What's up with the term premium?

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Overview of presentation

What is the term premium (risk premium)?

What influences the term premium?

Are bond yields appropriate now?

What is the term premium?

Bond yield component not due to expected interest rates
(unobserved, so necessarily a model estimate)

Simple algebra: observed yield curve (**R data**) components:

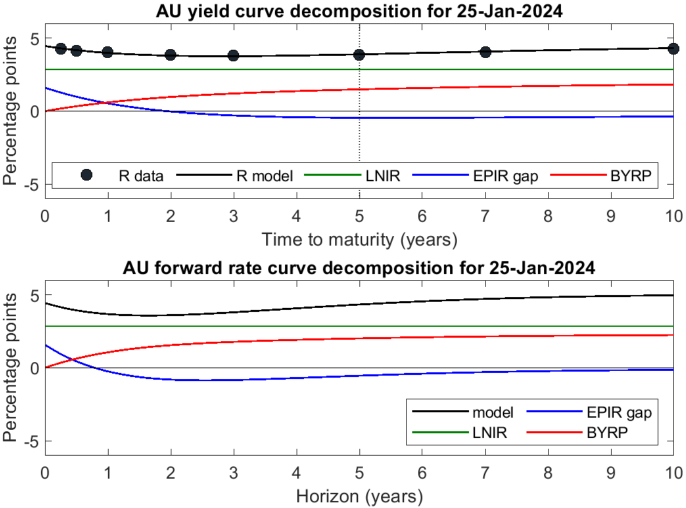
- Expected Policy Interest Rate (**EPIR**)
- Bond Yield Risk Premium (**BYRP**)
- negligible residuals, i.e. **R model** $\simeq$ **R data**, so ...

R data = EPIR + BYRP

Useful to express with **EPIR gap = EPIR – LNIR**
Long-horizon Natural Interest Rate $\simeq$ nominal GDP growth

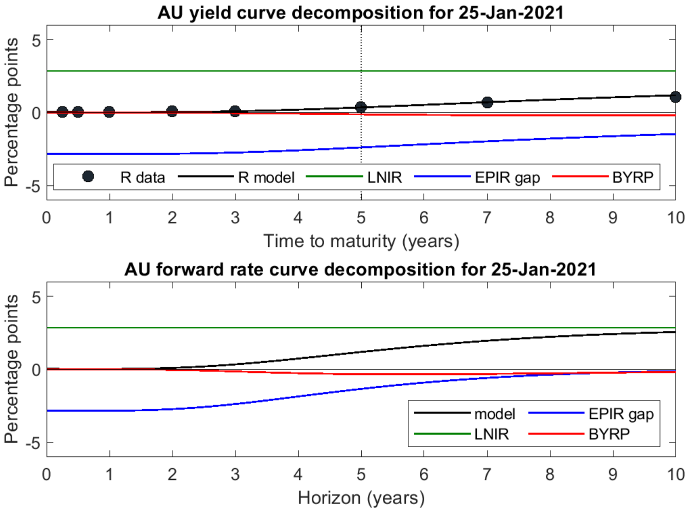
R data = LNIR + EPIR gap + BYRP

Example: AU yield curve recently ("tight" -> "easier")



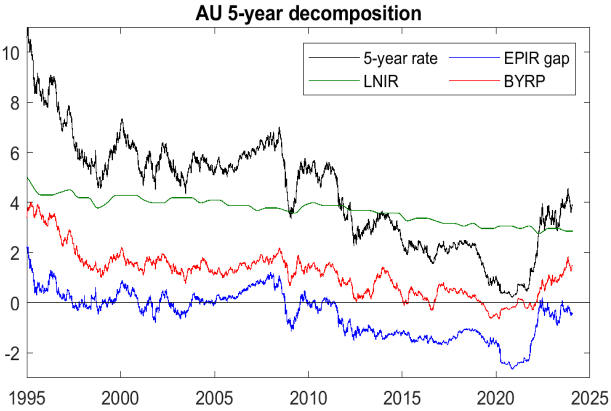
EPIR in forward curve is expected interest rate path

Example: AU yield curve 3 years ago ("easy" -> "tighter")



Long period at lower-bond was expected, before “lift-off”

5-year yield decomposition for Australia over time



LNIR: mild decline, reflects long-horizon GDP growth & inflation

EPIR gap: cyclical with stimulatory monetary policy since GFC

BYRP: material decline, mainly inflation risk

(similar for US, EA, UK, CA, NZ & JP the exception)

What influences the term premium?

Aspects other than interest rate expectations
(LNIR and EPIR account for interest rate expectations)

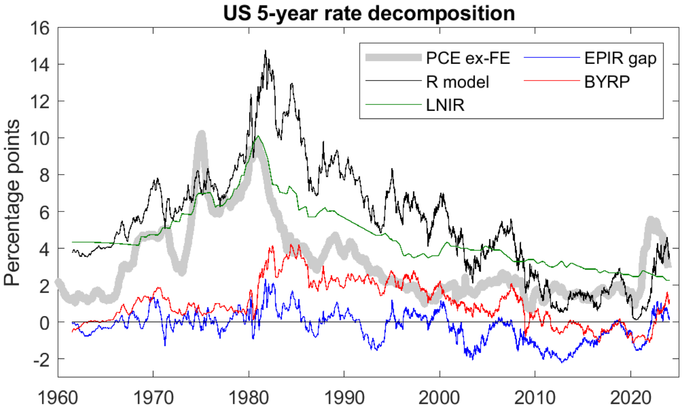
Fundamental influences:

- how do bonds perform in a portfolio?
  - more desirable when offering diversification with other assets
  - bond/equity return correlation provides a perspective
- related: bond performance in different economic environments
  - better hedge when uncertainty in GDP growth dominates
  - worse hedge when uncertainty in inflation dominates

Other important influences:

- effect of central bank bond purchases
- safety/liquidity premium
- default risk (never say never!!)

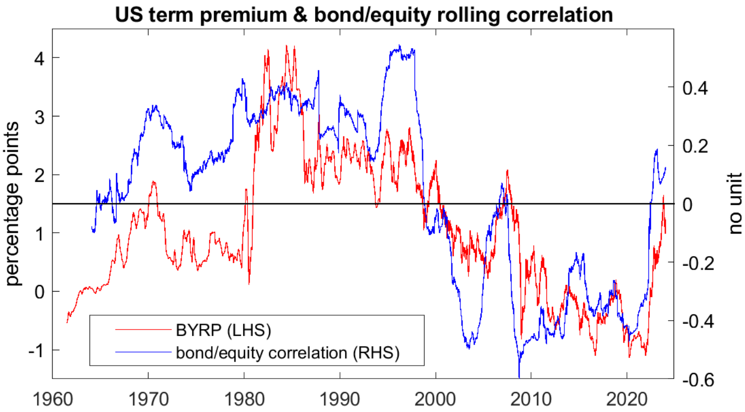
US inflation & 5-year rate decomposition



Inflation (differently) affects LNIR, EPIR gap, and BYRP

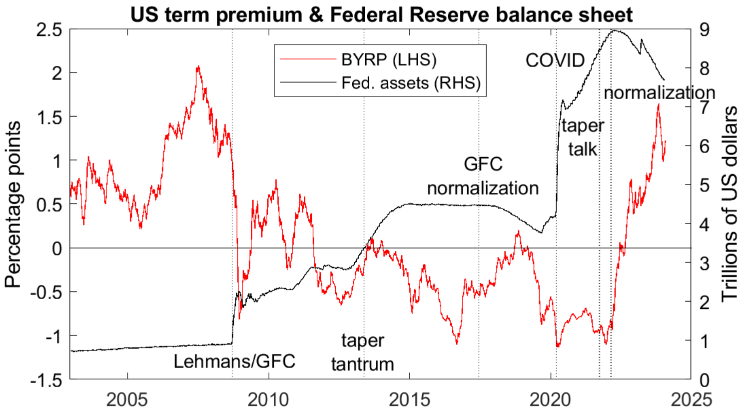
BYRP: persistently elevated after 1970/80s inflation & declined as inflation-targeting credibility increased

Bond/equity correlation



BYRP is lower/−ve (i.e. bond prices higher)
when bonds offer better diversification for equities
BYRP higher/+ve when poor diversifier (e.g. inflation risk)

Central bank & safety/liquidity influences



Marked safety/liquidty declines at onset of GFC & COVID

Link to central bank balance sheet also apparent:

broadly, BYRP declines/increases with QE/QT

Are bond yields appropriate now?

It largely depends on your faith in central bankers
(and politicians: fiscal policy, debt, inflation targeting regime, etc.)

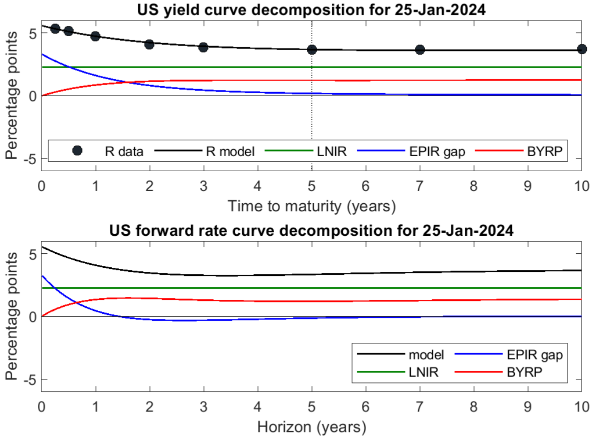
Current market central view:

- **LNIR:** OK, inflation-target credibility remains intact
- **EPIR gap:** OK, tightening done, easing imminent
- **BYRP**: OK, compensation for main influences

Easy to think of upside risks:

- **LNIR:** credibility dented as elevated inflation lingers?
- **EPIR gap:** tighter for longer, or second leg needed?
- **BYRP**: scope for 1980s inflation-risk premium levels?

Components underlying latest US yield curve



EPIR gap: large & early easing factored in by markets

BYRP: no longer contributing to inverse yield curve

Are bonds appropriate FOR PORTFOLIOS now?

YES (and nearly always yes)

Why?

Previous slide is a market/trading view

- by all means, **underweight** bonds if the upside risks on any or all components for bonds ring true
- & bond/equity correlation suggests some reweighting of benchmark allocations may be appropriate

But don't throw baby out with the bathwater

- bond yields & BYRP are back to pre-GFC levels
- bond/equity correlation is now around zero
- bonds provide diversification for risk/return within a portfolio
- **& a hedge for downside risk: recession**