and is attributable to, Standard Chartered Bank (Brunei Branch) | Registration Number RFC/61. Standard Chartered Bank is incorporated in England with limited liability by Royal Charter 1853 Reference Number ZC18 and Standard Chartered Securities (B) Sdn Bhd, which is a limited liability company registered with the Registry of Companies with Registration Number RC20001003 and licensed by Autoriti Monetari Brunei Darussalam as a Capital Markets Service License Holder with License Number AMBD/R/CMU/S3-CL.

**China Mainland:** This document is being distributed in China by, and is attributable to, Standard Chartered Bank (China) Limited which is mainly regulated by China Banking and Insurance Regulatory Commission (CBIRC), State Administration of Foreign Exchange (SAFE), and People's Bank of China (PBOC).

**Hong Kong:** In Hong Kong, this document, except for any portion advising on or facilitating any decision on futures contracts trading, is distributed by Standard Chartered Bank (Hong Kong) Limited ("SCBHK"), a subsidiary of Standard Chartered PLC. SCBHK has its registered address at 32/F, Standard Chartered Bank Building, 4-4A Des Voeux Road Central, Hong Kong and is regulated by the Hong Kong Monetary Authority and registered with the Securities and Futures Commission ("SFC") to carry on Type 1 (dealing in securities), Type 4 (advising on securities), Type 6 (advising on corporate finance) and Type 9 (asset management) regulated activity under the Securities and Futures Ordinance (Cap. 571) ("SFO") (CE No. AJ1614). The contents of this document have not been reviewed by any regulatory authority in Hong Kong and you are advised to exercise caution in relation to any offer set out herein. If you are in doubt about any of the contents of this document, you should obtain independent professional advice. Any product named herein may not be offered or sold in Hong Kong by means of any document at any time other than to "professional investors" as defined in the SFO and any rules made under that ordinance. In addition, this document may not be issued or possessed for the purposes of issue, whether in Hong Kong or elsewhere, and any interests may not be disposed of, to any person unless such person is outside Hong Kong or is a "professional investor" as defined in the SFO and any rules made under that ordinance, or as otherwise may be permitted by that ordinance. In Hong Kong, Standard Chartered Private Bank is the private banking division of Standard Chartered Bank (Hong Kong) Limited.

**Ghana:** Standard Chartered Bank Ghana Limited accepts no liability and will not be liable for any loss or damage arising directly or indirectly (including special, incidental or consequential loss or damage) from your use of these documents. Past performance is not indicative of future results and no representation or warranty is made regarding future performance. You should seek advice from a financial adviser on the suitability of an investment for you, taking into account these factors before making a commitment to invest in an investment. To unsubscribe from receiving further updates, please click [here](#). Please do not reply to this email. Call our Priority Banking on 0302610750 for any questions or service queries. You are advised not to send any confidential and/or important information to the Bank via e-mail, as the Bank makes no representations or warranties as to the security or accuracy of any information transmitted via e-mail. The Bank shall not be responsible for any loss or damage suffered by you arising from your decision to use e-mail to communicate with the Bank.

**India:** This document is being distributed in India by Standard Chartered Bank in its capacity as a distributor of mutual funds and referrer of any other third party financial products. Standard Chartered Bank does not offer any 'Investment Advice' as defined in the Securities and Exchange Board of India (Investment Advisers) Regulations, 2013 or otherwise. Services/products related securities business offered by Standard Chartered Bank are not intended for any person, who is a resident of any jurisdiction, the laws of which imposes prohibition on soliciting the securities business in that jurisdiction without going through the registration requirements and/or prohibit the use of any information contained in this document.

**Indonesia:** This document is being distributed in Indonesia by Standard Chartered Bank, Indonesia branch, which is a financial institution licensed, registered and supervised by Otoritas Jasa Keuangan (Financial Service Authority).

**Jersey:** The Jersey Branch of Standard Chartered Bank is regulated by the Jersey Financial Services Commission. Copies of the latest audited accounts of Standard Chartered Bank are available from its principal place of business in Jersey: PO Box 80, 15 Castle Street, St Helier, Jersey JE4 8PT. Standard Chartered Bank is incorporated in England with limited liability by Royal Charter in 1853 Reference Number ZC 18. The Principal Office of the Company is situated in England at 1 Basinghall Avenue, London, EC2V 5DD. Standard Chartered Bank is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority. The Jersey Branch of Standard Chartered Bank is also an authorised financial services provider under license number 44946 issued by the Financial Sector Conduct Authority of the Republic of South Africa. Jersey is not part of the United Kingdom and all business transacted with Standard

Chartered Bank, Jersey Branch and other SC Group Entity outside of the United Kingdom, are not subject to some or any of the investor protection and compensation schemes available under United Kingdom law.

**Kenya:** This document is being distributed in Kenya by, and is attributable to Standard Chartered Bank Kenya Limited. Investment Products and Services are distributed by Standard Chartered Investment Services Limited, a wholly owned subsidiary of Standard Chartered Bank Kenya Limited (Standard Chartered Bank/ the Bank) that is licensed by the Capital Markets Authority as a Fund Manager. Standard Chartered Bank Kenya Limited is regulated by the Central Bank of Kenya.

**Malaysia:** This document is being distributed in Malaysia by Standard Chartered Bank Malaysia Berhad. Recipients in Malaysia should contact Standard Chartered Bank Malaysia Berhad in relation to any matters arising from, or in connection with, this document.

**Nigeria:** This document is being distributed in Nigeria by Standard Chartered Bank Nigeria Limited, a bank duly licensed and regulated by the Central Bank of Nigeria.

**Pakistan:** This document is being distributed in Pakistan by, and attributable to Standard Chartered Bank (Pakistan) Limited having its registered office at PO Box 5556, I.I Chundrigar Road Karachi, which is a banking company registered with State Bank of Pakistan under Banking Companies Ordinance 1962 and is also having licensed issued by Securities & Exchange Commission of Pakistan for Security Advisors. Standard Chartered Bank (Pakistan) Limited acts as a distributor of mutual funds and referrer of other third party financial products.

**Singapore:** This document is being distributed in Singapore by, and is attributable to, Standard Chartered Bank (Singapore) Limited (Registration No. 201224747C/ GST Group Registration No. MR-8500053-0, "SCBSL"). Recipients in Singapore should contact SCBSL in relation to any matters arising from, or in connection with, this document. SCBSL is an indirect wholly-owned subsidiary of Standard Chartered Bank and is licensed to conduct banking business in Singapore under the Singapore Banking Act, Chapter 19. Standard Chartered Private Bank is the private banking division of SCBSL. IN RELATION TO ANY SECURITY OR SECURITIES-BASED DERIVATIVES CONTRACT REFERRED TO IN THIS DOCUMENT, THIS DOCUMENT, TOGETHER WITH THE ISSUER DOCUMENTATION, SHALL BE DEEMED AN INFORMATION MEMORANDUM (AS DEFINED IN SECTION 275 OF THE SECURITIES AND FUTURES ACT, CHAPTER 289 ("SFA")). THIS DOCUMENT IS INTENDED FOR DISTRIBUTION TO ACCREDITED INVESTORS, AS DEFINED IN SECTION 4A(1)(a) OF THE SFA, OR ON THE BASIS THAT THE SECURITY OR SECURITIES-BASED DERIVATIVES CONTRACT MAY ONLY BE ACQUIRED AT A CONSIDERATION OF NOT LESS THAN S\$200,000 (OR ITS EQUIVALENT IN A FOREIGN CURRENCY) FOR EACH TRANSACTION. Further, in relation to any security or securities-based derivatives contract, neither this document nor the Issuer Documentation has been registered as a prospectus with the Monetary Authority of Singapore under the SFA. Accordingly, this document and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the product may not be circulated or distributed, nor may the product be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons other than a relevant person pursuant to section 275(1) of the SFA, or any person pursuant to section 275(1A) of the SFA, and in accordance with the conditions specified in section 275 of the SFA, or pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. In relation to any collective investment schemes referred to in this document, this document is for general information purposes only and is not an offering document or prospectus (as defined in the SFA). This document is not, nor is it intended to be (i) an offer or solicitation of an offer to buy or sell any capital markets product; or (ii) an advertisement of an offer or intended offer of any capital markets product. **Deposit Insurance Scheme:** Singapore dollar deposits of non-bank depositors are insured by the Singapore Deposit Insurance Corporation, for up to S\$75,000 in aggregate per depositor per Scheme member by law. Foreign currency deposits, dual currency investments, structured deposits and other investment products are not insured.

**Taiwan:** Standard Chartered Bank ("SCB") or Standard Chartered Bank (Taiwan) Limited ("SCB (Taiwan)") may be involved in the financial instruments contained herein or other related financial instruments. The author of this document may have discussed the information contained herein with other employees or agents of SCB or SCB (Taiwan). The author and the above-mentioned employees of SCB or SCB (Taiwan) may have taken related actions in respect of the information involved (including communication with customers of SCB or SCB (Taiwan) as to the information contained herein). The opinions contained in this document may change, or differ from the opinions of employees of SCB or SCB (Taiwan). SCB and SCB (Taiwan) will not provide any notice of any changes to or differences between the above-mentioned opinions. This document may cover companies with which SCB or SCB (Taiwan) seeks to do business at times and issuers of financial instruments. Therefore, investors should understand that the information contained herein may serve as specific purposes as a result of conflict of interests of SCB or SCB (Taiwan). SCB, SCB (Taiwan), the employees (including those who have discussions with the author) or customers of SCB or SCB (Taiwan) may have an interest in the products, related financial instruments or related derivative financial products contained herein; invest in those products at various prices and on different market conditions; have different or conflicting interests in those products. The potential impacts include market makers' related activities, such as dealing, investment, acting as agents, or performing financial or consulting services in relation to any of the products referred to in this document.

**UAE:** DIFC - Standard Chartered Bank is incorporated in England with limited liability by Royal Charter 1853 Reference Number ZC18. The Principal Office of the Company is situated in England at 1 Basinghall Avenue, London, EC2V 5DD. Standard Chartered Bank is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority. Standard Chartered Bank, Dubai International Financial Centre having its offices at Dubai International Financial Centre, Building 1, Gate Precinct, P.O. Box 999, Dubai, UAE is a branch of Standard Chartered Bank and is regulated by the Dubai Financial Services Authority ("DFSA"). This document is intended for use only by Professional Clients and is not directed at Retail Clients as defined by the DFSA Rulebook. In the DIFC we are authorised to provide financial services only to clients who qualify as Professional Clients and Market Counterparties and not to Retail Clients. As a Professional Client you will not be given the higher retail client protection and compensation rights and if you use your right to be classified as a Retail Client we will be unable to provide financial services and products to you as we do not hold the required license to undertake such activities. For Islamic transactions, we are acting under the supervision of our Shariah Supervisory Committee. Relevant information on our Shariah Supervisory Committee is currently available on the Standard Chartered Bank website in the Islamic banking section at: <https://www.sc.com/en/banking/islamic-banking/islamic-banking-disclaimers/>

**UAE:** For residents of the UAE – Standard Chartered Bank UAE does not provide financial analysis or consultation services in or into the UAE within the meaning of UAE Securities and Commodities Authority Decision No. 48/r of 2008 concerning financial consultation and financial analysis.

**Uganda:** Our Investment products and services are distributed by Standard Chartered Bank Uganda Limited, which is licensed by the Capital Markets Authority as an investment adviser.

**United Kingdom:** Standard Chartered Bank (trading as Standard Chartered Private Bank) is an authorised financial services provider (license number 45747) in terms of the South African Financial Advisory and Intermediary Services Act, 2002.

**Vietnam:** This document is being distributed in Vietnam by, and is attributable to, Standard Chartered Bank (Vietnam) Limited which is mainly regulated by State Bank of Vietnam (SBV). Recipients in Vietnam should contact Standard Chartered Bank (Vietnam) Limited for any queries regarding any content of this document.

**Zambia:** This document is distributed by Standard Chartered Bank Zambia Plc, a company incorporated in Zambia and registered as a commercial bank and licensed by the Bank of Zambia under the Banking and Financial Services Act Chapter 387 of the Laws of Zambia.

Here for good