THE OMNIVEST MARKET VIEW

Investments

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Yield Ratios Highlight Unusual Value

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Often times when benchmark yields are either very high or very low, looking at yield ratios helps to evaluate whether yield spreads are indeed wide or narrow. In the current environment, with Treasury benchmark yields at or near historical lows, we think it is useful to look at the yield ratio of corporate debt to Treasury debt in order to determine value in a low rate environment. It is likely that investors will be forced to live with low interest rates for beyond the foreseeable future as Fed Chairman Ben Bernanke recently made it clear that the Fed intends to keep fed funds rate at an unusually low level, well past the time when the economy is back on a sustainable growth path. As such, he is making the case for Treasury yields to remain range-bound through 2014/2015.

The yield ratio of the investment grade corporate market and the Treasury market is currently at 3.188. To put this in perspective, the only period when this ratio was greater than 3.188 was during the peak of the financial crisis in the fourth quarter of 2008 when the ratio hit a high of 4.83. In fact, from 1986 through the 3rd quarter of this year, this ratio has averaged 1.55 suggesting that corporate yields have further room to fall if Treasury yields remain range-bound.

The longer the Treasury yields remain range-bound, the more valuable corporate yields become. The Merrill Lynch Corporate Master Index currently yields 2.86% vs. the Merrill Lynch Treasury Master Index that yields only 0.90%. Assuming that Treasury yields remain relatively flat and the corporate/treasury yield ratio reverts to its mean (1.55 x), then it is reasonable to expect the yield of the corporate market to fall to 1.40%.

Given that the duration of the corporate market is 6.05 years, a drop in yields to 1.40% from 2.86% would produce an expected rate of return of 11.70% which is not materially different than the 10.98% that has been generated over the past 12 months. The major factor that will influence the expected rate of return is whether the Federal Reserve is truly committed to keeping the Fed Funds rate at or near 0% for a prolonged period of time. If so, then investors will have the confidence to continue to seek yield in lower rated asset classes.

As a point of reference, the yield on the 10-year Japanese government bond over the last 3 years has traded in a range of 0.73% to 1.41%. This has resulted in the yield of the Japanese government bond market trading in a range of 0.59% to 0.87% with the yield of the Japanese corporate bond market trading in a range of 0.64% to 0.99%. All of this has occurred as the Bank of Japan maintained its own version of a zero interest rate policy (ZIRP). While Treasury yields can remain low for a prolonged period of time producing low single digit returns, such an environment should increase the demand for higher yielding corporate debt, in turn raising the expected return profile of the corporate bond market potentially far in excess of its current yield to maturity.

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