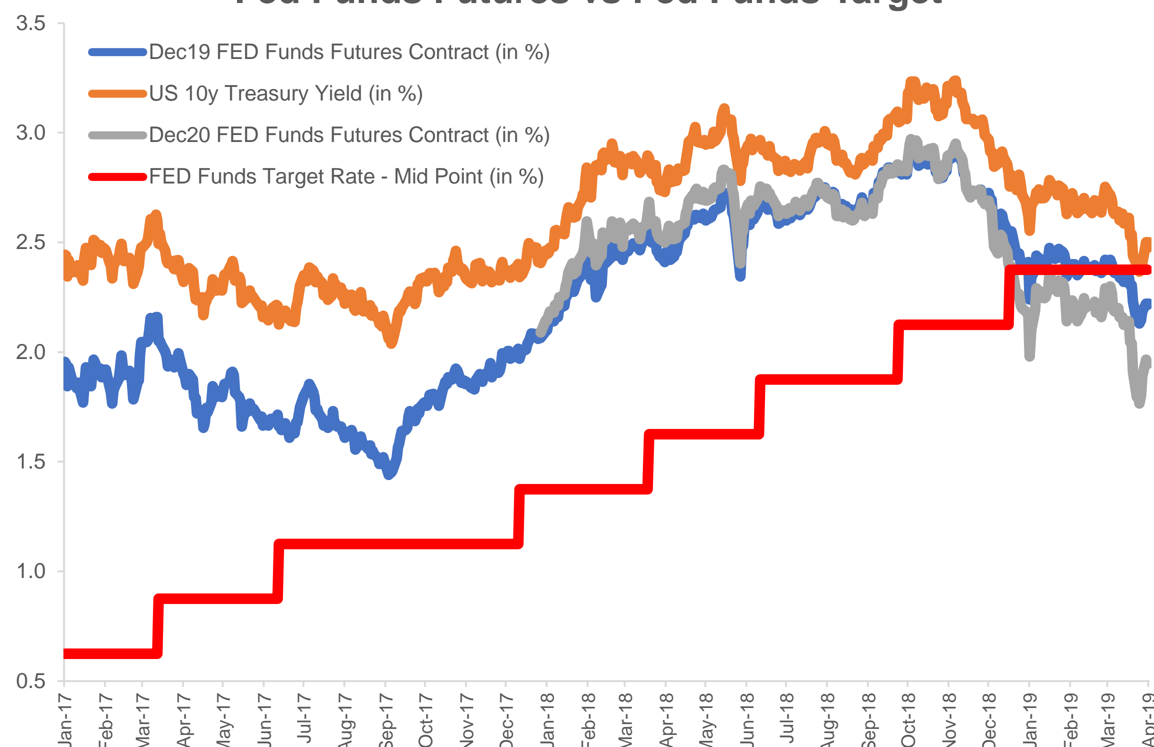
Fixed Income Quarterly

April 2019

The continuation of the drop in global bond yields has been a feature of 2019. Much of this has been driven by the marked turnaround in the monetary policy stance of the US Federal Reserve. Whilst changes in certain economic and financial indicators (PMI, Retail sales, US yield curve) support this shift in outlook, other (inflation expectations, employment, wages) metrics have remained resilient. Perhaps most notable of all is the continued strong performance of risk assets in the face of increasing global uncertainty. Below we take a closer look at what we believe is driving the Fed's current thinking and what, if anything, we can glean from the current dichotomy between risk assets and the bond market.



1. Changing Expectations

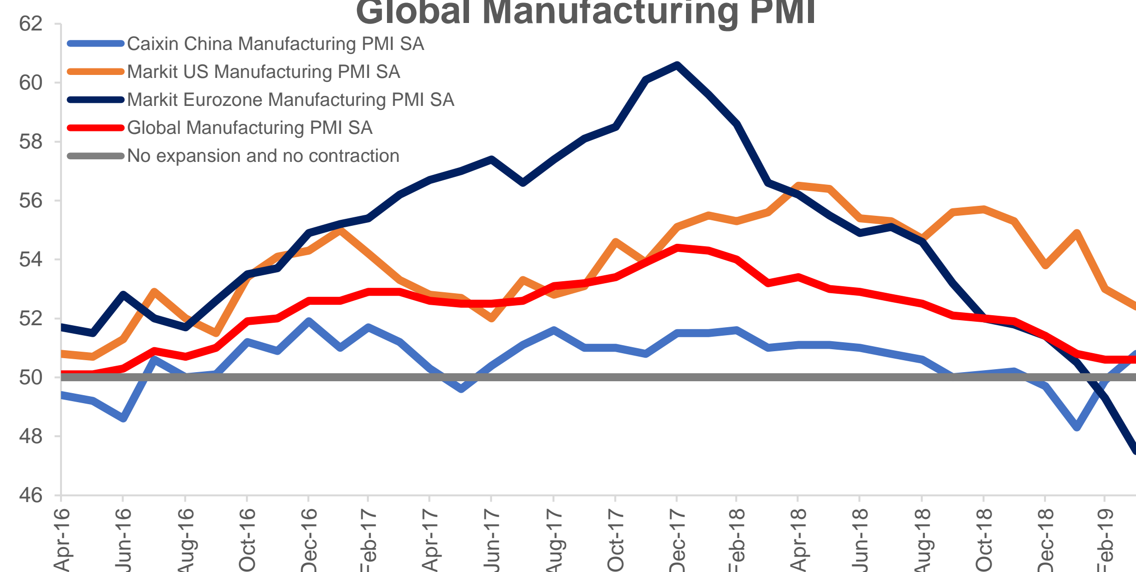
The discernible shift in the Fed's tone began with December's 'dovish hike' and has continued since. What followed was a sizeable swing in market expectations from pricing up to 2 additional hikes by the end of 2020, to as many as 2 rate cuts per current market estimates. This though is only part of the story. The announcement in March of the end of the Quantitative Tightening (QT) programme represents another major turnaround in policy. Throughout much of 2018 the Fed had been deliberate about playing down the negative impacts of balance sheet reduction. The sudden change in messaging during the December volatility however betrays a deeper level of concern in our view.

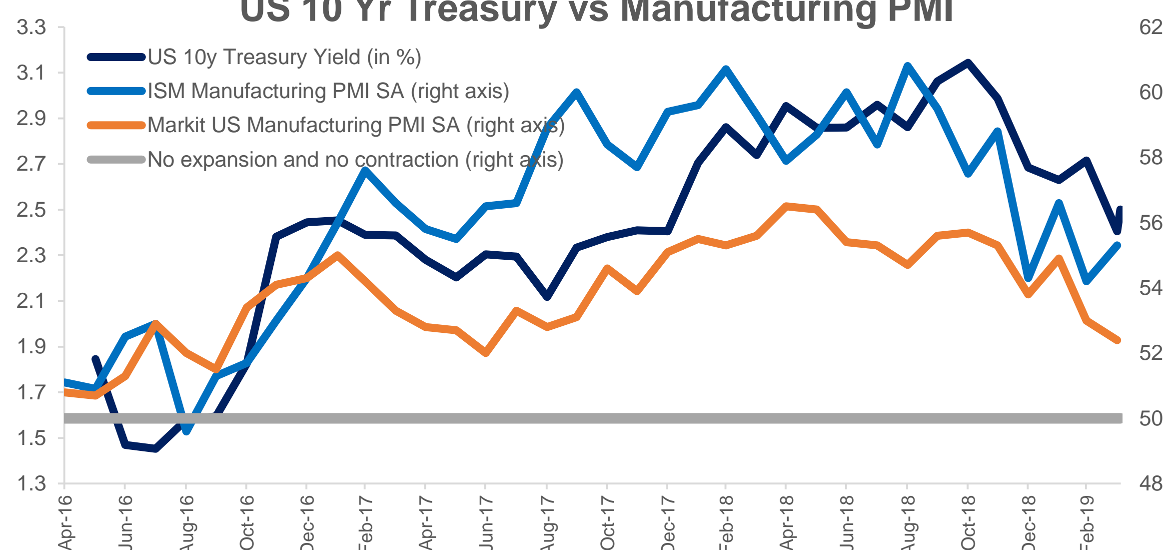
2. Weaker Economic Data

European and Chinese data in particular has been soft. As regards the US, data is certainly weaker although not yet at recessionary levels. Some of the most notable releases in March in respect of the bond market impact included:

- 7 March 2019: ECB's forecasts quite weak, 10y Trsy down ~ 5bps
- 20 March 2019: dovish FED, 10y Trsy down ~ 9bps
- 22 March 2019: weak PMI from Germany, 10y Trsy down ~ 10bps

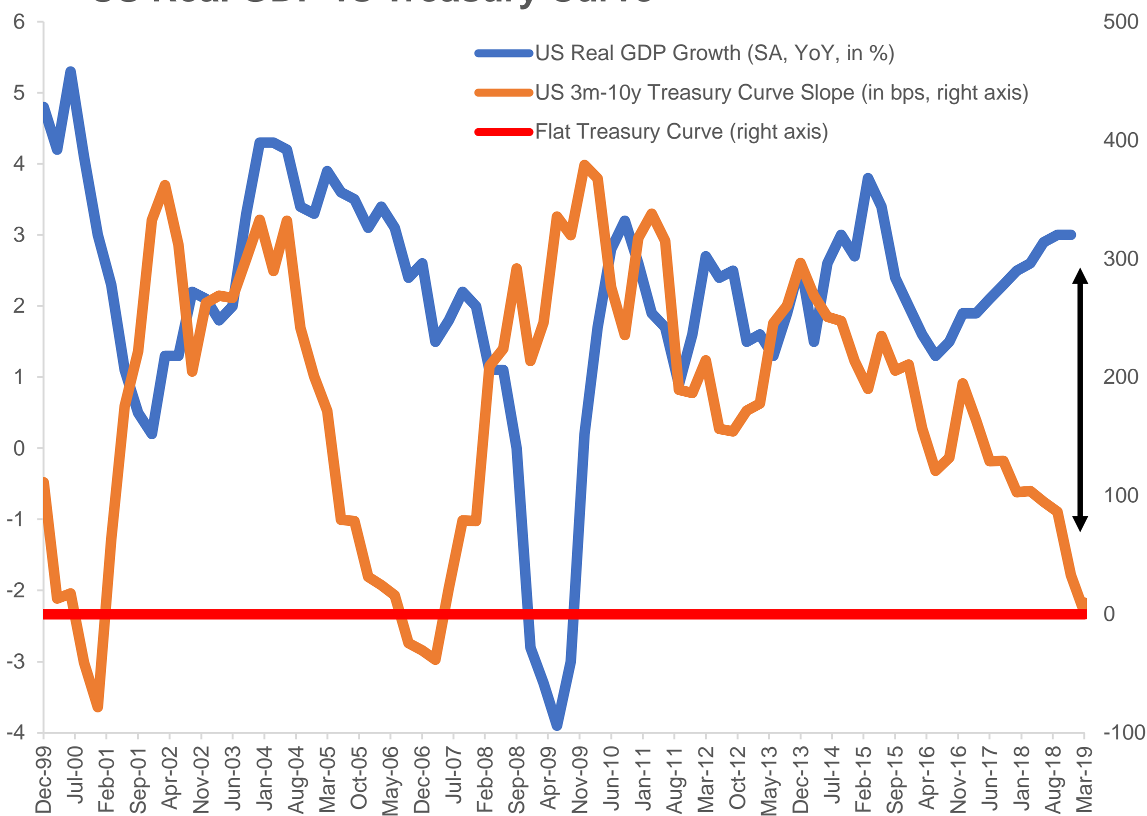
The trajectory of future economic data will dictate to a large extent the Fed's perceived stance and the ultimate path of interest rates. The current directionality is broadly consistent with a global slowdown, however we would question whether the data alone justifies the extent of the Fed's recent dovish tone and the market's subsequent reaction.





Source: Bloomberg

Rubrics Asset Management



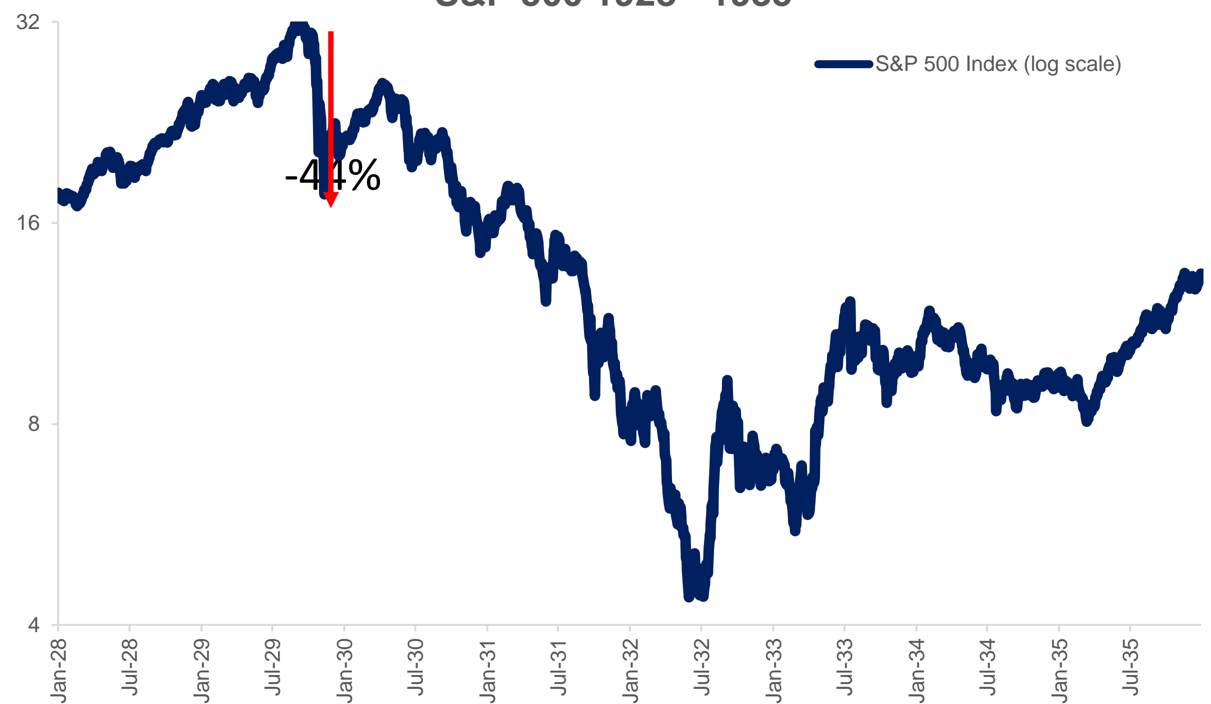
Source: Bloomberg

3. Market Psychology – Signalling Effect

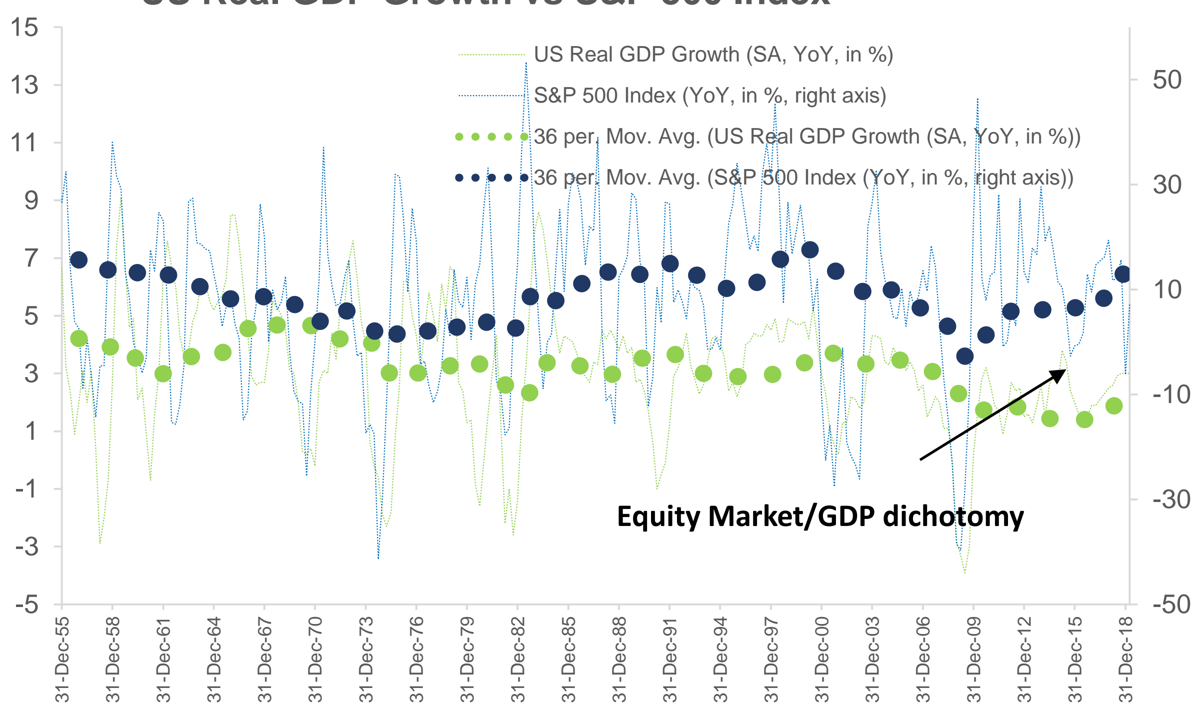
Given the scale of post crisis monetary intervention, it is possible in our view that the signalling impact of the yield curve has been distorted. Nonetheless, the extent of the yield curve flattening in recent months has surprised many. We believe the Fed's most recent about-turn has created an additional element of fear and uncertainty in the bond market which has amplified the downward pressure on yields. It is not surprising therefore that the Fed have come out strongly to allay recessionary fears. ***Whilst it can be argued that current economic data does not justify the sharp correction in bond yields, that does not mean that the bond market has got the long term growth story wrong.***

4. Fear of Financial Instability

The Fed in 2019 have put the 'fear of god' in the markets – but is this because in December the markets put the 'fear of god' in them? There is no question financial stability is of chief concern to the Fed and the rapid nature of the selloff in December likely rattled them considerably. Are they frightened of the potentially de-stabilising effect of a severe market correction? Whilst today represents a very different environment to that of 1929, the collapse in aggregate demand that resulted from the stock market crash is nonetheless something that should not be ignored.



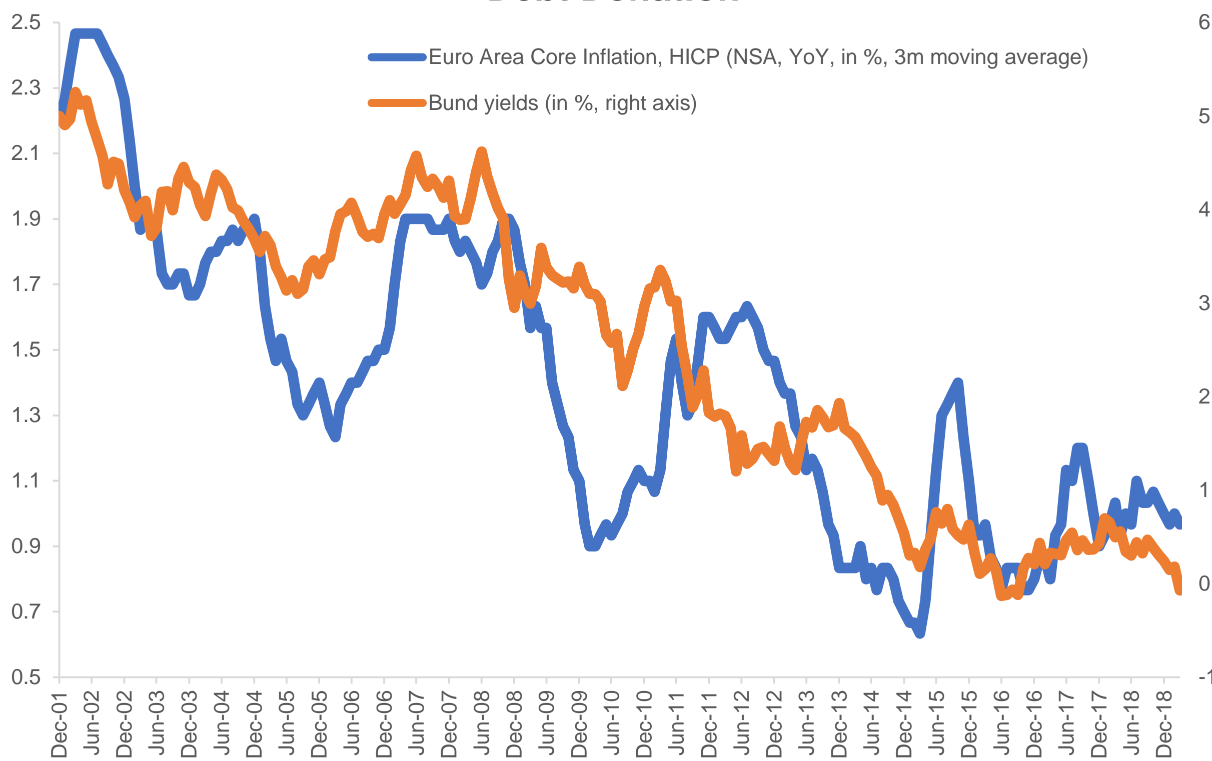
Source: Bloomberg



Source: Bloomberg

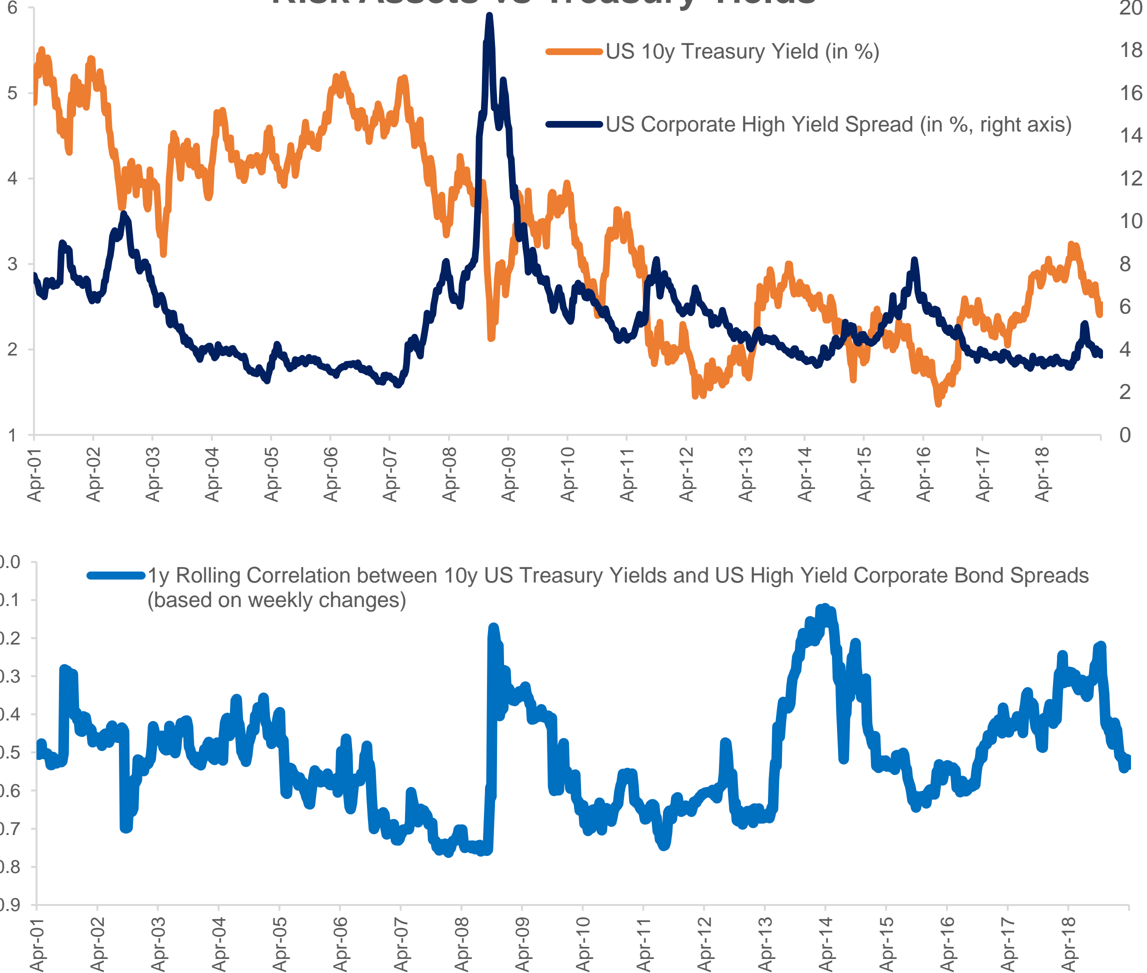
5. Functioning of Capital Markets

After 9 years of endless market interference from central banks, is it possible that markets can no longer function efficiently? The selloff in December, followed by the swift rally in January and February is the most recent example of erratic market behaviour. While the recent collapse in bond yields would suggest a heightened risk of recession, current pricing of risk assets is telling a very different story.



Source: Bloomberg

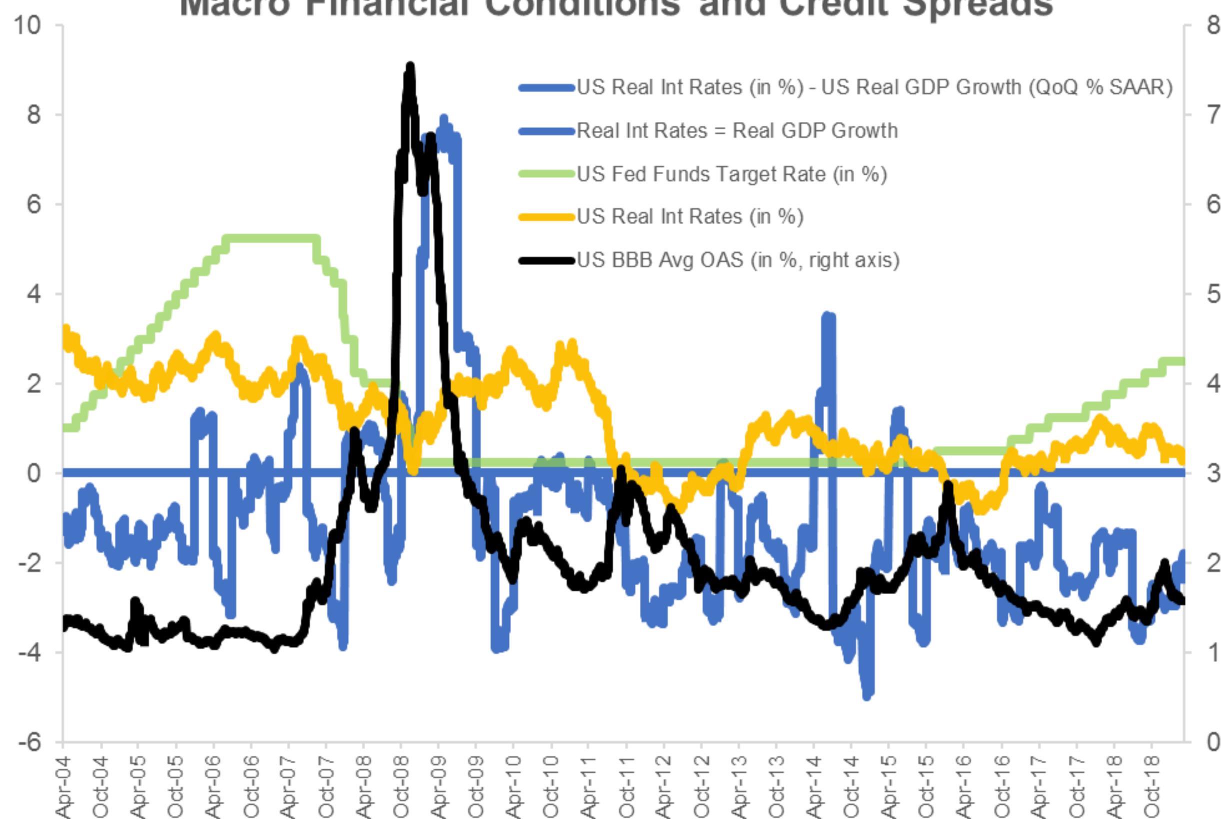
While there may be a short term positive impact to recent stimulus (+$300bln ytd increase in USD liquidity), longer term how much more does current monetary policy have to give? For risk assets, financial conditions can remain loose in the short term which could be supportive. However this cannot continue indefinitely absent a turnaround in growth/corporate profitability. ***Herein lies the problem for risk assets from our perspective - longer term, we simply do not believe a sustained global reflation will be forthcoming.***



Source: Bloomberg

6. Where to Next?

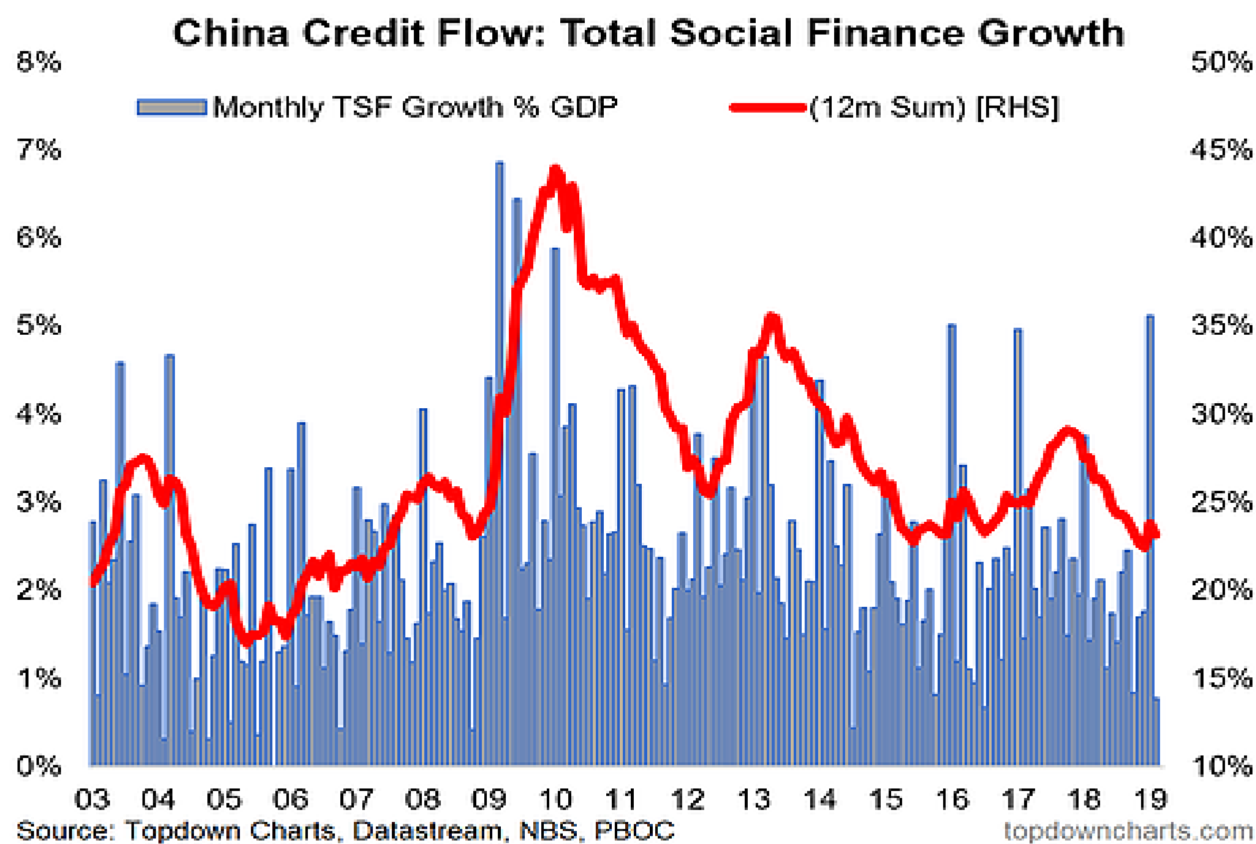
It remains our view that the real recession risk is more elevated now than at any time since 2008. Of greatest concern is the lack of options at policy makers' disposal when a recession does eventually arrive. On the face of it, the world appears to be walking straight into Japanification – zero rates indefinitely. Critically however, there are no historical examples of zero/negative rates or financial repression that have successfully created a sustainable reflation. Certainly not one that didn't end in a bust.



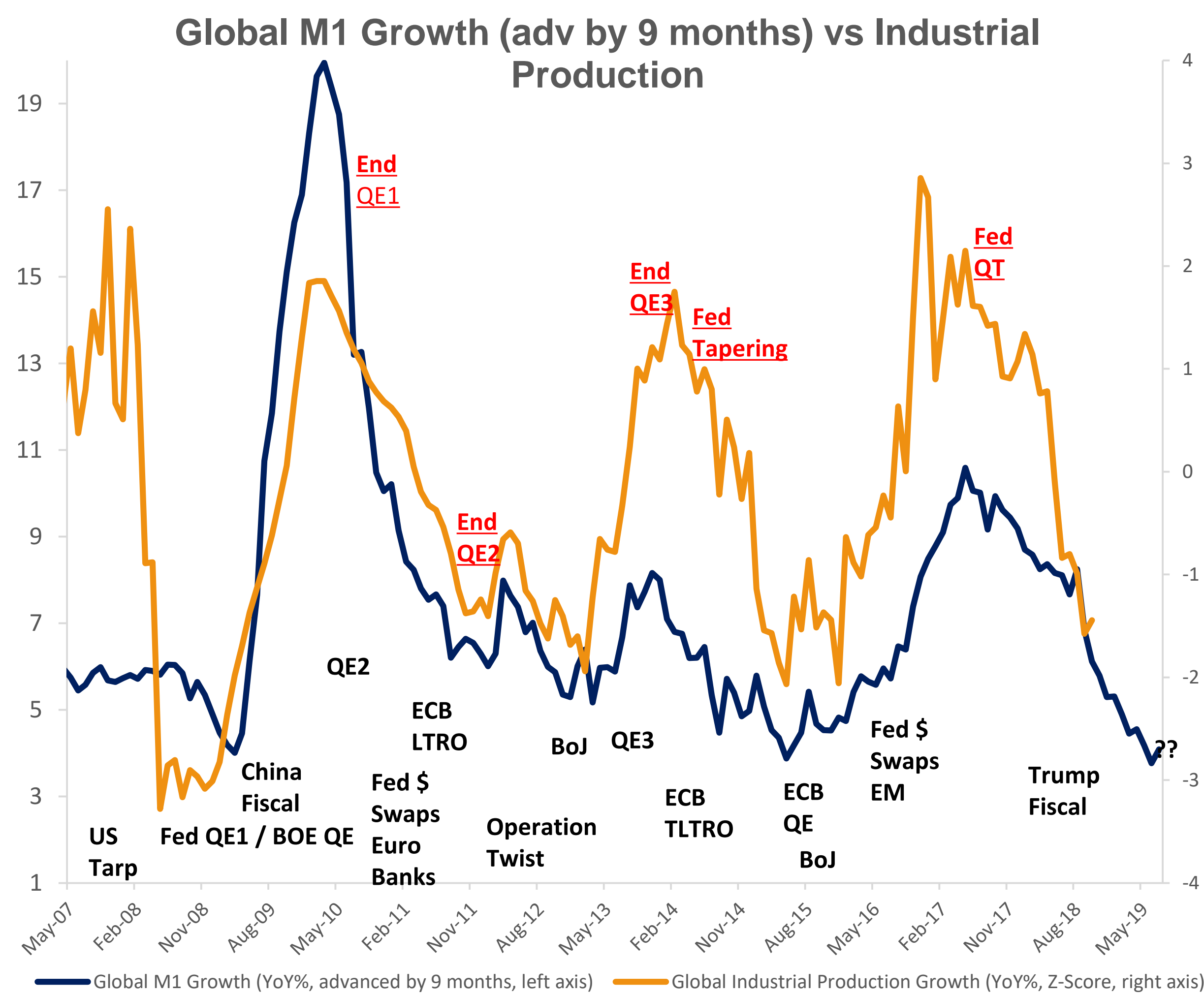
Source: Bloomberg

The correlation between global bond yields and risk assets (as evidenced by credit spreads in the chart opposite) has been firmly negative for a long time. Based on this historic relationship, it is unlikely that risk assets and bond yields can trend in opposite directions indefinitely. ***One explanation of the recent divergence between the two is the difference in time horizons employed. Whereas the bond market is factoring in long term structural forces such as the global debt overhang, risk assets are more concerned with the short-term stimulative impact of lower rates. A convergence at some point is surely inevitable.***

7. A Word on Reflation



The stimulus recently announced by the Chinese government to counteract economic weakness is very much in the mode of stabilisation rather than expansion. Deficit spending is set to increase by just 0.2% of GDP and the theme of stabilisation is prominent throughout the Government Work Report. China's Total Social Financing is targeted to grow in line with GDP. The amount of leverage in the system in China means that credit fuelled expansion is no longer a viable option with stable debt dynamics as an objective. GDP for 2019 is projected to be in the range of 6-6.5%, a slower rate of expansion than 2018's 6.6%.



Source: Bloomberg

Similarly, the Fed's recent decision to end the reduction in the size of its balance sheet later this year, is not going to add fresh stimulus to the US economy. This policy change serves to help end a tightening of financial conditions rather than introduce looser conditions. The combined policy changes of the Chinese government and the Fed may lend some support to economic conditions but are unlikely to deliver the kind of reflationary stimulus that the markets seem to be expecting.

Source: Bloomberg

IMPORTANT INFORMATION

April 2019

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