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Don't let Lowe yields get you too down

27 September 2016 | [Jeffrey A. Johnson](#)[Print](#)[Share](#)

After 10 years stewarding the Reserve Bank of Australia through a tumultuous market and economic environment, marked by the GFC and Australia's economic rebalancing, Glenn Stevens has officially stepped down as Governor.

All eyes will be focused on his successor, Philip Lowe, who inherits a record-low 1.5% cash rate, down from 2% one year ago and more than 5% prior to the GFC.

How we got here is pretty well understood - weaker demand from Australia's major trading partners has contributed to lower commodity prices, slower domestic growth and inflation below the RBA's 2-3% target. On the bright side, a weakening of the currency, combined with low interest rates (which help drive house prices higher), has helped the economy remain resilient and rebalance.

As cash rates have fallen, so too have bond yields, punishing income-oriented bond investors, and also leading some to question the role of bonds in their portfolios. And in Australia, we are lucky (again the lucky country!) by comparison given *negative* yields in Japan and much of Europe.

I will leave it to Dr Lowe to prescribe monetary policy (hint: the market is pricing in some stability, with no anticipated moves over the next 6-12 months), but I would like to offer some perspective around how even at record low yields, bonds deserve your attention. And in some respects, low is a *good thing*!

Let me explain.

First, low yields on bonds need to be considered within the context of a low inflation environment. With inflation expected to hover at or below 2%, yields of a globally diversified portfolio of government and corporate bonds of between 2.5-3% should produce a positive, albeit small, inflation-adjusted return. Cash may struggle to do the same, and while dividend-paying equities may produce more income, they are also subject to much larger swings in price, particularly if the dividend comes under pressure.

Second, and as important when constructing portfolios, what gets us excited are asset classes that diversify one another. This chart measures the rolling 5-year correlation between equity markets and changes in bond yields for both Australian and US markets. What it shows, is that even in an environment of low yields and low cash rates, bonds have continued to exhibit *negative* correlation with equities, meaning that they have continued to provide a dampening effect for investors' portfolios.

Bonds remain an effective diversifier



Sources: Vanguard's calculations based on data from Bloomberg and Robert Shiller Online.

Australian equities are represented by the S&P/ASX Index. US equities are represented by the S&P 500 Index. Australian fixed interest (government) represented by Australian government bonds generic 10-year. US fixed interest (government) represented by the 10-year treasury constant maturity rate.

Notes: Data cover the period 06/1992 - 07/2016. All returns are total returns in their local currency. Past performance is not an indicator of future performance.

So even if the RBA keeps rates low as we expect, bonds can continue to play an important role in investor portfolios as a diversifier to more volatile equities.

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