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THE DEMAND FOR SAFE ASSETS: A HIGH REGIME'S HOLD ON REAL RATES

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Executive Summary

- *Nominal and real sovereign yields, especially developed market yields, have structurally compressed*
- *All else equal, neutral rates should reflect trends in labor force and productivity growth*
- *Persistent deviations therein may reflect trends in investor demand for "safe" assets*
- *We quantify the statistical effects of investor demand for safe assets on real US neutral rates, proxied by the real 1-year Treasury yield*
- *We weigh the likelihood of medium-term persistence of high investor demand for safe assets*

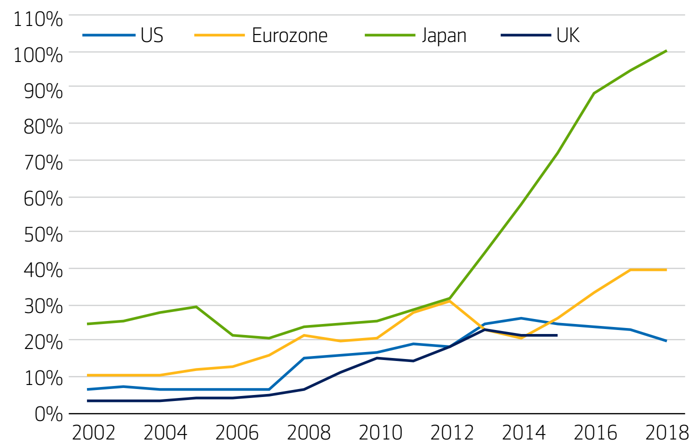
US Treasury yields have been on a multi-decade decline, and have shown little signs of reversal. The yield curve—which factors in potential output and inflation—has inverted and prospects for medium-term economic growth remain tepid due to a declining rate of population growth and modest productivity gains. The great moderation ushered in by the Fed likely has had an impact on nominal yields as inflation has been successfully anchored, but real yields have followed a similar trajectory, and so have shorter-term Treasury yields.

Hypotheses abound as to the sustained decline in yields. Ben Bernanke has discussed a savings surplus, a world awash in liquidity, including the flow of capital from emerging economies to the US and developed markets. Larry Summers has revived the secular stagnation theory, which would imply a lower natural rate of interest, the rate that neither cools nor heats up the economy.

In practical terms, various factors have exacerbated the persistent decline in yields, especially following the global financial crisis. Beyond foreign private and official demand for US Treasurys, the Fed has likely had an outsized influence on US yields through its quantitative easing programs. Additionally, the growth of pension funds, and their need to hedge against riskier investments undertaken to repair balance sheets post-crisis, have incrementally pressured yields lower.

Enter the "safe" asset.* The National Bureau of Economic Research defines a safe asset as "an asset that is almost always valued at face value without expensive or prolonged analysis."[1] New regulations such as Dodd Frank and Basel III have increased liquidity and capital requirements, in effect prompting banks to bolster their balance sheets by holding larger amounts of safe assets. For instance, Dodd Frank requires systemically important financial institutions—those whose failure may trigger a financial crisis—to maintain at least a 4% tier one capital to risk-weighted assets ratio, an 8% ratio or higher for regulatory capital to risk-weighted assets, and a leverage ratio, or regulatory capital to average total assets, of at least 4%; levels that the largest financial institutions did not meet pre-crisis. Basel III is the international regulatory framework for banks. It requires banks to hold at least as much high quality liquid assets as it does outgoing capital for the next 30 days.

Exhibit 1: Central bank balance sheet as a percentage of GDP



Source: Bloomberg. As of December 31, 2018.

We have written at length about various factors behind the secular decline in yields, namely those impacting future short-term rates, expected inflation and the term premium. Our focus will be a bit more myopic. Within the framework of a neutral rate of interest proxied as the summation of labor force growth, labor force participation growth and the demand for safe assets, we will attempt to quantify the effect that the demand these assets has on real short-term interest rates.

The economic grounding of such an approach is simple. All else equal, the real neutral rate should be determined by the drivers of potential output: labor force and productivity growth. Deviations from the balance of those effects may be explained by the demand for safe assets. A high demand for safe assets typically detracts from yields, so when there is a high demand for safe assets, real rates should be pressured lower. While the term premium has a theoretically similar premise, it is often associated with all the trappings of longer-dated Treasurys.

Furthermore, as the demand for safe assets ebbs and flows over time, we find it helpful to identify these persistent/prevailing states of high (negative) and low (positive) investor demand for safe assets, otherwise known as high regimes or low regimes. The definition of regime, for our purposes, is a prevailing state/system/paradigm. It is important to keep this in mind as we pry into its effect on real natural rates, proxied in this case by the 1-year Treasury yield deflated by the Dallas Fed's trimmed mean PCE. Using a two-state regime (when there are two regimes at any point in time, high or low) switching statistical process, and assuming similar volatility in both regimes, the results of the study, through first quarter 2019, as outlined below.

*All investments contain risk and may lose value.

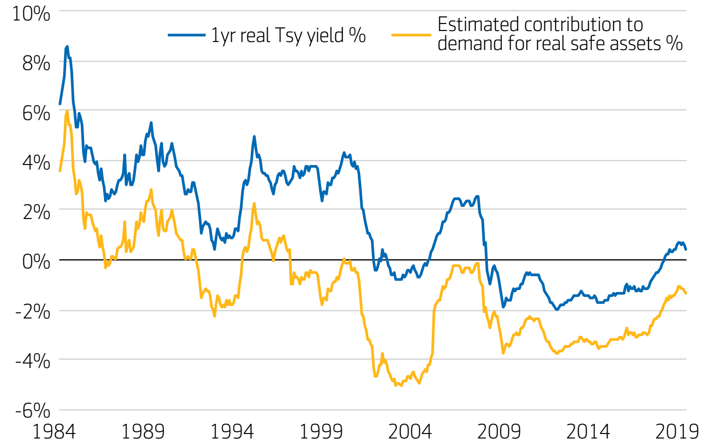
[1]Gorton, Gary B. "The History and Economics of Safe Assets." The National Bureau of Economic Research. April 2016.

The demand for safe assets is currently characterized by high investor demand which has served to depress the real natural rate, with a high probability of remaining in the current regime (high demand) high in the near-term. The trend mean is -292 basis points, implying that during this cycle, the demand for safe assets has on average extracted 292 basis points from the real natural rate of interest. Exhibit 2 displays the 1-year real Treasury yield in blue, and the estimated contribution of the demand for safe assets to said yield in orange, controlling for the effects of labor force and productivity growth. In practical terms, questions arise as to the likelihood of the demand for safe assets remaining high.

The Fed has signaled an early end to its quantitative tightening program, and near-term tightening prospects for central banks across developed markets are dim, so supply and demand factors do not suggest a pronounced reversal of the policies that encouraged the demand for safe assets. Absent material reversals on the regulatory front, systemically important banks both in the US and abroad are likely to remain partial to safe assets in order to adhere to Dodd Frank and Basel III standards.

Policy smoothing of private pension funds' discount rate may end in 2020, potentially lowering discount rates, marginally worsening funding ratios and increasing minimum contributions on the margin. The improved funded status following a multi-year market rally, the growth, and the push for matching liabilities of both public and private pension funds should be supportive of a broadly persistent demand for safe assets.

Exhibit 2: Natural rates and the demand for safe assets



Hypothetical example for illustrative purpose only.

Sources: Haver, R Core Team[1], Aegon Asset Management. As of March 31, 2019.

[1]R Foundation for Statistical Computing, Vienna, Austria.

Disclosure