ClearBridge Investments

Preparing for a Range of Interest Rate Outcomes

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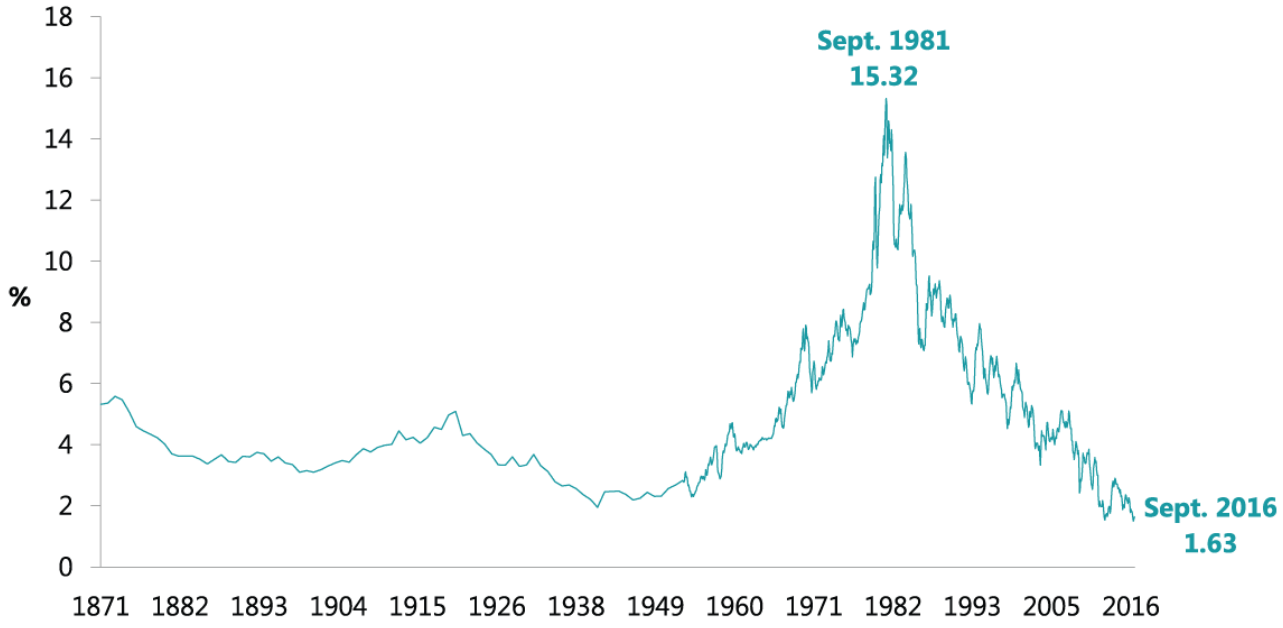
Despite policy dysfunction, a rolling series of sovereign crises and record levels of outstanding government debt, it has never been cheaper for sovereign governments to fund themselves. Before we provide a couple narratives of how this could be, it's always good to look at historical data. Exhibit 1 shows the 10-Year U.S. Treasury yield since 1871. At the current 1.63% yield, Treasury yields have been higher more than 99% of the preceding 145 years! This extreme reading in the bottom 1% of observations holds true for all the major developed countries' 10-year government yields, which now include $9.3 trillion, or roughly 35%, of outstanding government debt in negative-yield territory.

Exhibit 1: U.S. 10-Year Treasury Yield (1871 to September 2016)



Source: Robert Shiller (www.econ.yale.edu/~shiller/data/ie_data.xls; accessed on Oct. 4, 2016), ClearBridge Investments.

Extreme readings of this nature are often associated with asset bubbles, which are typically inflated by the collective madness of the crowd, excess capital and exuberance. Much of this holds true in the current environment, with the odd exception that this extreme reading is driven by pessimism. Mathematically, mean

reversion argues for a bet on higher yields, but there are current beliefs and mechanisms that must be challenged for this bet to pay off. The risk of this bet is that valuation alone is never a good timing mechanism, and this is especially true when prices are unanchored from past norms. From a broad perspective, two major narratives are generally utilized to explain current yields and both capture deeply embedded investor pessimism despite U.S. equity markets near all-time highs:

> **Central Bank Manipulation:** Central bank buying and monetary experimentation has overwhelmed market fundamentals and pushed yields down to record levels. These policies may have kept us out of an economic depression following the Great Financial Crisis, but the result has been asset price inflation that is not sustainable and has driven populist anger through increasing wealth disparity. This anger will dominate policy agendas going forward, driving fiscal policy expansion and ultimately major market dislocations.
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> **Deflationary Debt Trap:** The world experienced several decades of above-trend growth fueled by a massive debt cycle. The resulting buildup of excess credit has led to a series of economic crises, and the weight of outstanding debt has reached a level where marginal credit can no longer drive economic growth. The low resulting nominal growth combined with excess outstanding debt has boxed the world into a deflationary debt trap. Essentially, the model for the world is Japan, and we must endure structurally low growth and resulting yields for decades to come.

The reason why macro forecasting is almost always wrong is that these simple and linear causal narratives, like the 0% or 100% belief state, comfort us with a seeming clarity and understanding, but they fail to capture the true complexity of market and economic dynamics. In 1981, the embedded inflation narratives of the day sure didn't support a 35-year bond bull market, but change-events like Volcker do happen. All we can know is that yields are at extreme levels, and extreme levels ultimately get replaced by something closer to average. As the narratives inevitably change, the transition will not be fun for most investors, and we have to prepare for a wide range of possible outcomes, including the risks of both lower AND higher rates.

About the Author

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- 24 years of investment industry experience
- Joined ClearBridge, LLC (f/k/a Legg Mason Capital Management, LLC) in 2005
- MBA from University of Chicago
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