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Corporate Cash Alert

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Turn and Face the Strange

Rates are falling, the curve is flattening, and the Fed is cutting – **but** the economy is still growing and we're at 50-year lows in unemployment. These are strange times in the US bond market, and this dynamic isn't likely to change anytime soon. Read on for our thoughts.

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Rates Market Keeps Moving

Since our last Alert (*Corporate Cash Alert: Slowing and Steady Wins the Race?*, 6/14/19), we've seen two Fed rate cuts paired with tumbling short-end rates and broadly-stable credit spreads. The curve has flattened, and the market is pricing in one more rate cut in 2019.

Maturity	As of 6/10/19		As of 10/18/19		Change in Yields
	Treasury Yield	Slope	Treasury Yield	Slope	
3 Mo	2.26%	-	1.62%	-	-0.64%
6 Mo	2.19%	-0.07%	1.58%	-0.04%	-0.61%
1 Year	2.04%	-0.15%	1.59%	+0.01%	-0.45%
2 Year	1.90%	-0.14%	1.58%	-0.01%	-0.32%
3 Year	1.87%	-0.03%	1.56%	-0.02%	-0.31%

Source: Bloomberg

These moves have occurred despite no substantial shift in domestic economic conditions:

- The US continues to grow at a steady but unspectacular pace
- Inflation remains tame despite a tight and robust labor market
- Although there are vulnerabilities – such as the uncertain impacts of the US-China trade war– these have been apparent for a long time

We think something else is driving rates lower.

Got A Nickel For My Dime?

In our view, that "something" is the result of international capital flows into US assets, as global investors try to escape an ever-growing bubble in developed economy bond markets. A decade of radical central bank monetary policy experiments has severely mispriced global bond markets. This is most visible in the rapidly-growing stock of negative-yielding debt.

Recent deterioration in European and Japanese economic data have compelled the ECB and BOJ to double-down on market-manipulating strategies including "QE forever" and negative benchmark interest rates. As a result, the scope of the distortions has only gotten worse. For example:

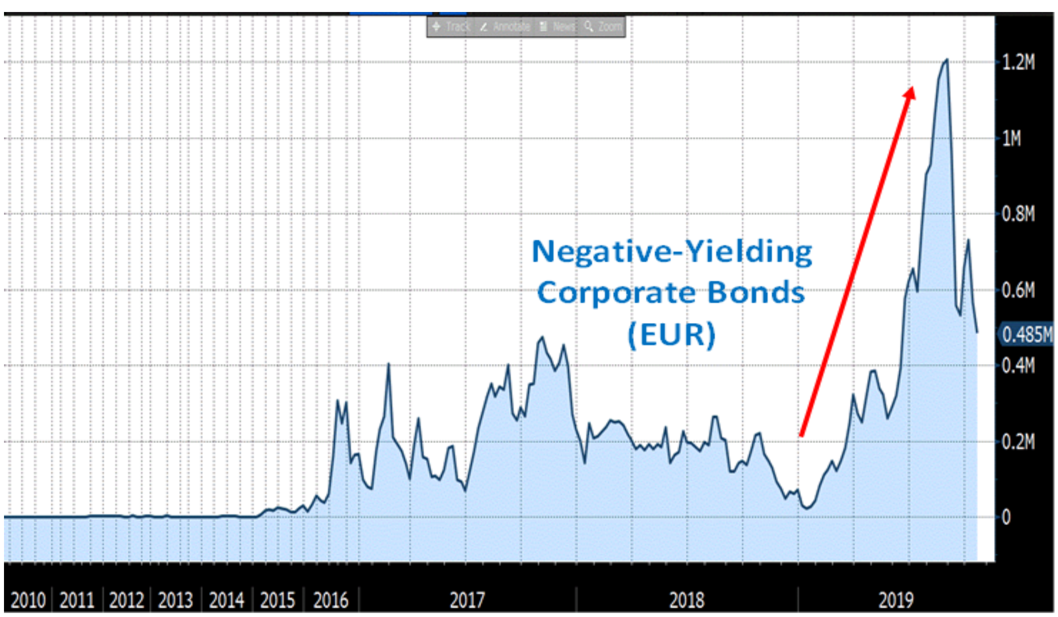
- Nearly $13.5 trillion of bonds – over 20% of global bonded debt – trades with negative yields. Just a couple months ago, this peaked at an astounding $17 trillion/30%.

Global Negative-Yielding Debt

Source: Bloomberg

- Almost 500 million euros' worth of European corporate debt has gone negative (this figure had breached 1.2 trillion in early September).

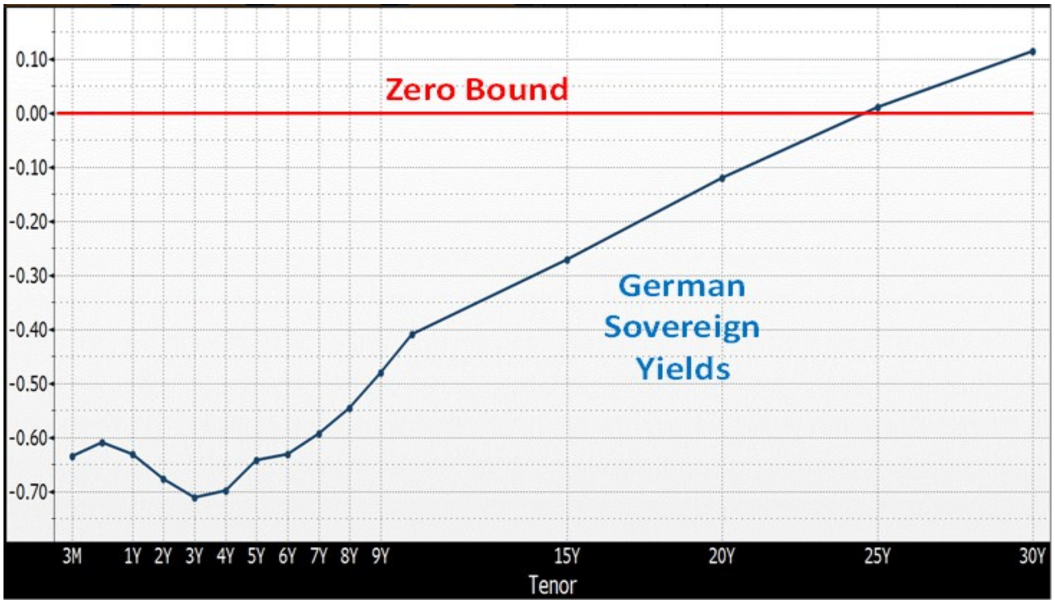
Global Negative-Yielding Corporate Debt



Source: Bloomberg

- Only the 25 and 30-year maturities on the German sovereign yield curve are (barely) above the zero-bound.

German Sovereign Yield Curve



Source: Bloomberg (as of 10/17/19)

While negative yields aren't a new development, they are a persistent problem that's only getting worse and harder for international investors to avoid.

Global Sovereign 2 Year Yields Over Time

Country	2 Year Rates Now	2 Year Rates 1 Year Ago	2 Year Rates 2 Years Ago
Switzerland	-0.59%	-0.75%	-0.86%
Denmark	-0.73%	-0.51%	-0.65%
Germany	-0.68%	-0.51%	-0.71%
Netherlands	-0.66%	-0.53%	-0.72%
Finland	-0.62%	-0.47%	-0.69%
Belgium	-0.62%	-0.43%	-0.56%
France	-0.63%	-0.34%	-0.50%
Sweden	-0.53%	-0.45%	-0.67%
Spain	-0.45%	-0.24%	-0.32%
Japan	-0.25%	-0.11%	-0.14%
Italy	-0.26%	0.75%	-0.22%
United Kingdom	0.50%	0.81%	0.45%
United States	1.60%	2.81%	1.48%

Source: Bloomberg (as of 10/17/19)

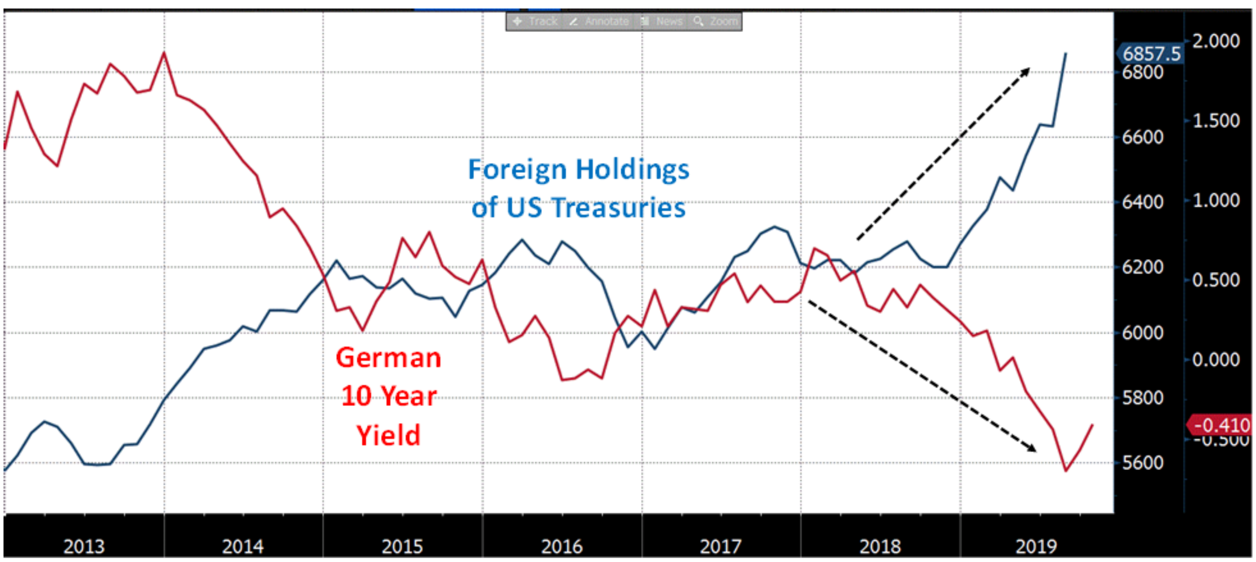
For a more in-depth dive on this phenomenon, see our recent white paper *When the World Turns Upside-Down: Positioning Portfolios During a Bond Bubble* at treasurypartners.com.

Global Yield Contagion?

While the US economy certainly appears to be slowing, we don't expect a recession within the next 12 months. Nevertheless, domestic yields are falling and the Fed is easing, which is what we'd expect if recession were imminent. Why the disconnect?

We believe contagion from abroad is causing domestic rates to move lower despite an economy that's still expanding. The overseas "monetary repression" doesn't seem to be stimulating consumption and economic investment. In fact, there's mounting evidence the Eurozone and Japanese economies are slowing. As a result, European, Japanese and global investors are "voting with their feet" and seeking the comparatively high – read, *positive* – yields available in the US.   As one example, the chart below reflects the increased foreign holdings of US Treasuries (blue) as the yield on German 10 Year sovereign bonds plummeted.

Foreign Ownership of US Treasuries vs. Key International Rates



Source: Bloomberg

The primary near-term force behind lower domestic rates has been increased international demand for US bonds, which has driven down US yields and spreads. While domestic economic fundamentals and the potential GDP slowdown from the trade war are having an impact, rates are marching lower primarily due to weak global conditions.

Unfortunately, we don't see the global economy improving anytime soon, or anything else happening that would cause the ECB and BOJ to reverse course. Until that happens, negative overseas rates are likely here to stay, and the resulting tsunami in foreign demand for US debt appears primed to continue. This means the domestic bond market will most likely continue to price bonds as if we're entering a recession.

Protect Against the Rising Tide

As a result, we suggest protecting against falling rates now, before the rising tide of the negative rate environment swamps our domestic shores. While it's not our base case, a decline to 0.25% or 0.50% on the 2 Year Treasury is entirely possible. Keep in mind that we spent most of 2011-2015 in precisely this trading range despite a growing economy (sound familiar?).

Specifically, we recommend the following strategies:

- For those portfolios that are already near their portfolio weighted-average maturity ("WAM") limits, reinvest to maintain upper-end WAMs and avoid cash buildups.
- For portfolios which are below WAM limits, have new cash to deploy, or are cash flow positive, focus reinvestment activity on longer maturities to extend the portfolio's WAM.
- If possible, focus on adding exposure to high grade corporate debt. Although corporate credit spreads remain compressed, they nonetheless offer an adequate premium to Treasuries and Agencies to negate the flatness of the government curves.

Eyes Peeled Open

The biggest risk with strategy would be a spike in inflation, which would force the Fed to change course and begin tightening monetary policy. Under this scenario, rates would reverse their current downtrend and move higher. While this is not our base case, we're vigilant for signs of its potential return.

In fact, we've witnessed a dramatic increase in M2 money supply growth over the last 3 months, which could be inflationary. However, the countervailing deflationary forces are very strong and for now, we're not concerned about inflation returning in the next 3-6 months.

Portfolio management will always involve picking and choosing between risks, and for now we judge the risk of rising inflation to be the lesser of two evils. In this context, we see the risk of having to reinvest a surplus of cash at near-zero rates as the more immediate threat that must be addressed.