Aviance Capital Partners

FOCUSED ASSET MANAGEMENT

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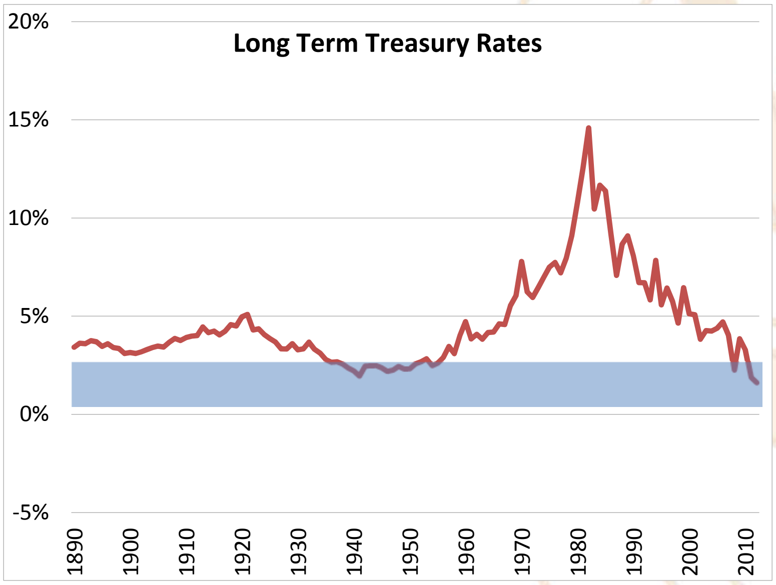
What are the implications of record low U.S. Treasury yields?

Investors who are overly conservative today face a greater than normal risk of losing the battle with inflation. The history of low yield environments provides some fairly clear implications that bonds will likely underperform stocks and inflation. Specifically, we study data from 1871 through today, and zero in on the 20 years with the lowest 10-year Treasury yields.



Source: Robert Shiller. 10-year Treasury Bond yields used from 1953 to present. Before 1953, it is government bond yields from Sidney Homer A History of Interest Rates.

Interestingly, the bulk of these years occurred between 1936 and 1955. As a result, this note is in many ways a comparison between today and the score of years following the Great Depression, which includes WWII and the post-war era. While today is a different world, a familiar setting seems to exist for these periods (besides low rates): heightened geo-political risks, elevated global economic risks, and higher levels of government debt particularly among developed economies.

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These factors seem to promote low stock prices (relative to such things as earnings) and a preference for safety – as in owning Treasury bonds (pushing up bond prices and thus, lowering bond yields).

Over the past twelve years, for example, investors have clearly favored bonds relative to stocks (bonds have outperformed stocks). Over this time, corporate earnings have doubled while stock prices are broadly lower today than 1999. Meanwhile, Treasury yields have set new record lows.

Now, the risks that are on the tips of tongues are economic risks related to the so-called "fiscal cliff" (expiring Bush tax cuts, automatic government spending cuts, and debt ceiling limits), European problems, slowing growth in China, and a presidential election. These risks continue to encourage investors to favor bonds over stocks.

Unfortunately for bond investors, ultra-low yields are typically followed by poor bond returns relative to both inflation and stocks. So the challenge today for investors is to maintain perspective.

As we demonstrate in the following exhibits, **when markets already reflect ultra-low yields and heightened levels of fear, investors who take risk (i.e. favor stocks) tend to do well, while investors who avoid risk tend to suffer. Specifically, bonds tend to generate negative returns when adjusted for inflation and under-perform stocks by a wider-than-normal margin.**

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Exhibit 1: Lowest Treasury Yields in U.S. History

Year-End (Low Yield Environment Years)	10-Year Treasury Bond Yield	S&P 500 Price	P/E (next year's earnings)	Cyclically-Adjusted P/E (Shiller method)	Stock yields minus Treasury Yields
1936	2.7%	17	15	21	4%
1938	2.6%	13	14	17	4%
1939	2.4%	12	12	17	6%
1940	2.2%	11	9	14	8%
1941	2.0%	9	9	10	11%
1942	2.5%	10	10	9	8%
1943	2.5%	11	12	11	6%
1944	2.5%	13	14	12	5%
1945	2.4%	17	16	15	3%
1946	2.2%	15	9	12	7%
1947	2.3%	15	7	11	11%
1948	2.4%	15	7	10	13%
1949	2.3%	17	6	10	13%
1950	2.3%	20	8	11	11%
1951	2.6%	23	10	12	8%
1954	2.5%	35	10	15	7%
1955	2.6%	45	13	18	5%
2008	2.3%	878	17	16	2%
2011	1.9%	1258	14	20	5%
6/8/12	***1.6%***	***1325***	***12.7****	***19***	***6%***
Low Yield Environment Median (above)	**2.4%**	**--**	**11**	**13**	**6%**
All-Time Median (1871-present)	**3.9%**	**--**	**14**	**16**	**2%**

Source: Robert Shiller, Standard & Poor's, Aviance Capital Partners.
*based on S&P top-down estimated earnings

Observation – the 20 years with the lowest Treasury yields:

- Treasury yields are typically 1.5% lower than long-term history
- Price-to-Earnings ratios (P/E) tend to be relatively lower on average.
- Earnings Yields (Earnings-to-Price) vs. Bonds yields are higher by a factor of 2-to-3 in low yield environments.
- Today's valuation levels are consistent with the historically typical low yield environment.

Exhibit 2: Inflation Following the Lowest Treasury Yields in U.S. History

In the years that follow low yields, inflation has tended to be moderately higher over subsequent 1, 3, 7, and 10-year periods.

	10-Year Treasury Bond Yield	Inflation: Next 1-Yr	Inflation: Next 3-Yrs	Inflation: Next 7-years	Inflation: Next 10-Yrs
Low Yield Environment Median)	2.4%	3%	3%	3%	4%
All-Time Median (1871-present)	3.9%	2%	2%	2%	3%

Source: Robert Shiller, Standard & Poor's, Aviance Capital Partners.

Exhibit 3: Inflation-Adjusted Stock Market Returns Following Low Yields

Low bond yields tended to have little impact on the stock market, and market returns tended to be productive, but normal during the subsequent 1, 3, 7, and 10-year periods.

	10-Year Treasury Bond Yield	Stocks: Next 1-Yr (Real)	Stocks: Next 3-Yr (Real)	Stocks: Next 7-Yr (Real)	Stocks: Next 10-Yr (Real)
Low Yield Environment Median	2.4%	8%	7%	5%	11%
All-Time Median (1871-present)	3.9%	8%	7%	4%	7%

Source: Robert Shiller, Standard & Poor's, Aviance Capital Partners.

Exhibit 4: Inflation-Adjusted Bond Returns Following Low Yields

Following periods with low bond yields, inflation-adjusted bond returns has tended to be significantly lower than normal (and in fact negative) during the subsequent 1, 3, 7, and 10-year periods.

	10-Year Treasury Bond Yield	Bonds: Next 1-Yr (Real)	Bonds: Next 3-Yr (Real)	Bonds: Next 7-Yr (Real)	Bonds: Next 10-Yr (Real)
Low Yield Environment Median	2.4%	-1%	-2%	-1%	-2%
All-Time Median (1871-present)	3.9%	3%	3%	1%	1%

Source: Robert Shiller, Standard & Poor's, Aviance Capital Partners.

Exhibit 5: Stock Market Returns versus Bond Returns…Following Low Yields

Following the 20 years with the lowest Treasury yields, stocks tend to outperform bonds by a meaningfully larger margin than normal.

	10-Year Treasury Bond Yield	Stocks vs. Bonds: Next 1-Yr	Stocks vs. Bonds: Next 3-Yr	Stocks vs. Bonds: Next 7-Yr	Stocks vs. Bonds: Next 10-Yr
Low Yield Environment Median	**2.4%**	**11%**	**9%**	**8%**	**13%**
All-Time Median (1871-present)	**3.9%**	**6%**	**4%**	**3%**	**4%**

Source: Robert Shiller, Standard & Poor's, Aviance Capital Partners.

Conclusion

As always, an investor's specific situation remains the most important factor for asset allocation decisions. Aside from this factor, however, choosing to be overly conservative in a ultralow bond yield environment is ironically risky.

The stock market (based on the S&P 500) has been a losing bet since the late 1990s. Over this period, stock prices have more-or-less gone sideways, but earnings have more than doubled. In essence we have gone from a market betting on turbo-charged growth to a market with conservative expectations. All the while bond yields have plummeted. A rear-view mirror based decision might lead many investors to favor bonds over stocks.

Further, large geopolitical and economic issues have led many to avoid traditional risk, like stocks. However, investors who are overly conservative today based on poor relative returns or "what's going on in the world" are choosing to accept yields less than inflation. As a result, we believe investors with horizons of more than three years will benefit by investing in equities and looking beyond the most conservative fixed-income space.