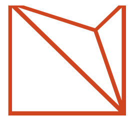

RUBRICS

Fear of Fear Itself

Fixed Income Macro View

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Rubrics Fixed Income Macro View

Introduction

Financial markets can often provide an accurate representation of our collective emotional state. Within this it is often the bond market that acts as the medium through which the market expresses this emotion. It is instructive then to note that US bond yields have retreated to the same levels they were at prior to Trump's presidential election. But what a difference in outlook between now and then. Casting our minds back to 2016, optimism was rife at the prospect of fiscal stimulus and the knock-on impact on growth and inflation. Bond yields soared. Today that optimism has all but evaporated. Instead the bond market is reacting to one thing. Fear. Fear of further trade war escalation. Fear of market illiquidity. Fear that the end of this economic cycle will be worse than anything seen since the Great Depression. With some $17 trillion in negative yielding bonds, covering everything from government to high yield debt, the fear is palpable.

Source: Bloomberg

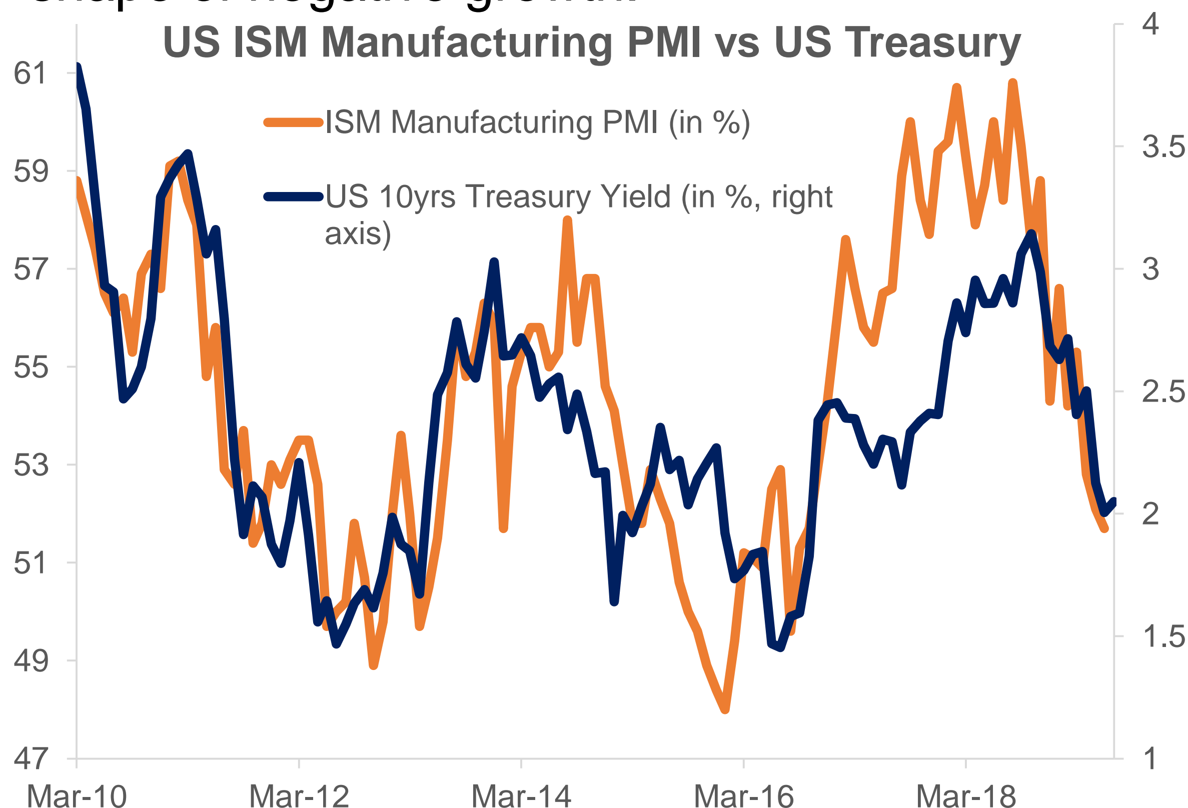
Rubrics Fixed Income Macro View

We have been very negative on the structure of the global economy for the last few years as many will know. Much of this negativity was due to the decision-making process at the highest levels – reacting to market/economic crises rather than proactively implementing policies to build sustainable future growth. Every time the economy hit a bump in the road the solution was always the same. More debt. Patching up today's problems at the expense of tomorrow's growth. While there have been opportunities for the global economy to re-calibrate, nobody has the political stomach for it – certainly not with populism on the rise.

At a more structural level, the current collapse in global rates has its origins in the policy response to the global financial crisis. Namely the repeated use of global stimulus packages for continuously less gain. However more recently, Trump's knee-jerk imposition of 10% duties on $300bln of China imports has surely added fuel to the bond rally. What really spooked the markets however was China's retaliatory devaluation of the Yuan. This was their line in the sand – 'anything you can do we can do better' - or worse from the global economy's perspective. This was also Trump's moment for sober reflection. Continue down this path and lose the next election or back down and have a fighting chance in 2020. He blinked first of course - what bullies will often do. In so doing he has openly admitted it is the US consumer that will ultimately pay for the tariffs, just like the taxpayer would ultimately pay for the Wall. What was that about fake news? Perhaps the most concerning aspect of this stand-off is the lack of a unified end game strategy from the US. What do they really want from China, better trade terms or the abolition of China as a world power? Trump for the former, Pence et al for the latter I suspect. As a result confusion will continue to reign, and nowhere more so than in the White House.

Challenge for the Bond Market

Global growth and inflation expectations have been declining since Q1 2018 and Q4 2018 respectively. With Trump's tweets added to an environment of thin August liquidity, the conditions were ideal for a pick-up in bond volatility. The markets didn't disappoint. The concern now with rates in negative territory is the lack of tools available for central banks to fight the real downturn. Market interest rates are at historic lows while at the same time unemployment rates are at some of the most benign levels seen in decades. Meanwhile inflation rates are far from negative in most countries. Although manufacturing has been painting a gloomy picture for some time, services and in particular the labour market have thus far held up. The next few weeks from a markets' perspective will be telling in terms of whether or not we see follow through in the shape of negative growth.

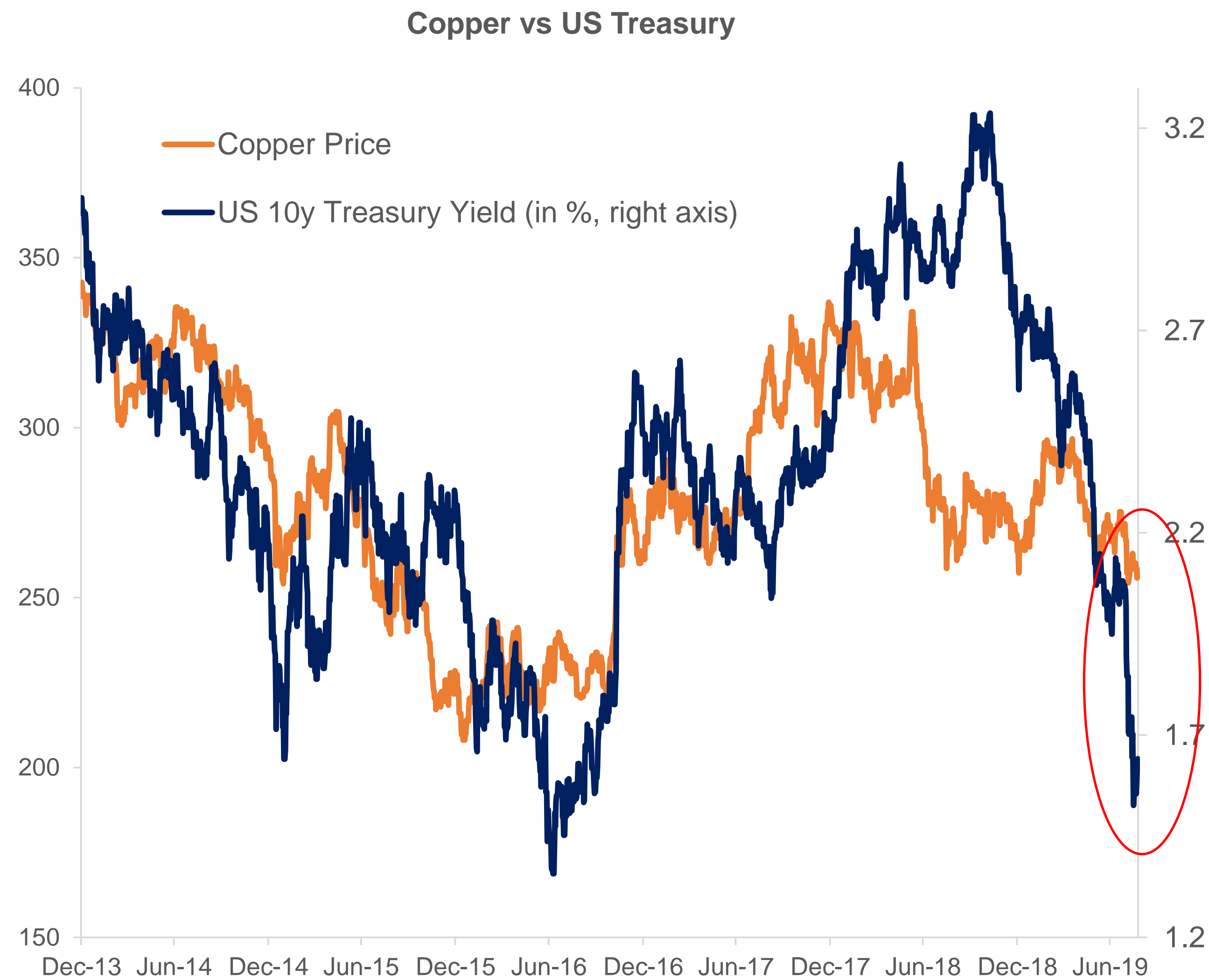


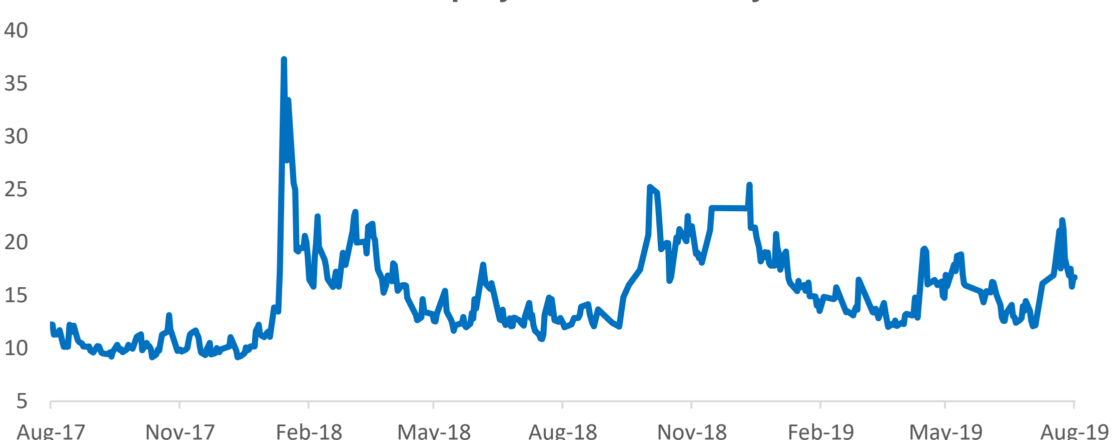
It has been argued that either the bond market is wrong, or risk assets are wrong. Ultimately decisions made will determine the outcome. Indeed sometimes the best decisions are made at the precipice – Germany might do the right thing and spend instead of saving. Trump may attempt to defuse the ticking trade time bomb and maybe the ECB realise that punishing the banks with further negative rates will not help them achieve their goals. China has a role to play in all of this as the chief contributor to marginal changes in global growth over the last two decades. Europe and more specifically Germany have built a whole business model around this. China's credit bubble needs to be defused, but this cannot happen with the world so reliant on China's demand. China's rise as a global power may need to take a break for a while. Can the global economy handle this? At the moment no. But perhaps this does not have to remain the case indefinitely.

Source: Bloomberg, Rubrics Asset Management.

Current Bond Market Behaviour

While the bond market is currently screaming deflationary recession – or at least that one is right around the corner - our own economic analysis over the past few months has not confirmed this. In fact quite a few key indicators have been showing continued strength - looking at economic data outside of manufacturing PMIs this has been the case anyway. And what of other markets, have they confirmed the move in rates? The answer is no. The oil price and FX markets (so often early indicators of economic stress) are not currently suggesting disaster. That the Japanese yen is not trading below 100 instead of 106 plus is instructive and outside of exceptional cases like Argentina the dollar is not rallying the way one would expect during a period of genuine market stress.





Source: Bloomberg

Against the backdrop of poor August liquidity - the market has had some fun at the expense of some individual names such as GE, Burford and even Argentina. In the case of the latter's hundred-year bond, holding securities that virtually guarantee losses can only work for so long. Fundamentals will eventually re-assert themselves even if central banks fight it all the way. Might we see the type of volatility that confirms we have turned the corner and have started to look for solutions? It may be some of the best volatility we have seen in a long time. Bring it on

There is no doubt the global economy is facing many critical challenges moving forward. Global growth will be moving at a significantly lower trend level from here on in - but are we at the end of days scenario that the $17 trillion in negative yields would indicate? We don't think so, not yet anyway. The situation could deteriorate, however we would not have that as our base case just yet. One of two things will have to happen from here. Either growth confirms the rates move and risk assets are in for a rough ride, or rates will have to reflect a more balanced view of the global economy - slowing but not 1929 (even then rates weren't this low). We did not see the scale of the move we saw in August, at the same time we see it as perfectly plausible that some of these moves could quickly be reversed on any number of policy decisions. Central banks have played their part by cutting rates and promising more stimulus, ultimately however the real-world outcomes will matter most at this stage of the cycle.

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