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Portfolio Tactics: When the World Turns Upside-Down

Positioning Portfolios During a Bond Bubble

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Race to the Bottom

We've periodically discussed how the actions of global central banks, particularly the European Central Bank ("ECB") and Bank of Japan ("BOJ"), are distorting markets. These actions include massive purchases of sovereign and corporate bonds (Quantitative Easing), negative nominal rates, and large investments in equity ETFs. Their stated objective is to promote economic growth by suppressing yields and incentivizing savers to reallocate from cash and "safe" bonds to riskier, more "productive" assets. The ECB and BOJ frame their radical actions as stimulus that encourages risk-taking, spurs corporate capital expenditures, and supports credit markets.

We think differently. A decade's worth of unprecedented market manipulations will generate serious negative consequences. Worse, there's scant evidence these monetary programs, undertaken without the aid of a coordinated fiscal policy, have actually spurred growth - the nominal GDPs of both the Eurozone and Japan are still lower than they were before the Great Financial Crisis.

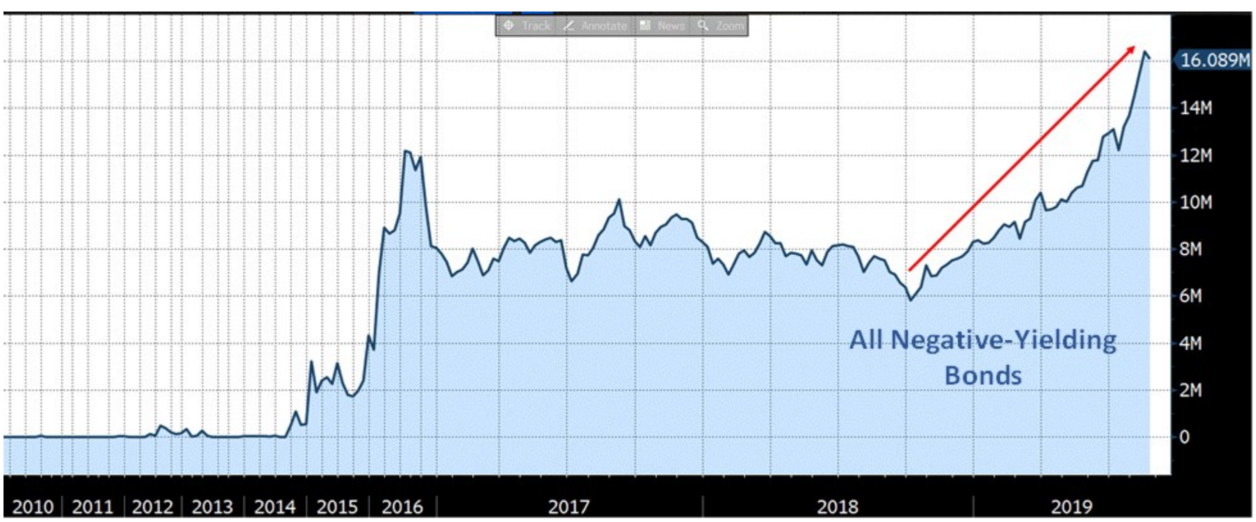
We're concerned that the firing of these "monetary bazookas" has spawned a host of significant market distortions which are already impacting client portfolios. Read on for our rationale.

Got a Nickel for My Dime?

Over $16 trillion worth of bonds are currently trading with negative yields. That's 29% of total global debt and 46% of the world's investment-grade bonds (excluding the US). The lion's share of negative debt is in Europe and Japan.

And the amount of negative-yield debt is ballooning. When we released our **2019 Mid-Year Review** a mere 5 weeks ago, negative-yielding debt totaled "just" $13.2 trillion/24% of global bonds. This is a troubling phenomenon.

Aggregate Value of Global Negative-Yielding Debt (USD)



Source: Bloomberg

Remember: anyone who buys and holds a negative-yielding bond to maturity is guaranteed a loss of principal. It is the equivalent of paying a fee to store money in a safe-deposit box: in fact, there have been measurable spikes in sales of household safes in countries when rates swung negative. This represents a fundamental shift in how financial markets function.

Close Your Eyes and Hope for the Best?

The level of interest rates is typically based on several factors, including the credit-paying ability of the borrower. The higher the probability of timely repayment, the lower the interest rate the borrower pays. Conversely, as the likelihood of repayment diminishes, rates rise.

Markets have turned this logic on its head. Greece nearly defaulted several years ago, remains mired in an economic depression, and has little practical control over its own economic system (the Bank of Greece can't simply print Euros). Every rating agency justifiably considers their debt speculative ("junk") grade. Four years ago, Greek 10 Year bonds yielded 15%, reflecting their highly risky claims-paying ability.

Now, the same Greek 10 Year bonds recently traded at *the same yield as 10 Year US Treasuries*. The market is implying that the Greek Republic's likelihood of repaying principal is roughly equivalent to that of the United States, the global benchmark for safety.

US vs. Greek 10 Year Government Debt Yields

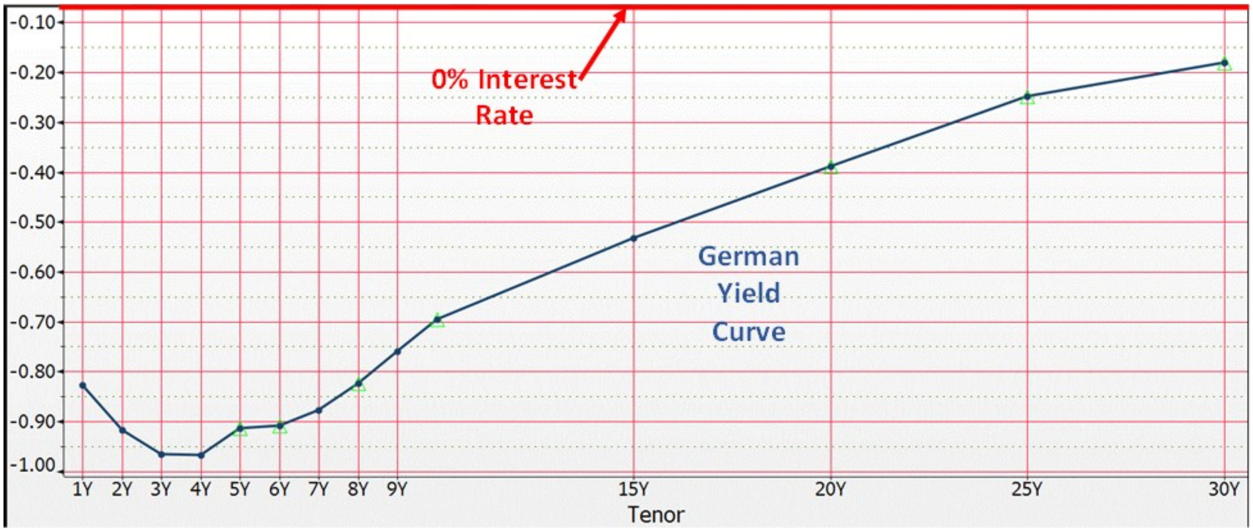
Source: Bloomberg

This is a mispricing of credit risk resulting from European investors' desperate hunt for any source of positive yield in euro-denominated debt.

Everything Is Negative

For other European countries, their sovereign debt yields are negative in almost every available maturity, even out to 30 years. For example, the entire German sovereign curve is below zero.

German Government Debt Yields



Source: Bloomberg

Perhaps the most extreme example of the mayhem isn't negative. The Republic of Austria has a 2117-maturity bond that currently trades at a yield of just 0.70%. Investors who buy this "century bond" give up the right to their principal for their lifetimes and are rewarded with less than a 1% guaranteed annual return. Keep in mind that the Austrian state has ceased to exist twice in the last hundred years.

Meanwhile, bond math tells us that if its yield rises to just 2% (a level it reached about a year ago), its price would decline by **half**. Needless to say, we have no appetite for this issue.

Austrian Government "Century Bond" Price and Yield

Source: Bloomberg (ISIN AT0000A1XML2)

Negative Yielding Junk Bonds- Really?

Negative-yielding sovereign debt has fanned the flames of overvaluation in other markets. The transmission mechanism is via 'risk free rates' which are based primarily on sovereign yields. All non-governmental borrowers in an economy must add a 'credit spread' on top of a relevant risk-free rate when raising capital. Artificially-depressed sovereign bond yields thus filter through to other issuers, pushing down borrowing costs.

This effect is best illustrated by the fact that not all negative-yielding bonds are sovereigns. *In Europe, over €1 trillion of corporate bonds – by definition, debt issued by companies that can and periodically will default – also feature negative yields.* Moreover, approximately one-third of these are rated BBB+ or below (marginally investment-grade) – including, for the first time ever, some negative-yielding junk bonds.

Aggregate Value of Global Negative-Yielding Corporate Debt (EUR)

Source: Bloomberg

Keep in mind that these extreme central bank policies are being deployed not in the depths of a crisis, but merely a disappointing stretch of growth. What happens if they don't stave off actual recessions? What further tools do central bankers have if conditions deteriorate and the situation legitimately becomes dire? Unfortunately, we can't dismiss the possibility these distortions would become even more extreme.

US Importing Trouble?

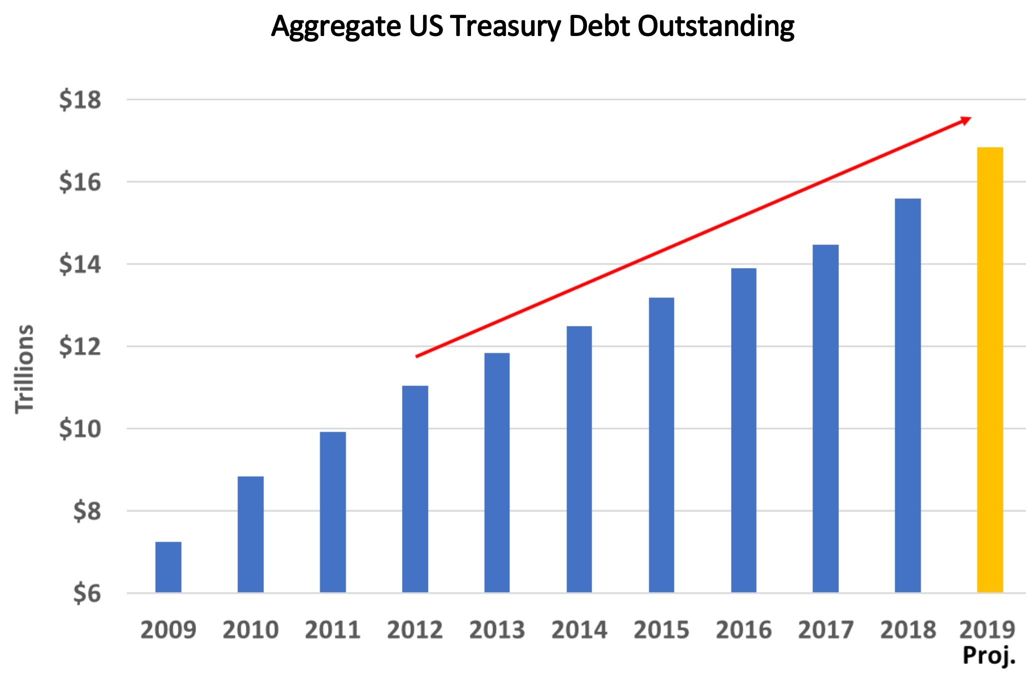
Since capital flows across borders, these massive overseas distortions impact both our domestic assets and Federal Reserve policy decisions. Their magnitude and scale have upended traditional market relationships, such that historically reliable signals and indicators aren't behaving normally.

The Fed just cut rates by 0.25% despite benign domestic conditions – indeed, as Philip Miller of Strategic International Securities puts it:

> ***"[US] Unemployment claims are at a 60-year low, the unemployment rate is at a 50-year low…employment gains were over 200,000 last month, there are more job openings than unemployed, yet in [the Fed's] alternative reality, the economy is headed toward an economic abyss [that necessitates a cut]."***

The US yield curve recently inverted (10 year Treasuries yielding less than 2 Year Treasuries), which normally signals a recession. However, given the global bond market distortions, we find this indicator less reliable than usual. In part, this is because the collapse in Treasury rates is occurring during one of the largest periods of government debt issuance in US history.

There's currently $15.9 trillion in marketable Treasury debt, over $1 trillion of which was created in 2018 alone. With the federal deficit surging, we'll likely issue a similar amount in 2019, at which point there will be 50% more Treasuries outstanding than there were just 7 years ago.



Source: SIFMA, Treasury Partners

This a staggering increase and should have presented a challenge for the market to digest. The basic laws of supply and demand typically resolve this situation via higher rates - that is, lower prices/higher rates compensate investors for mopping up the increase in supply. But we've seen the opposite – higher supply paired with falling rates. Should we thus conclude that the current low and negative-yield environment is a warning of an impending global recession? Or are fixed income market signals garbled by central bank distortions?

Both views may be right. But consider that just a few years ago the Fed was also printing money to buy bonds, and still holds $2.1 trillion in Treasuries (13% of the total) on its balance sheet. Practically, it's as if over 40% of the post-2012 increase in outstanding Treasury debt never even happened - the Fed simply vacuumed it up. It's likely this artificial reduction in supply has influenced rates.

The dangerous implication is that other market indicators that refer to Treasury yields may now also be artificially depressed, thereby distorting borrowing costs.

Sobering Math

The US economy is still growing, but at a slowing pace. Recession remains unlikely in the next 12 months but given overseas weakness, it's more possible than it's been in a long time. Although not reaching negative-yield extremes, domestic bonds prices now assume a recession is near. There's a paradox here - markets assume that inflation is dead, helping keep yields down. But isn't higher inflation exactly what central banks are trying to generate?

There's real risk in extending maturities in the current environment. Imagine we buy a 10 Year Treasury, currently yielding approximately 1.55%. If rates rapidly spike, we'd face significant unrealized prices losses.

10 Year US Treasury Yield vs. Price Change Calculations

Change in Current Market Yield	Decrease from Current Bond Price
+ 0.50%	-4.5%
+1.00%	-8.7%
+1.50%	-12.8%
+2.00%	-16.7%

Source: Bloomberg, Treasury Partners

Said another way, just a 0.50% increase in market yield to 2.05% (not unlikely - we were just there 3 weeks ago) generates a price decline that wipes out almost 3 full years' worth of interest income. A 1% bump in yield to 2.55% - last reached about 3 months ago – wipes out over 5 years' worth of income. When absolute rates are this low, the risk -return profile of longer-term bonds begins to mimic that of volatile equities rather than stable-value assets.

Treasury Partners View

When creating Asset Allocations, fixed income portfolios serve as "ballast," or the stable-value of our client's wealth. Our mandate as stewards of the capital is to preserve the real purchasing power of the principal over the long term, and not mimic a benchmark or chase performance.

In managing your bond portfolio, we've arrived at a crossroads. Do we disregard these unprecedented market distortions and reinvest maturing bonds out longer-term, matching average maturities with a benchmark? Stated differently, do we prioritize benchmark-hugging performance at the cost of exposing your ballast to the risk of losses if rates rise?

We generally expect further deterioration in the global economy and fear we're likely entering an extended period of low interest rates. This may push yields even lower from here. However, the meager yields available don't justify extending maturities and taking on the risk of material price declines.

Accordingly, instead of chasing yields we're staying shorter, accepting lower returns but receiving greater protection against downside risk. This includes reinvesting maturities in shorter-dated corporates and Treasuries, whose yields, although lower than corporates, are exempt from state and local taxes. Our eyes are wide open for attractive opportunities.

Please feel free to contact us if you have any questions or would like to continue the dialogue.