RUBRICS

Rubrics Fixed Income Quarterly

December 2019

Financial Markets' Opioid Crisis

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Rubrics Fixed Income Macro View

December 2019

The great global opioid crisis

It is a little over a year since central banks were talking of policy normalisation and synchronised global growth. How quickly the patient went from the withdrawal of stimulus to the urgent need for more. In fact, the need was so bad that the pace of the new opioids (stimulus) was only ever matched in 2008/09. It is crystal clear now, if it wasn't before (it was), that the global economy is completely addicted to its pain killers. The issue with all pain killers is that they can kill the patient. What the pain killers won't do, crucially, is make the patient heal. This is the fundamental flaw with the current strategy of global monetary policy; it would only ever work as a stop gap until real structural change is made. Without the necessary structural changes, the treatment becomes ineffective as it fails to address the underlying issues. Policy makers are trapped in a vicious cycle of ever decreasing marginal impact of stimulus with ever increasing costs. Ultimately any hope of being able to withdraw from the disease becomes lost.

Throughout 2019 issues such as the US-China trade war and Brexit have also dominated investor sentiment. It would, however, be wrong to suggest that these issues are not political side effects of the ten years of chasing top down monetary policies with little net gain for the average Joe. Inequality has become a significant aspect of the current global discontent. Political outcomes under these conditions are also sub-optimal and counter productive. Both central banks and governments no longer have any easy options and as such outcomes are becoming more and more unpredictable. The implications of bottom-up MMT style stimulus have had little analysis done, but the outcomes could be very unpredictable for the capital markets.

The reaction from policy makers on the state of play

Surprisingly there have been some pretty open discussions from policy makers about the ongoing benefits and costs of current policy tools. In Draghi's final meeting as head of the ECB he would have felt considerable hostility towards his decision to start QE again and reduce rates further into negative territory. Both the Swedish and the Danish, who have had exposure to negative rates for longer than the ECB has, sounded the warning bell that these policies do not work. They both point to the failure of inflation expectations to rise and that (counter to popular belief) savings rates started to rise, not fall, after a protracted negative rate regime.

The ECB has openly looked at the impact of their negative rates and discovered that it has unintended consequences. The central bankers are only now starting to find out that the outcomes of these policies have extremely unhealthy side effects which could severely hamper financial stability going forward. They have pointed out that the types of risks investors are now taking due to negative rates are in some cases extreme. But central banks are not yet united in this analysis. The acclaimed Irish economist Philip Lane at the ECB feels that all the furore about negative rates is all about nothing.

Of course, all this criticism of negative rates and QE needs to be balanced against the benefit side of the equation. The global economy needed to get back on its feet and the panic induced crisis needed subsiding in 2008. The initial actions worked wonderfully. Unfortunately, just as the costs and side effects of these policies start coming to light later, (not that anyone would have needed much of a crystal ball to see them earlier) the economic benefits are becoming more distant with every QE purchase. These policies bought time, did what was necessary, but now real workable solutions are required before time runs out and the central banks can no longer hold off a recession.

Rubrics Fixed Income Macro View

December 2019

When Rational expectations are no longer Rational

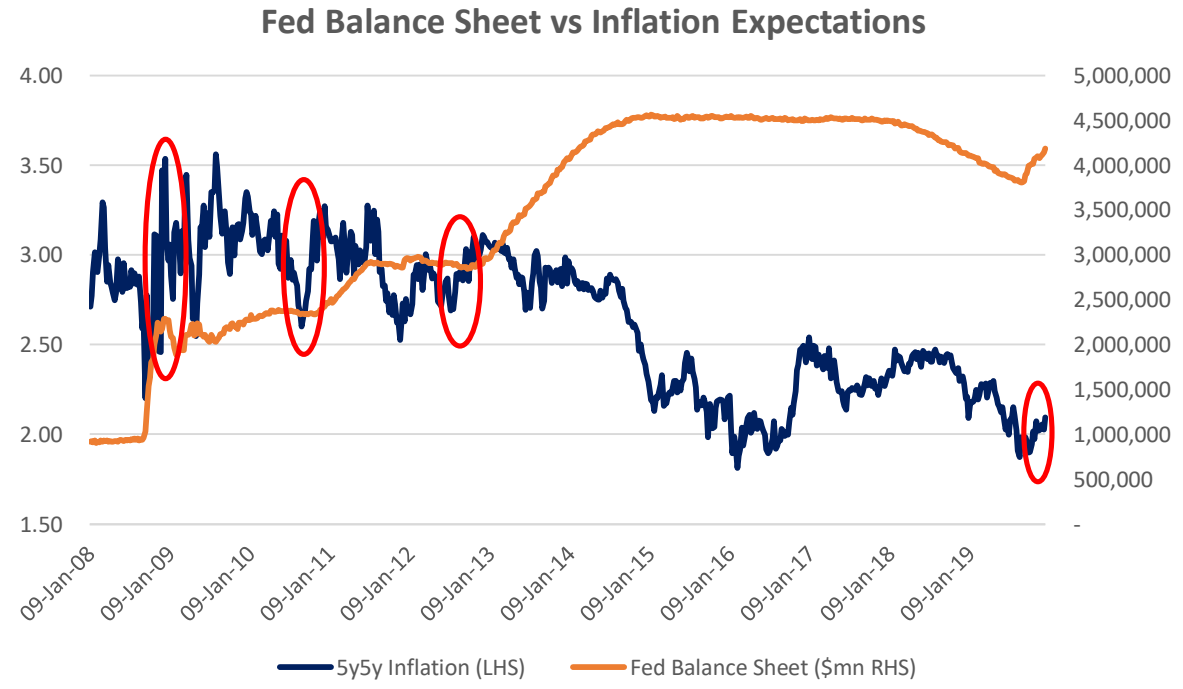
Central Bankers always argue things would have been worse if they did nothing, and to be clear there is some merit to this argument. However, their view was based on the belief that the rational thing for the markets to do when given cheap money is to take that money and invest it. This should eventually lead to more jobs, more productivity and ultimately a growth multiplier. This should then drive us away from the sub-par growth and productivity of post GFC.

The reality is that what central bankers like Bernanke thought would happen under the rational expectations model (Paul Samuelson), and what was rational for the heads of big corporations to do, were completely different things. While the CB's expected a rush to buy fixed assets and invest in future growth, what happened was that companies just bought financial assets (share buybacks/equities). This was not too dissimilar to what the central banks were doing in buying their own financial assets like government bonds. This all resulted ultimately in financial markets having massive outperformance versus the real economy. Worse than that, this has left a pile of debt in the real economy due to all the financial asset leveraging, which is now causing real sensitivity to any normalisation of interest rates anywhere. We have all seen much literature on the impact of debt on the system – it ultimately makes the system weaker not stronger if it does not induce strong growth multipliers.

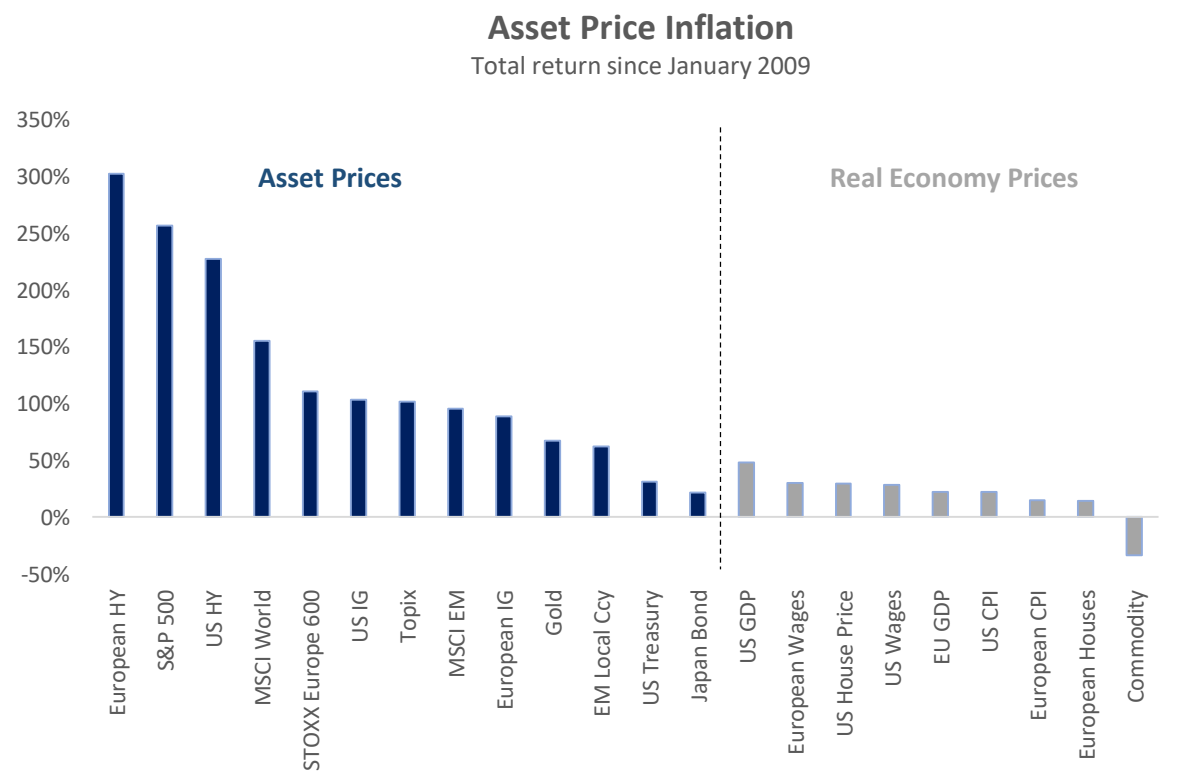
Central banks are locked in a maze of their own building – they can't now normalise rates due to the addiction the markets have to stimulus. Also, the debt overhangs which they induced with all the cheap money would be crushed by even the smallest moves higher in rates. On the other side, any double down on such policies risks significant unintended consequences, not just to market trust in central bankers but to the structure of capital markets themselves.

Pouring Concrete

Anyone lucky enough to watch the HBO/Sky mini-series on Chernobyl will clearly remember how the ultimate solution to the nuclear crisis was to poor concrete on it. In many ways that is what the global central banks did in 2008, they poured their form of concrete on the situation, i.e. newly printed debt. We now know that it was ultimately concrete not rocket fuel because every time we administer the pain killers to the system in the way of more debt, the more the system ultimately becomes more and more unresponsive to the stimulus. Current levels of stimulus as at the end of 2019 are significant in terms of nominal figures but are clearly having the weakest impact on economic conditions and inflation expectations.



Source: Bloomberg as at 23 December 2019



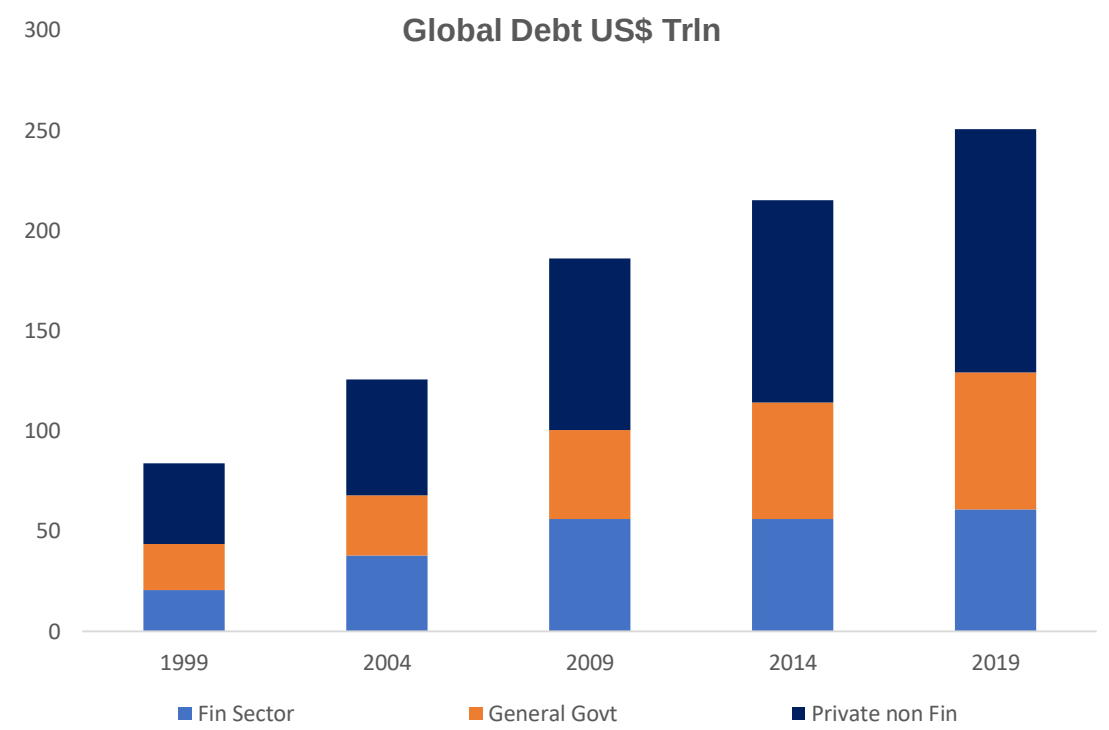
Source: Bloomberg as at 23 December 2019

Rubrics Fixed Income Macro View

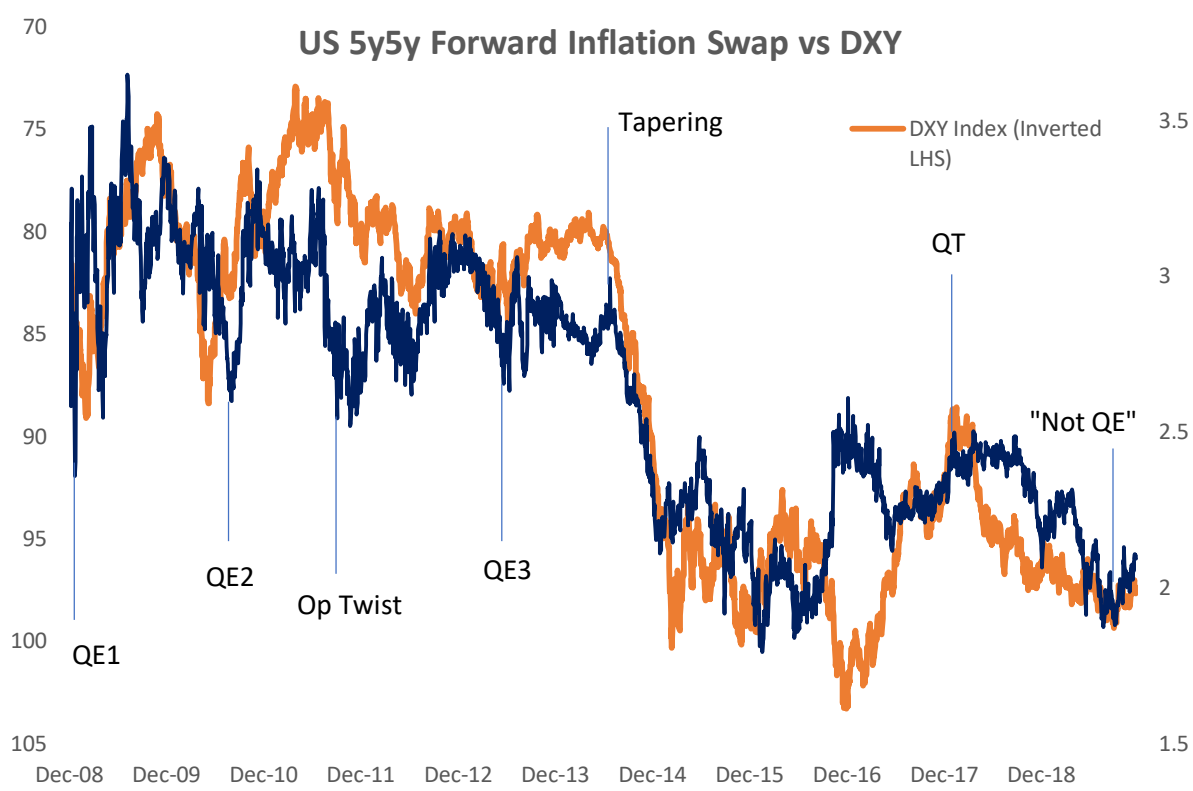
December 2019

The Dollar strength

Surprisingly, given the scale of the turnaround in US monetary outlook from hawkish to uber dovish today, the dollar has not weakened that much. Clearly other countries have also doubled down on dovish behaviour. However, given the muted impact on inflation expectations and other indicators, the stimulus has yet to filter deep into the system. A core element to any uptick in a global recovery will be a weaker dollar. Definitely worth watching in 2020.



Source: Bloomberg as at 23 December 2019



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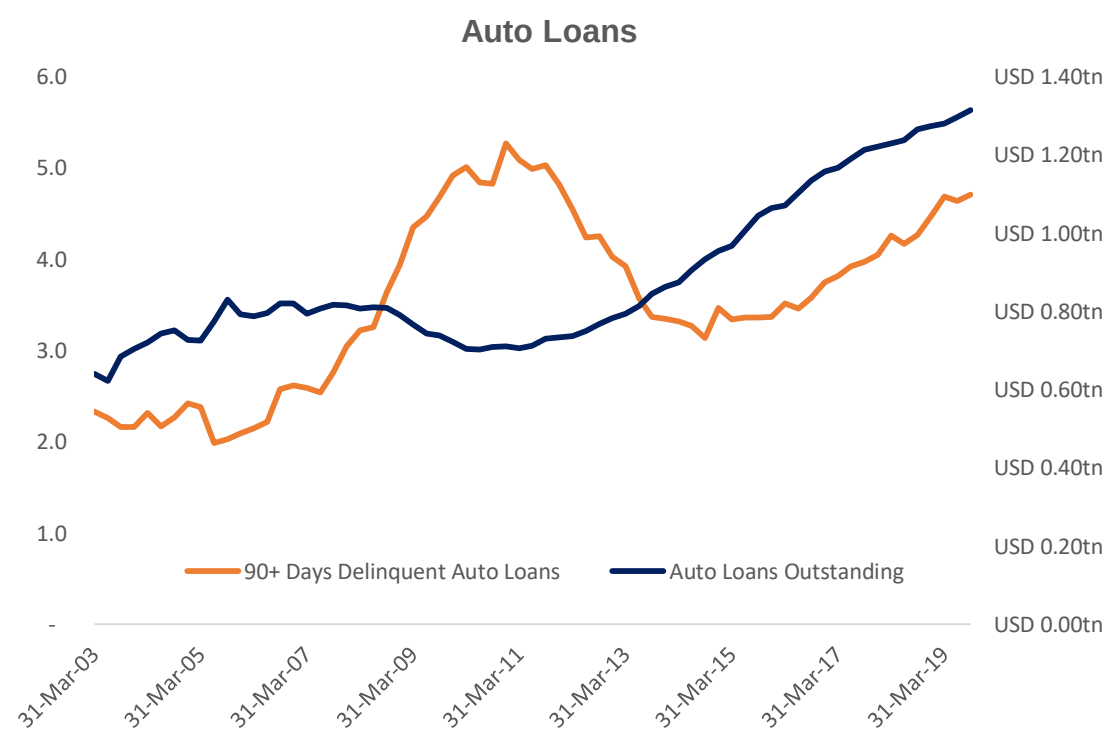
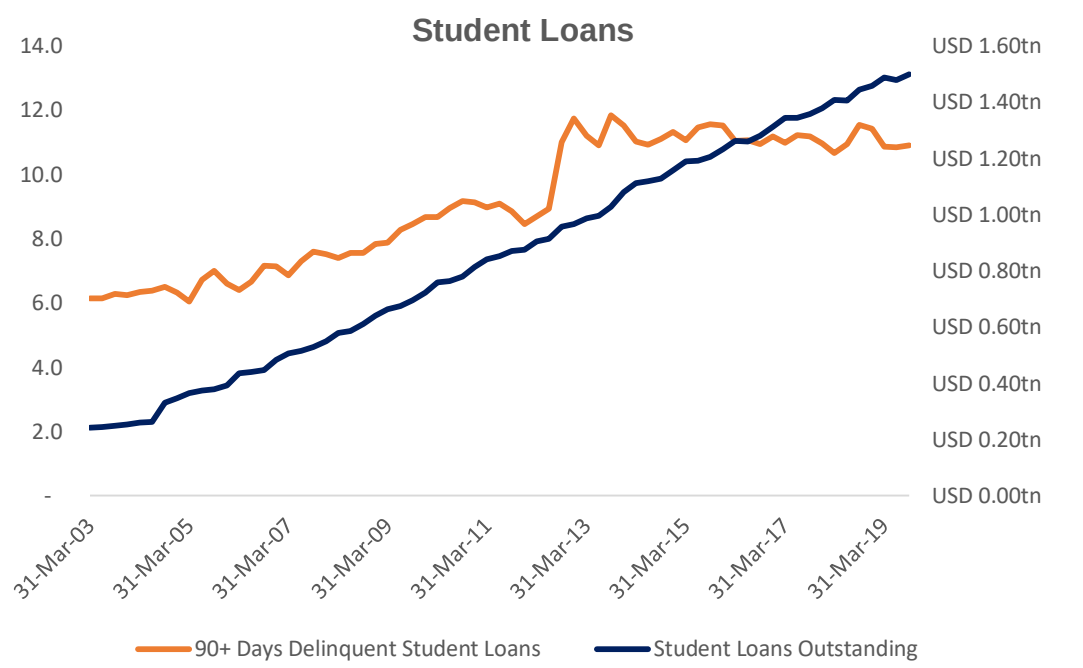


Source: Bloomberg as at 23 December 2019

Debt and the economy

Another reason why the stimulus may have become more ineffectual is because of the economy's lack of capacity to take on any more leverage. Many have argued that the government side of the equation could be lifted with MMT or direct monetisation etc. Of course it can, but with the additional problems of an already aging population and climate change, government spending would eventually crowd out private sector investments. An explosion in government spending replacing private sector investment is still extremely problematic, but potentially the only solution – and completely sub-optimal.



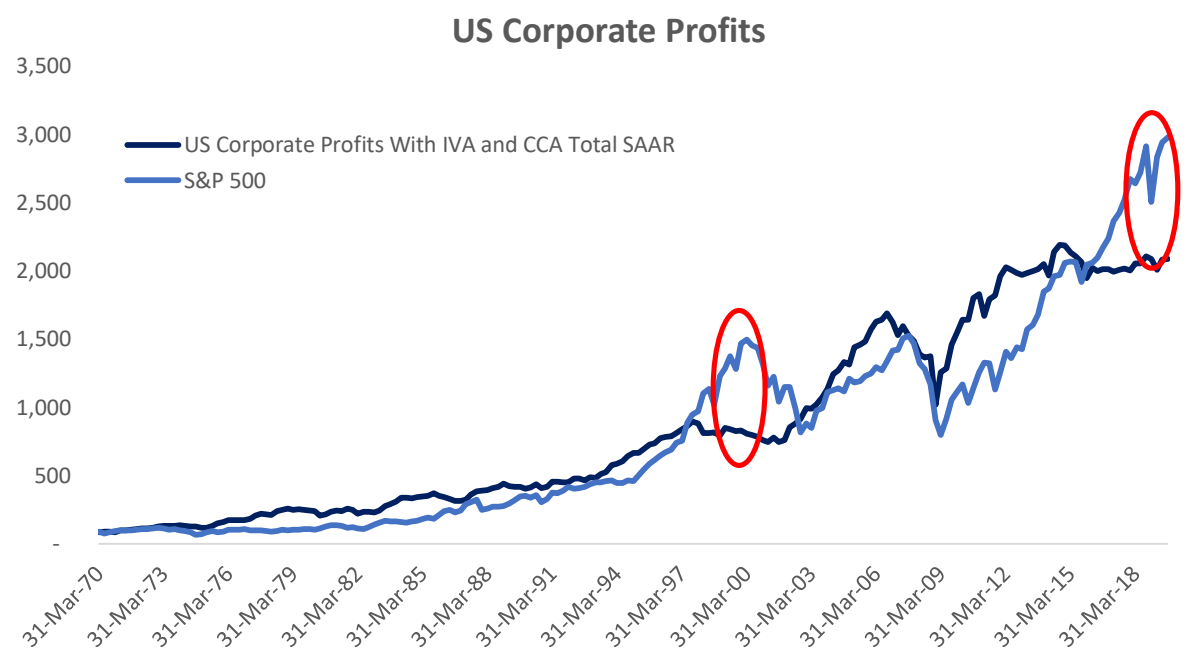
Source: Bloomberg as at 23 December 2019

Rubrics Fixed Income Macro View

December 2019

Stagnant corporate profitability

For all the excitement of improving earnings growth, simply ignoring non-GAAP earnings and focusing on a simple GAAP earnings model (as for example the BLS would) allows one to see that items like share buy backs and one off items are driving much of the EPS growth. Another issue facing the corporate market is falling profit margins with rising costs due to disruptions to supply channels, rising wages and flatlining productivity.



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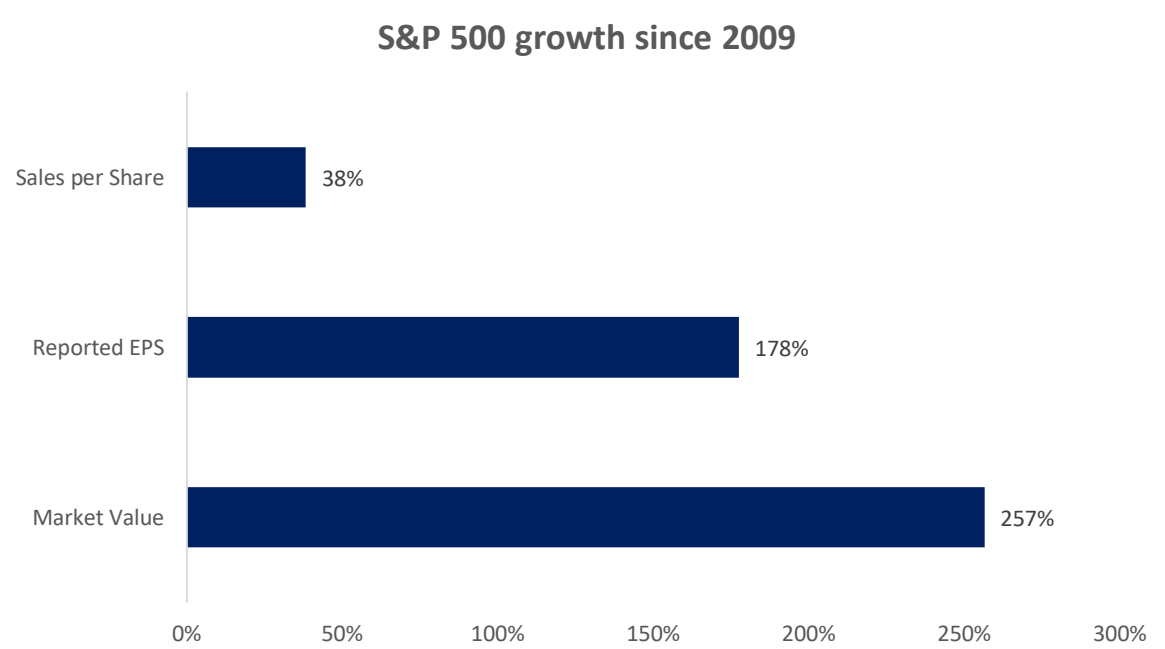
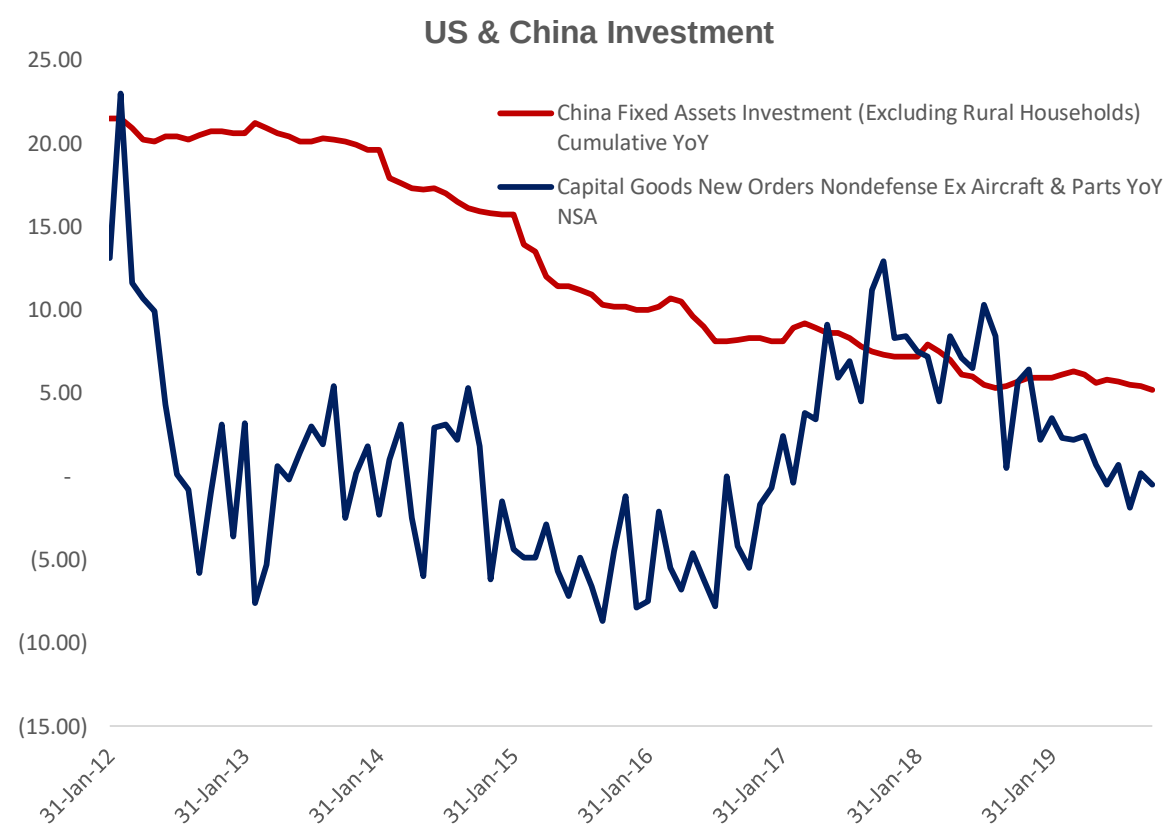


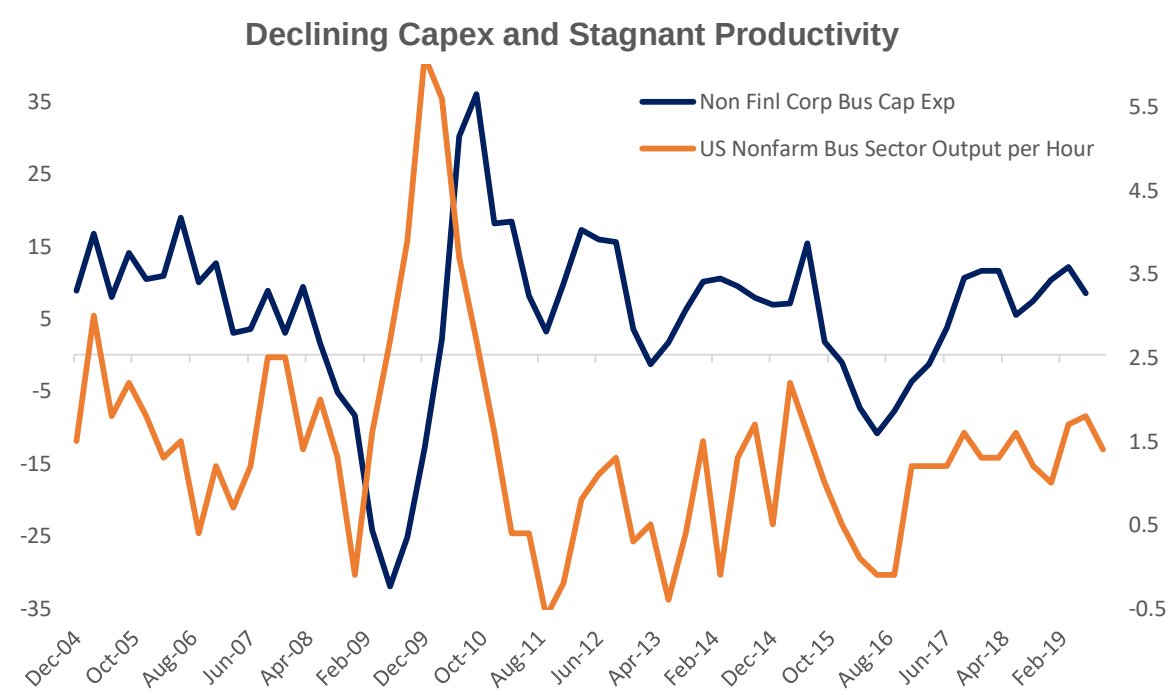
Source: Bloomberg as at 23 December 2019

Investment cycle going nowhere

For anyone looking for a significant uptick in global growth, or even basic productivity improvement, a significant improvement in the global investment cycle is required. However, looking at both China and the US, as of yet that has not happened. This is not to say that with some easing of the trade war that it might not happen. However, as it stands, it is a factor worth watching in terms of long-term growth outlook.



Source: Bloomberg as at 23 December 2019

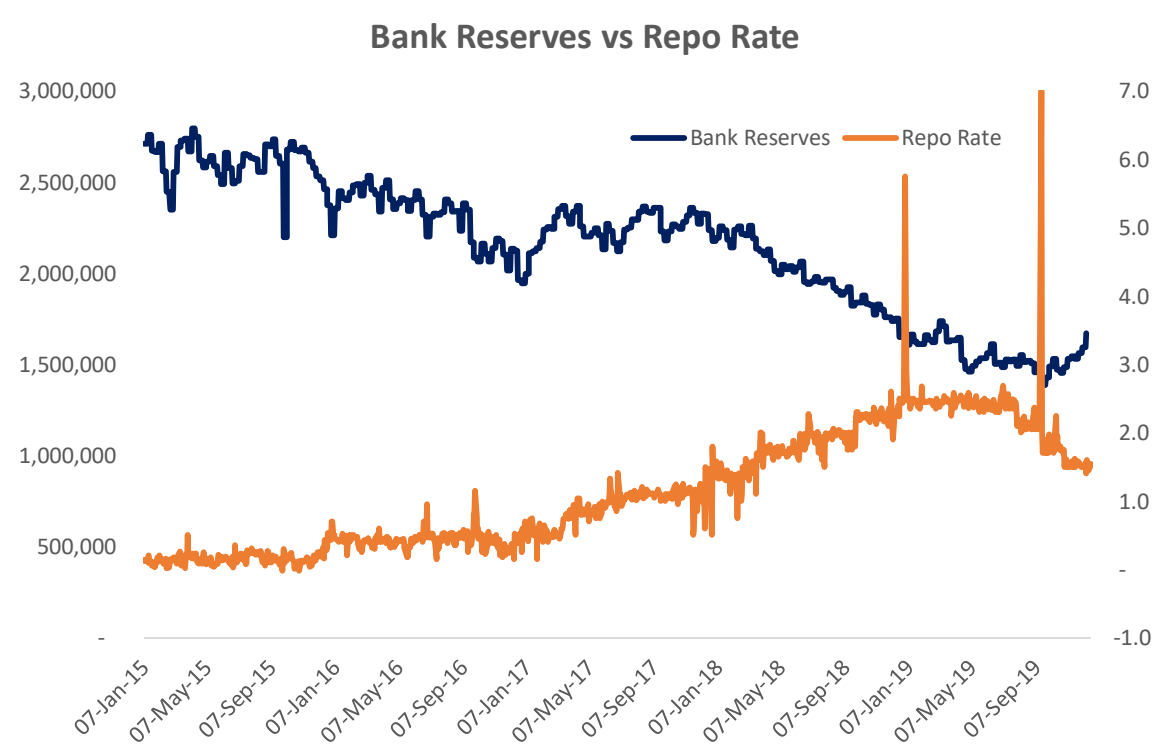


Source: Bloomberg as at 23 December 2019

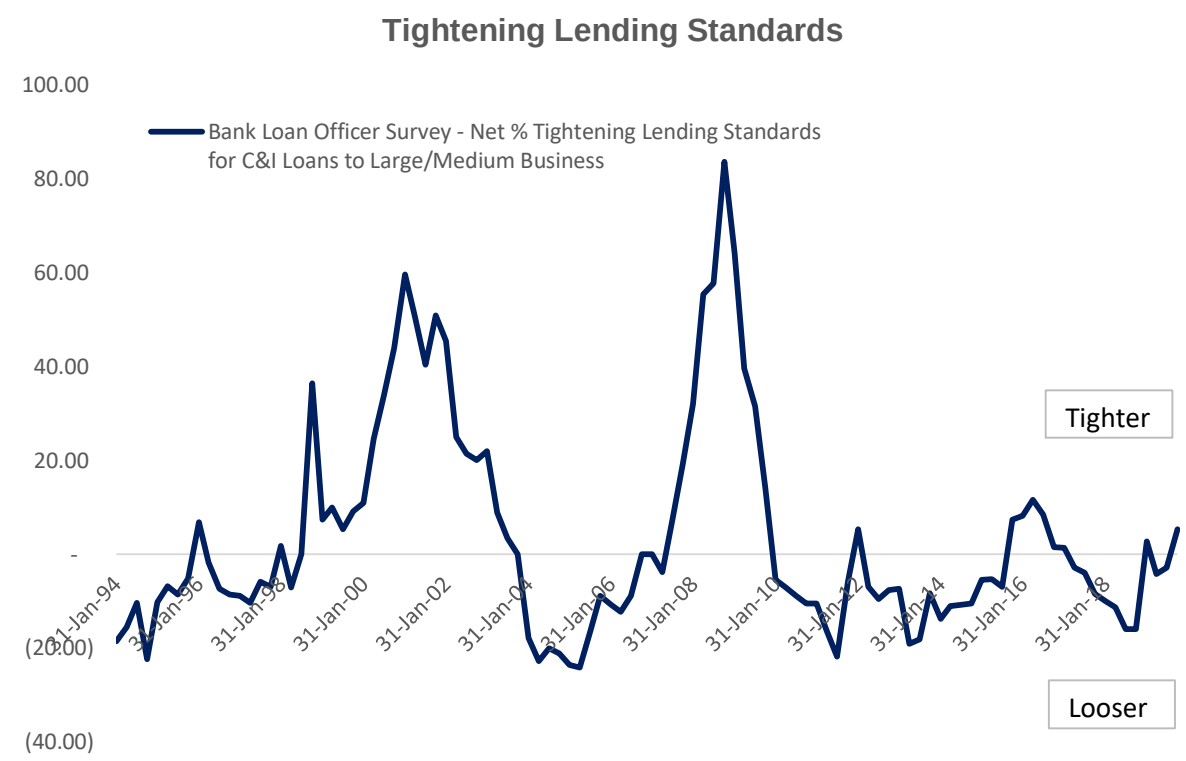
Rubrics Fixed Income Macro View

Where has all the liquidity gone?

Another factor that is crucial for market participants is market liquidity. Rubrics has highlighted this issue repeatedly over the last few years. A significant issue that came to light in 2019 was liquidity availability and funding costs in the US repo markets. Falling excess reserves in the banking system and JP Morgan's management of its balance sheet have been highlighted to explain the spike in the cost of overnight funding. As reserves become scarce banks are unwilling to lend them out as they manage their liquidity conservatively to comply with post GFC liquidity regulations. This results in an increase in the cost of repo funding to the market. Other concerns include issues surrounding both the Chinese and Indian banking systems. Central Banks have clearly been aware of other growing issues here yet failed to solve the problems. For example a lot of liquidity has moved to non-market areas like private equity and venture capital. The problem here of course is that given the limited opportunities and lack of transparency in this space, it might take a while to figure out if this was a good strategy or not. Central Banking policies have backed market participants into markets which ultimately may be inappropriate for the end client, but asset allocators have little alternative given the extremely low base rates and CB QE programmes.



Source: Bloomberg as at 23 December 2019



Source: Bloomberg as at 23 December 2019

Diseconomies of scale

The ultimate problem with pumping billions of dollars of monetary stimulus into the system is whether that money can be invested effectively. Massive misallocation of capital is always a concern. China has already started showing real signs of growing risks.

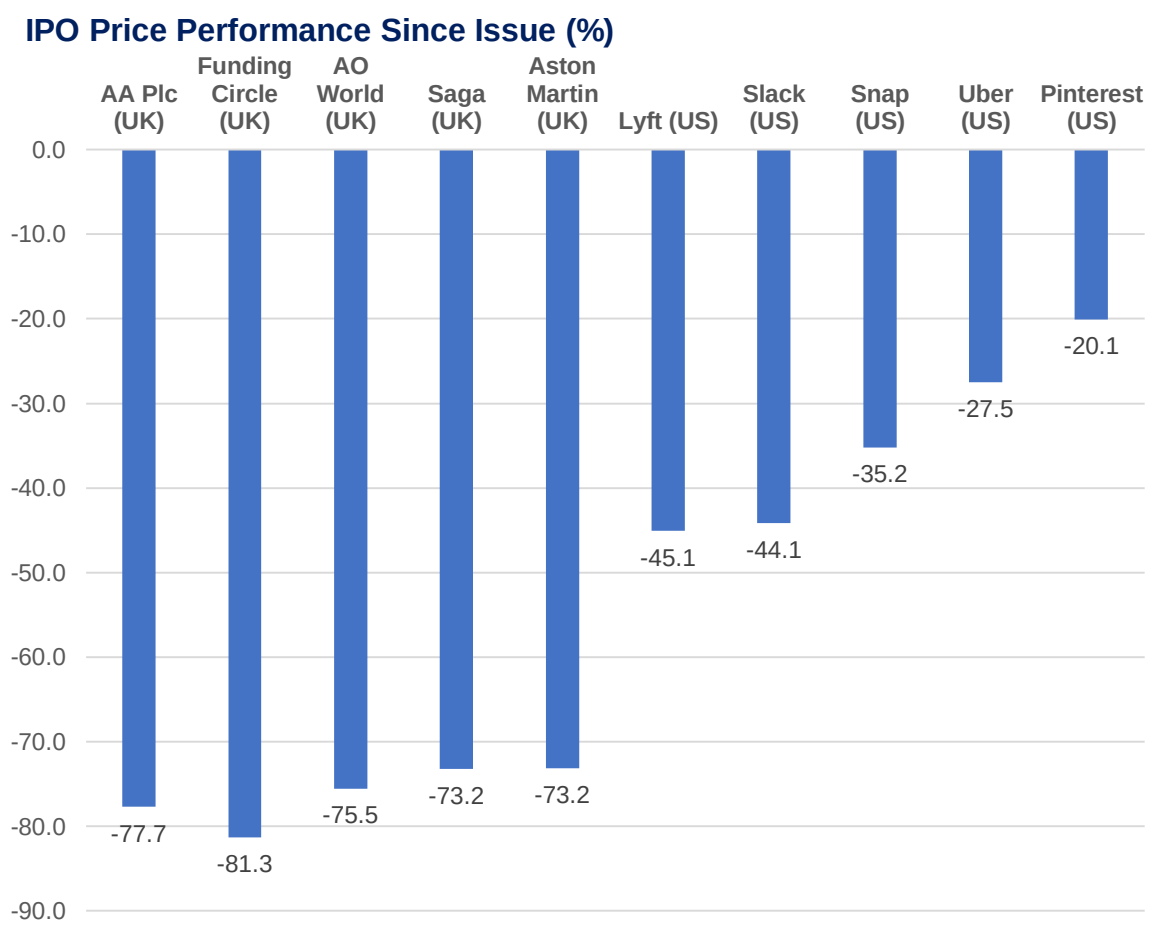
For example, in an attempt to revive its debt-laden private sector, state-run financial institutions in China have lent more than $22bn in the form of share pledge loans to distressed private sector companies. In spite of this state-led intervention, private companies have been defaulting on their debt obligations, raising questions over Beijing's efforts to rescue private groups using public funds. Of 339 listed private companies that have received government funding since August 2018, 75 later reneged on payments even after local courts ordered them to pay up. The turmoil prompted Beijing to step in for fear some of the companies, many of which are large employers, might fail and wreak havoc on their local economies. While rescue packages have provided a lifeline for embattled companies, they have not incentivised them to overhaul businesses to make them more profitable. The limitations of cash bailouts have prompted some cities to go a step further and acquire the troubled firms and install new management.

Rubrics Fixed Income Macro View

December 2019

Unicorn excitement is fading

2019 is the year of the failed IPO's and unicorn business models. Attempting to be the next Amazon in your chosen market is a lot more difficult then many venture capital firms imagined. Surprisingly, businesses that lose billions a year no longer look as attractive as they once did. The shock of it – unicorn business projections turn out not to be real! Who could imagine such a thing? Financial conditions have certainly tightened somewhat in 2019 for some – CCC's are no longer considered an easy way to prop up falling yields, covenant light leveraged loans no longer simple replacements for low risk investment grade bonds. Capital markets recovered, particularly from the crash of Dec 2018, however the tide has not lifted all boats. As this economic cycle slowly moves towards an inevitable end, more weak business models are being found out. Looking at the dynamics of the likes of General Electric and even Boeing clearly indicates that years of billions in share buybacks don't do any favours for corporate competence. Anyone willing to look at the success, or lack thereof, of corporate Japan since zero rates took hold would have predicted the outcomes we have seen.



Source: Bloomberg as at 23 December 2019

2019 in Review

In many ways 2019 was not so different to 2017. Capital markets exploded higher on a monetary policy induced rampage. New highs were reached in many markets. Some credit spreads reached new all-time lows and negative yielding securities peaked at over $17 trillion in value. All it took was 66 global rate cuts and now billions in monthly QE – not to mention significant loosening of fiscal policies in many countries (the US fiscal deficit will reach close to $1trillion for 2019). On the back of all this stimulus we certainly dispelled any recession concerns we saw in late 2018. In fact, the bounce back in investor confidence as measured by some indicators was the quickest on record. It is important to note that a great deal of this jump was in some way due to the problems in the US Repo markets which induced the Fed into "not QE" QE; this was a game changer in the Autumn.

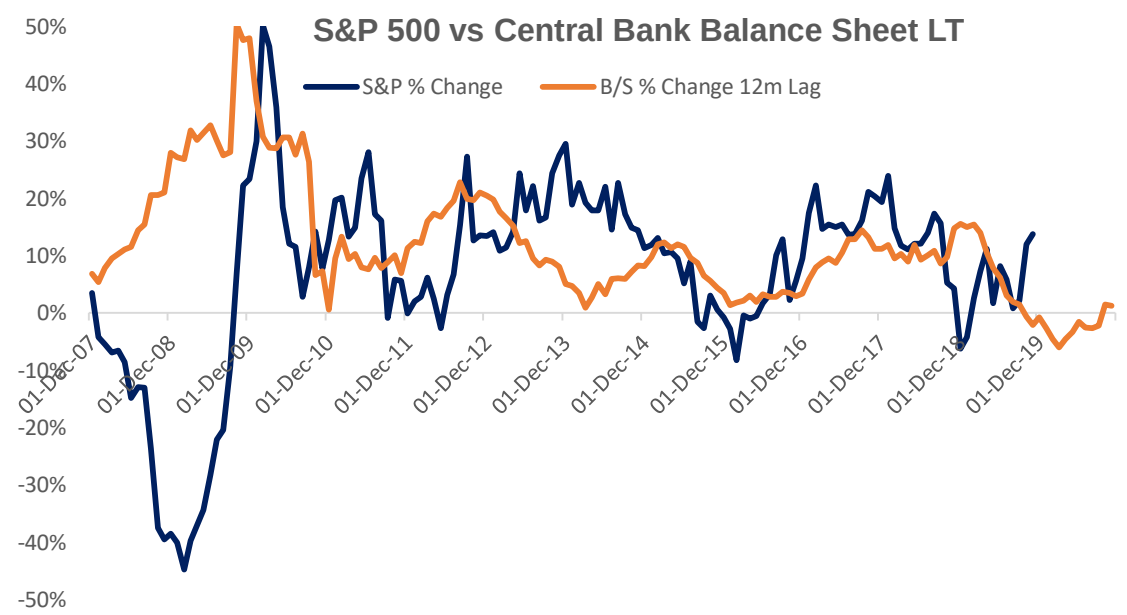
Through all that bullishness and confidence that central bankers will once again save the day, some concerns have appeared. There are, for the first-time, real discussions about the current policy mix and some are asking the question whether any of these policies provide any long-term benefit rather than just another short-term market fix. The global economy has certainly stabilised; however, a 2017 type reflation has not appeared. Many of the improving economic statistics are still very subdued by any historical standards. Could monetary policy be losing its magic on the real economy?

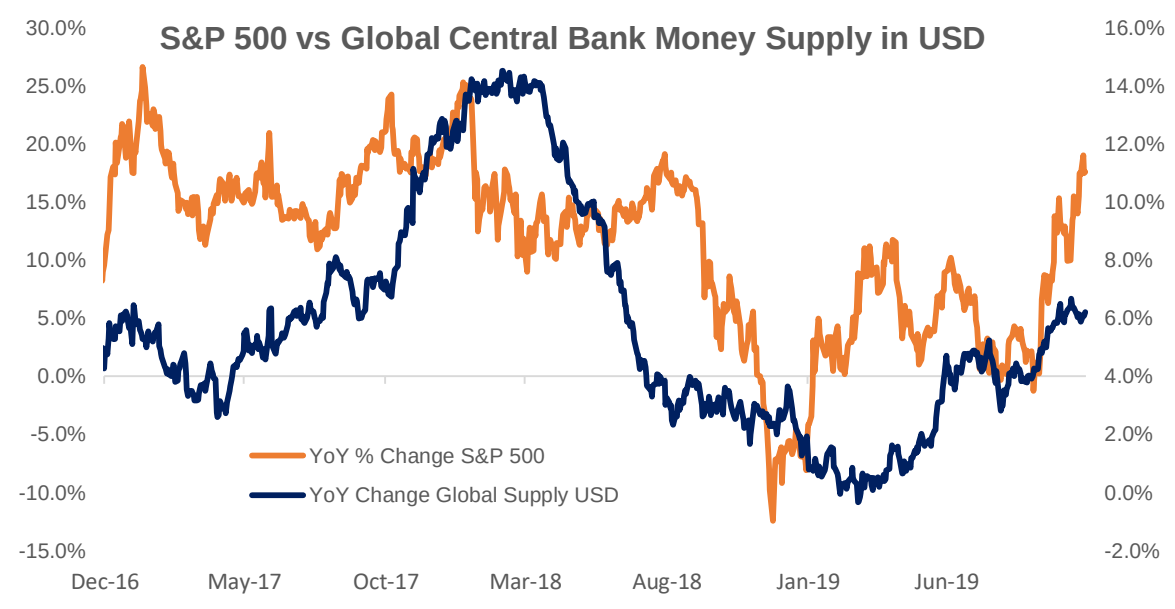
Recently Eric Rosenberg at the Boston Federal Reserve was surprisingly open about the risks of their current policies at a speech in the Forecasters Club, New York. He argues that if these policies fail to produce a real impact on the long-term growth potential of the US economy, they might be guilty of producing conditions for the very recession they were trying to avoid. He correctly points out that the last two recessions were due to collapsing asset markets which in turn pulled back economic conditions – might that happen again he ponders?

Rubrics Fixed Income Macro View

ECB vice president Luis de Guindos has openly questioned if their policies are inducing investment managers to take extreme risks. Are the very policies they are pursuing creating a market where the very risks they are now so openly concerned about (excess risk taking) are a result of their own actions? Christine Lagarde's first report as head of the ECB also questions the impact on risk taking of the ECB's policy decisions. In China, the authorities' reluctance to overstimulate their economy must clearly be a reaction to the bad debt and bond default problems their recent policies have created. Banks in China and India are faltering under the pressure of all the bad loans given over the last decade. Mal investment from China's property investments to America's tech unicorns is starting to demonstrate that QE eventually creates as many problems as it tries to solve. Paul Krugman's insistence that a property bubble would solve the Dot-Com bubble hang over or Ben Bernanke's stated policy that a rising equity market would offset the structural problems left behind from the GFC can now been seen from a long term perspective for what they are – ill-conceived and failed policy choices.

All the market's challenges will once again reappear when central bankers attempt to withdraw the opioids and the withdrawal symptoms kick in again. The short vol ETF's will once again blow up. The risk-parity funds will once again have to reduce risk and rebalance portfolios. Economic conditions will weaken. We will be left with unrealistic financial markets and little in the way of effective tools left at central banks. This is the same story as the one we have been reading for nearly a decade now. Except now most people are aware of the punchline – these policies fix nothing and even in their own analysis might even make the situation worse. As many have observed, the ability to implement these policies becomes more challenging each time. The silver lining here of course is that this rotation of risk once again allows long term investors opportunities to rebuild portfolios with real value without the pain of large drawdowns like Dec 2018.





Rubrics Fixed Income Macro View

December 2019

Credit Markets Overview

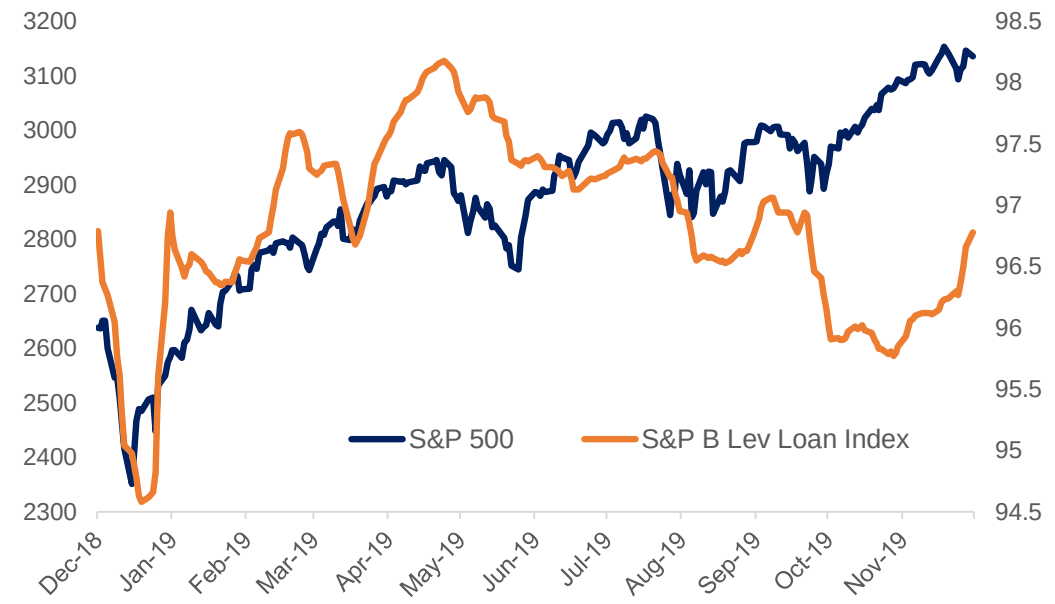
"Rising tide has not lifted all boats"

Central Bank QE has helped corporate crossover credit spreads considerably, but less so more speculative high yield, Emerging Markets bonds and Leveraged Loans. We suspect this trend will continue as investors remain discerning towards the riskiest credits for the fear of default. In EM, recent problems began with Argentina bonds halving in August followed by similar falls in Lebanon and then Ecuador. In US high yield, weakness originated in the Energy, Oilfield services, Coal Mining and Retail sectors. This appears to be spreading to sectors such as Telecom and Pharma. The common feature amongst CCCs in all these sectors is worsening fundamentals, unsustainable debt structures and weak investor protections. We will continue to monitor if this weakness leaks into BBs and higher rated credits, which could have wider implications for the IG market.

Strong year for Benchmark investors but where next?

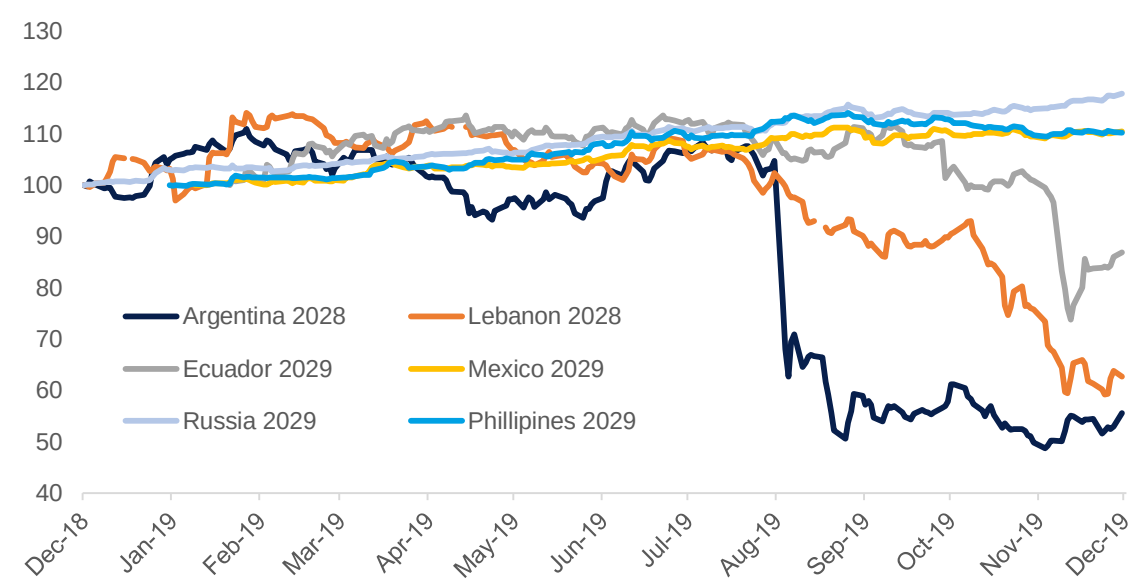
2019 started with Global IG Corporate[1] credit spreads at circa 155bps and we are set to close below 100bps at the end of December. Macro was very supportive for credit in 2019, demonstrated by 3 US rate cuts, a resumption of ECB QE and finally the Fed increasing its balance sheet through the purchase of T-Bills. Long dated IG Corporate credit has been the key beneficiary, and issuers have tapped into this, locking in low cost long term funding. Global IG Corp Benchmark duration is around 9.3 with a YTM of 2.3[2]. To generate similar returns to 2019, next year, benchmarked investors have to dial up the duration and/or increase credit risk further. After the rally that duration has had this year and with rising credit risk emanating from the lower rungs of the credit market, that may prove to be challenging.

B Rated Leveraged Loans and Equity Markets

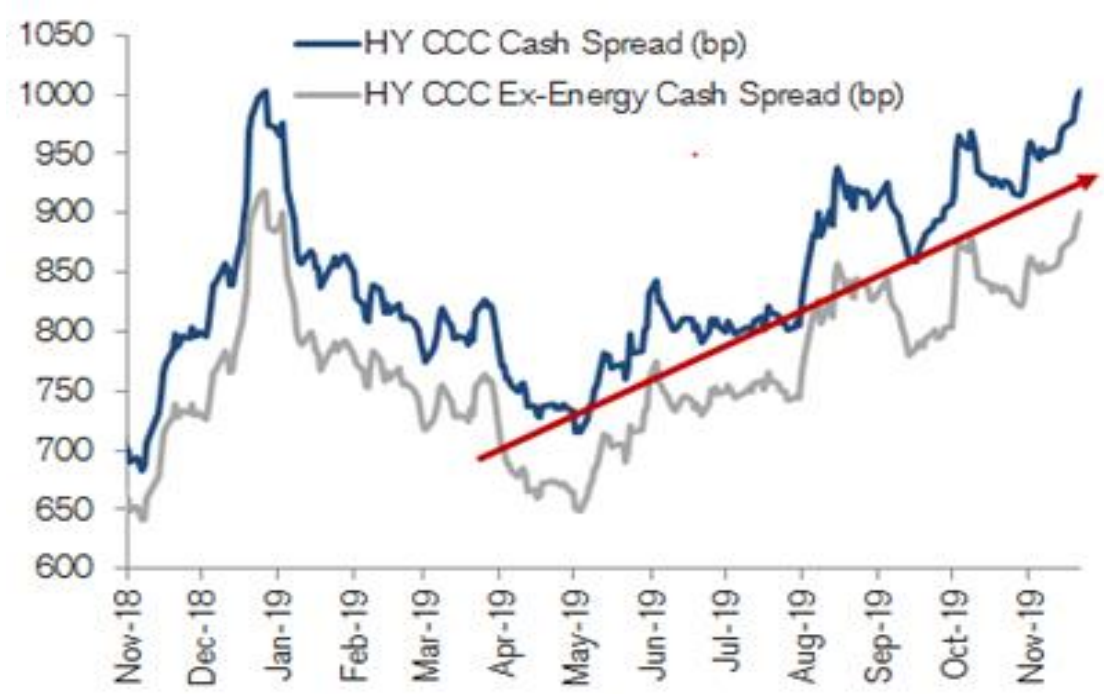


Source: Bloomberg as at 9 December 2019

Price performance of 10 year USD EM Bonds (rebased to 100)

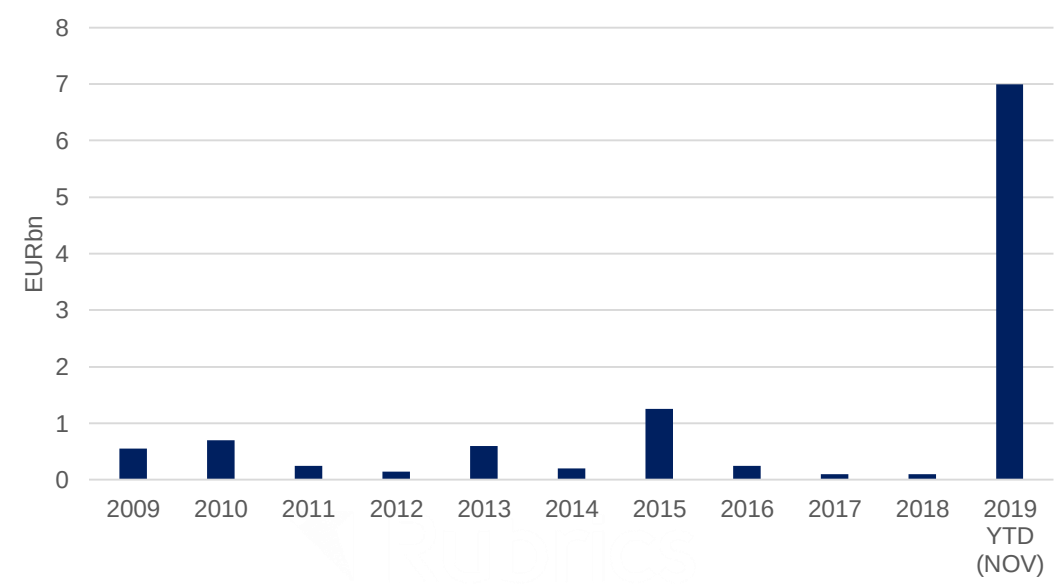


Weakness in CCCs broadening outside Energy



Source: Credit Suisse as at 9 December 2019

30+ year € corp. bonds issuance surged in 2019



Source: Credit Suisse as at 9 December 2019

[1] Barclays Global Corporate Aggregate Spread
[2] iShares Global Corporate Bond as at Nov 29 2019

Rubrics Fixed Income Macro View

While flows keep continuing into IG Credit, and the ECB keeps buying, IG corporates should still be able to refinance cheaply. However, as demonstrated in the US Energy sector, IG credits are not immune to worsening fundamentals, which is why US E&P credit trades around 50bps wide to aggregate BBB corporate spreads.

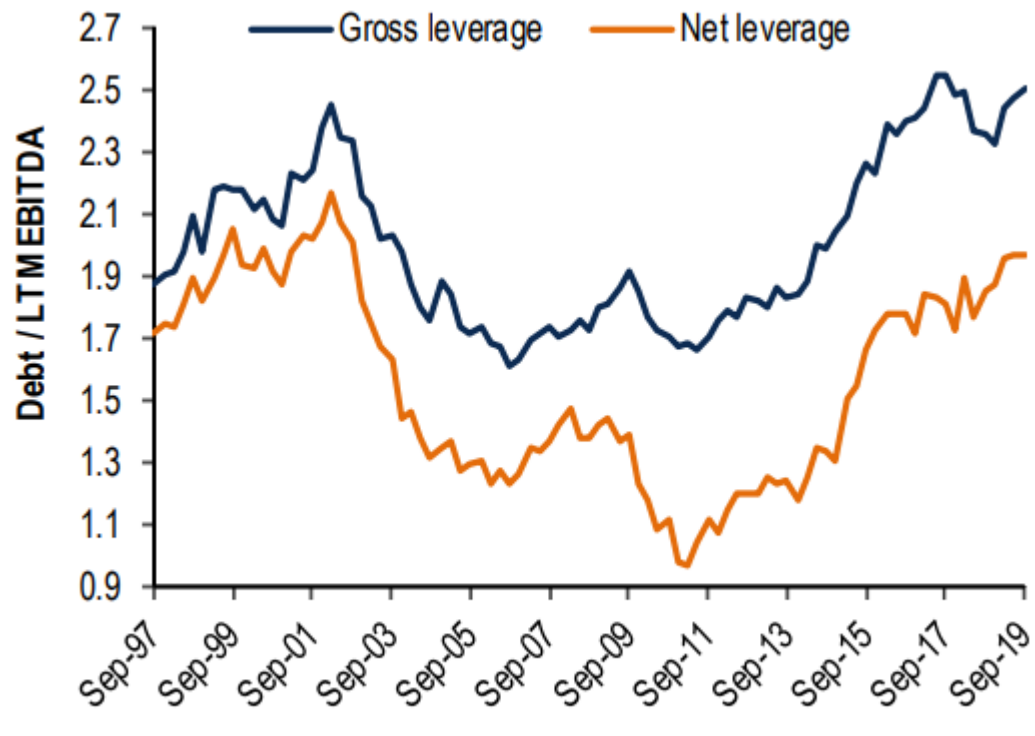
Corporate headwinds rising

Leverage levels have been increasing steadily since 2011. However, the significant drop in borrowing costs for large corporates has resulted in near record interest coverage ratios, especially in Europe where some companies are able to borrow at zero coupons.

S&P 500 Q3 earnings stats published by *Factset* showed a 2.2% decline in EPS for the quarter. Which would be the first time the index has reported three straight quarters of YoY declines in earnings since Q4-15 to Q2-16 and the largest YoY decline in earnings reported by the index since Q2-16. Earnings were dragged down by Energy, Materials and Info Tech sectors, and boosted by Utilities and Healthcare. We take these figures with a slight pinch of salt due to the noisiness of EPS compared to EBIT, but the trend is notable either way. Headwinds to US Corporate earnings include rising wage costs, the continued strong Dollar, and any negative tariff impact. The direction of travel in developed economies is one such that individuals should share in the benefits of corporate profits. In the UK, minimum wage increases since 2015 have delivered a £3bn[3] pay boost to low paid workers in 2018. In the US, Senator Bernie Sanders has been vocal about getting Walmart to pay a minimum wage to its employees of $15/hour. Rising wages is just one cost that Corporates will have to manage in order to maintain or grow their margins.

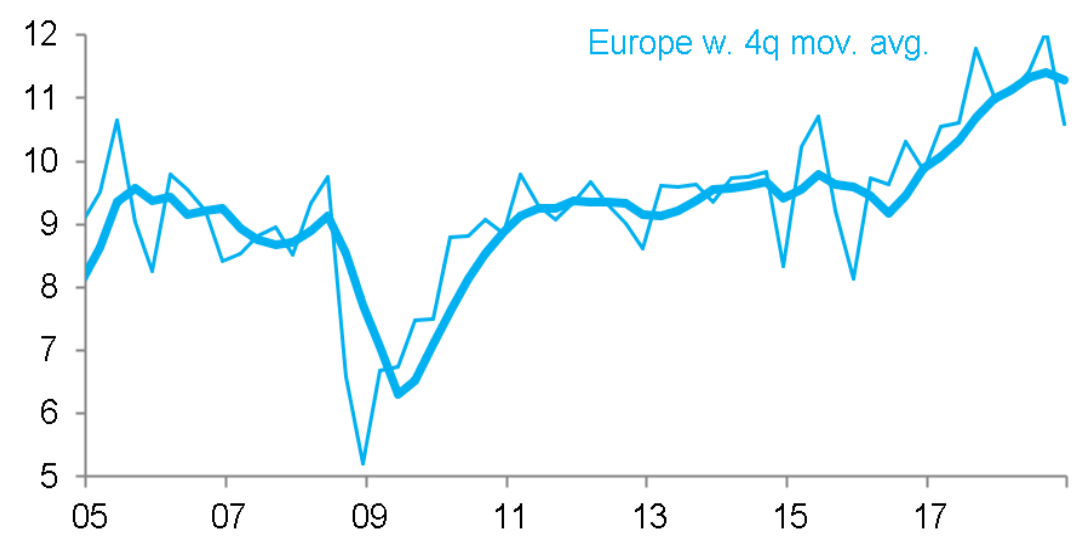
[3] Resolution Foundation

US IG Debt/EBITDA (Ex. Finance, Utilities)



Source: BAML

European corporate interest coverage near historical highs



Source: Citi Research, Bloomberg.

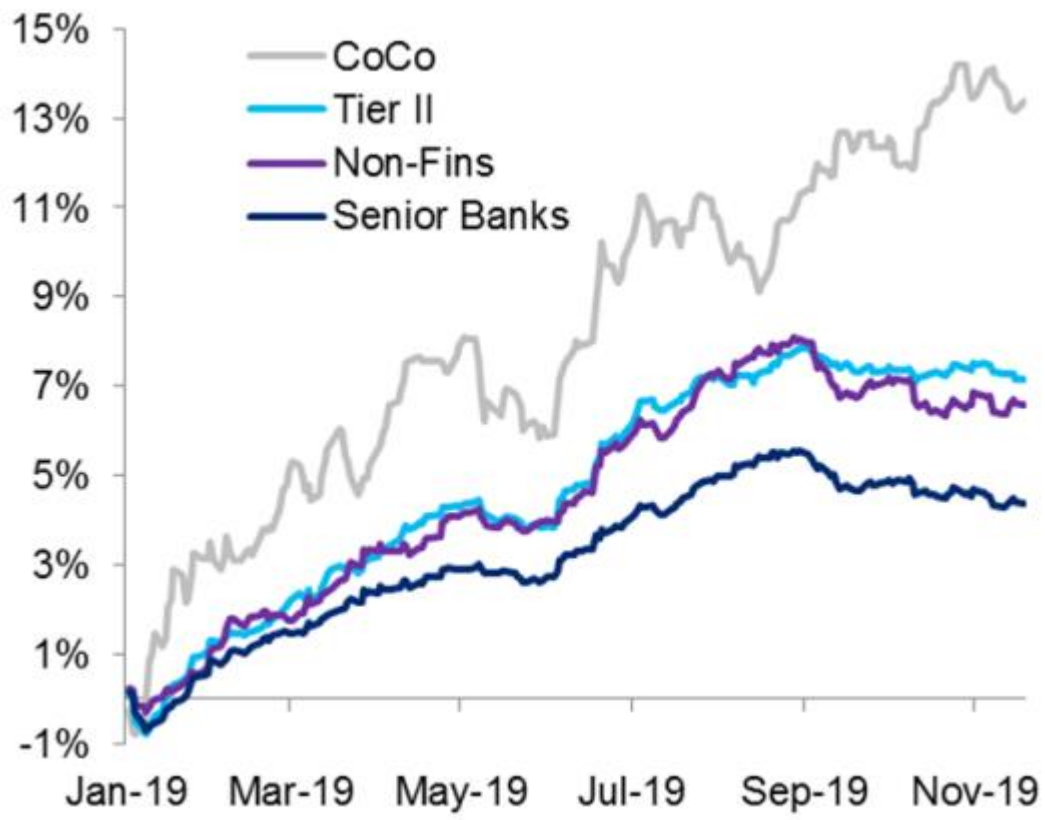
Banks and Insurers

The majority of financial issuers are successfully retiring legacy debt either at first call or strategically in the case of low reset discount perps. With the latter, firms are clearing up their capital structure by issuing outside their OpCo subsidiaries. We observe AT1 issuance from the 2014 vintage is starting to be redeemed at first call, e.g. the HSBC 5.625% (2020) call where HSBC have announced an intention to call. This has been supportive for other existing AT1 issuance as the supply of AT1 from solid issuers struggles to keep up with investor demand.

Bank Net Interest Margins ("NIM") are adequate in spite of low rates and the structural decline of markets revenues for banks with Investment Banking / Trading divisions. Central Banks and Prudential Authorities continue to prioritise stable banking systems in the main developed markets, demonstrated by policies like the deposit tiering scheme by the ECB.

As the AT1 asset class seasons, Ratings Agencies also appear to be updating their methodologies to benefit the more robust issuers in the sector. Rating Agency Fitch is currently looking at changing its rating methodology on Bank subordinated paper. The early analysis[4] suggests that there could be upgrades to certain AT1 bonds and downgrades for certain T2 bonds. This could draw more investors into the asset class which would be supportive for asset prices, but we await the final verdict from Fitch in 2020.

iBoxx Total Returns YTD for Bank Capital – CoCos in the Lead



Source: Citi Research as at 9 December 2019

AT1 Characteristics – Dollar issuance still leads

	Amount o/s	To Call - At issue (yrs)	To Call - Now (yrs)	Avg spread to call (bp)	Average YTC (%)
EUR	55,245	5.88	3.13	390	3.67
USD	105,700	7.18	4.05	368	5.29
GBP	13,839	7.29	4.60	441	5.20

Source: Citi Research as at 9 December 2019

[4] Citi Research

Rubrics Fixed Income Macro View

In the insurance capital asset class, we observe the growing Restricted Tier 1 ("RT1") market which is still in its infancy relative to Bank AT1s. Bonds in this space typically come with high headline coupons but long-call dates. Most RT1s started the year at wide spreads following the beta sell-off in December 2018 (e.g. Phoenix 5.75% RT1 – Call 2028 shown across). RT1s have done well in 2019 as investors piled into long duration credit. Our involvement in RT1s has been minimal so far as the long call dates are outside of our typical duration criteria. Our current preference is for the more seasoned asset class of Bank AT1 where there is a wider variety of instruments. However we would not rule out Insurance RT1s forming part of a tactical allocation following a spread widening.

Phoenix 5.75% RT1 (2028 call) – Cash price

Source: Bloomberg as at 9 December 2019

Environmentally Conscious and Sustainable investing

2019 has seen the shift towards more environmentally friendly and ethical investing pick up pace. With regards to the former, many large investors, multinationals and corporations have publicly made commitments to increase investment in renewable energy and reduce investment in new fossil fuel projects. In the UK, we observe that some renewable power sources (such as offshore wind) are just as cheap or cheaper than traditional energy sources. With renewable energy sources becoming more commercially viable, it is inevitable that more capital is allocated to this sector and less into fossil fuels. This trend could impact on cost of capital for issuers in the Fossil Fuels sector, and could even result in more sector restructurings as the lowest rated issuers struggle to secure capital from lenders. This phenomenon has already impacted Coal Miners in the USA, many of whom have filed for Chapter 11 this year.

Stakeholder	Proposed Action	Announced Date
BHP Billiton	BHP plans to replace coal with renewables at two huge copper mines in Chile	October 2019 (Company)
Enel	Enel Issued its first Sustainable Development Goals (SDG)-linked bond. The terms and conditions of the five-year instrument include a KPI which Enel commits to achieving for investors by 2021: the increase of its renewable energy installed capacity to at least 55% (from 46% as of H1 2019) of total capacity. Most interestingly, the company is allowing investors to hold it accountable for this strategy via a coupon 'step-up' clause.	September 2019
More than 600 institutional investors managing $37 trillion in client assets	Firms such as Britain's Aviva, the California Public Employees' Retirement System and Zurich Insurance Group demanded an end to thermal coal power plants worldwide, the introduction of a "meaningful" price on carbon, an end to fossil fuel subsidies and for governments to increase planned emissions cuts beyond what has already been pledged.	December 2019
EIB	The European Union is to stop funding oil, gas and coal projects at the end of 2021, cutting €2bn (£1.7bn) of yearly investments.	November 2019 (BBC)
Storebrand ASA	Life insurer Storebrand ASA has scrubbed all funds managed by its Swedish unit clean of fossil-fuel producers.	Bloomberg
Norway Sovereign Wealth Fund	Norway sovereign wealth fund to divest oil explorers	October 2019 (Reuters)

Rubrics Fixed Income Macro View

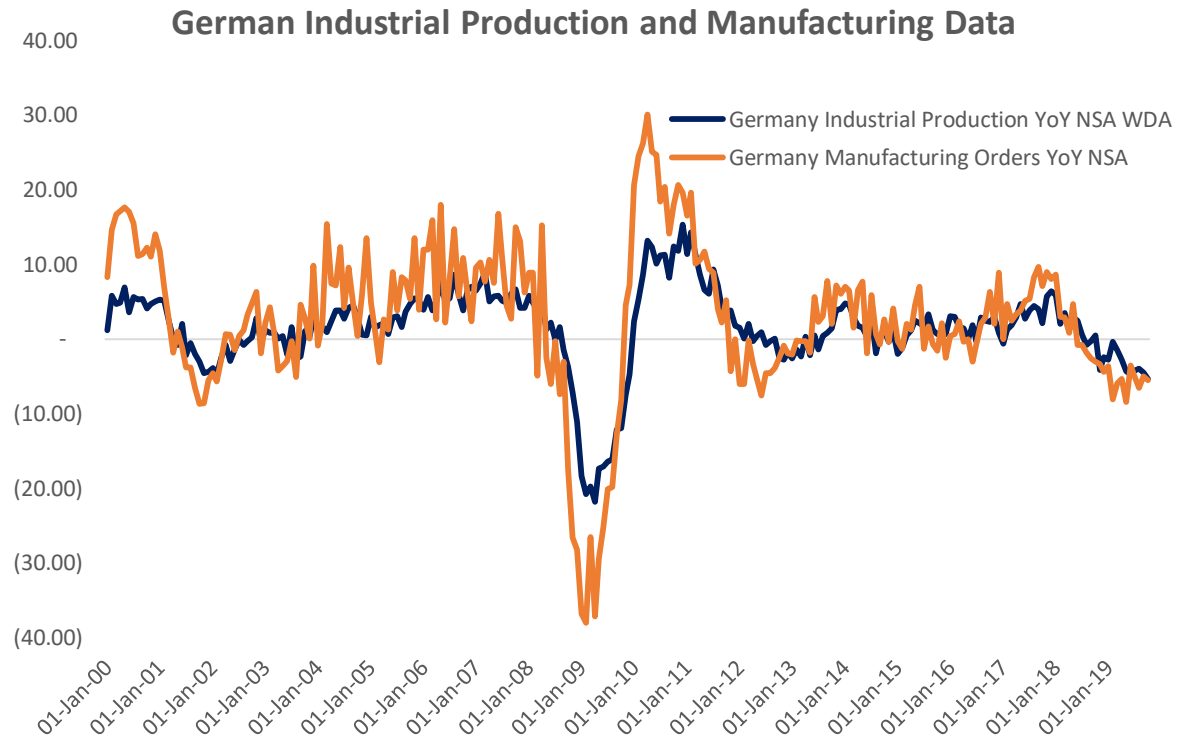
December 2019

The market outlook

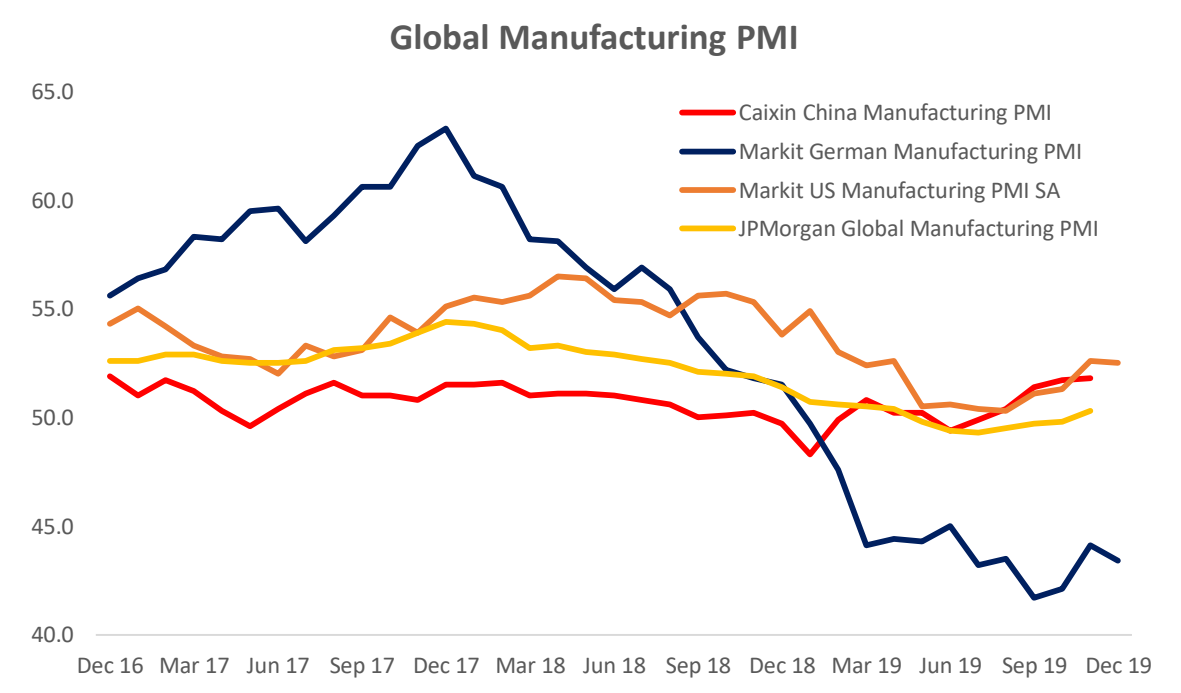
Clearly, the collapse in global trade and manufacturing panicked central banks into a complete U-turn on required stimulus. While risks of a recession were high at the end of 2018, we have seen considerable stabilisation in 2019, in no small part due to very aggressive central bank action. However, a large reflation story is not yet on the cards.

China will, under duress, resort to more stimulus but given its current debt problems it will be slow to do so as we pointed out in early 2019. China will benefit somewhat from a trade deal of sorts, but China's issues go much further than trade wars with the US. Xi has got complete control today, and with that comes opportunities and risks. These risks are currently being exposed in Hong Kong and in north western provinces of China. China is unlikely to surprise too much on the upside in 2020, and in fact the reality is we are going to see official GDP figures with a 5 handle. The Chinese investment cycle is nowhere near where it needs to be for a sustained reflation story. Commodity markets have started to price in more Chinese infrastructure spending – by the second quarter 2020 the reality of the Chinese situation my halt renewed hope.

In the US 2019 saw one of the biggest and quickest about-turns on monetary policy any of us have ever seen. In Nov 2018 we were planning for, according to the Fed, 3 or 4 more rate hikes and a continuation of QT. What we got in 2019 was 3 rate cuts and balance sheet expansion. The rate reversal in early 2019 eased recession concerns. However, it wasn't until Q3 & Q4 that the renewed QE ("Not QE") factored into an explosion higher in asset prices. This all happened due to problems in the repo market. It would have been remarkable for anyone to predict that such a localised issue in the US repo market would be the root cause of such an explosion higher in asset prices.



Source: Bloomberg as at 23 December 2019



Source: Bloomberg as at 23 December 2019

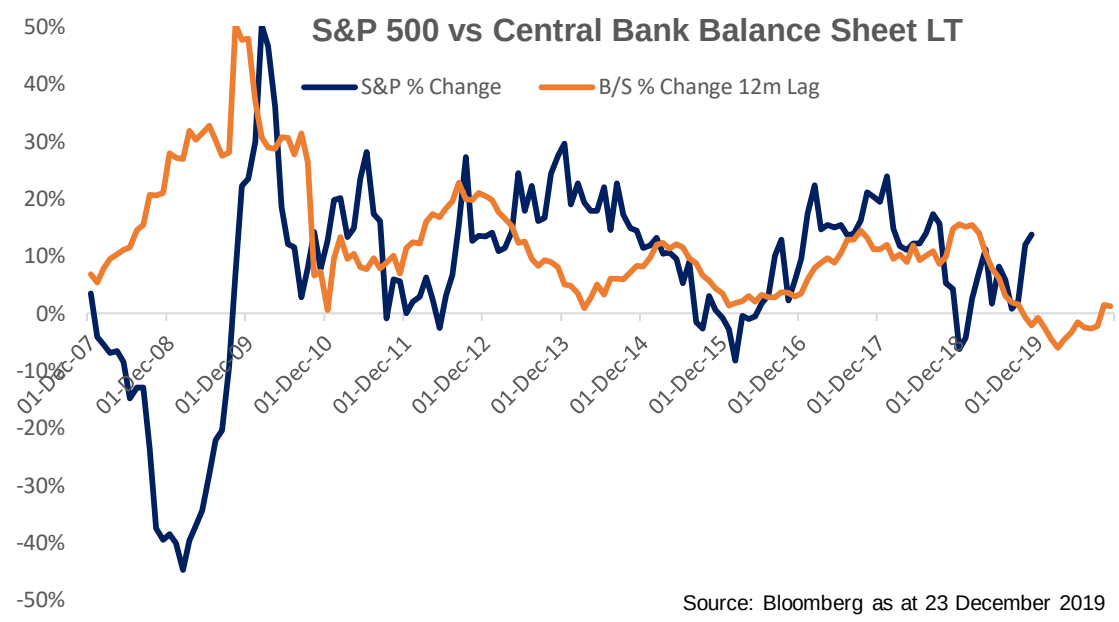
Rubrics Fixed Income Macro View

December 2019

The Federal Reserve should raise its balance sheet back to the point where it introduced QT in the first place. After that point we believe that rate cuts will be back on the cards more so than QE in terms of any future stimulus. The biggest risk we see for 2020 is that the recovery doesn't pick up much pace and more and more broken business models are exposed. Investors may start to question more and more what is actually going on behind the non-GAAP earnings reports. Can equity indices move much higher without any significant top line growth?

2020 will be dominated once again by the central banks and particularly the Fed's balance sheet – if the Fed pulls back on balance sheet expansion in March due to the stabilisation of growth and inflation, expect more market volatility. We would expect the Fed to attempt this. At the same time there is more and more pushback against negative rates in Europe as banks' retail clients are made to absorb more of the cost of negative rates. Of course, Brexit cliff edges will come up again as will a very acrimonious presidential election in the US. The Fed has once again succeeded in dampening volatility for the time being – it will be extremely difficult to continue to do so in the case of an economic slowdown or indeed an economic recovery. We may see a repeat of 2017/18 in 2019/20 – it is hard to envisage it right now due to the high levels of stimulus the markets are inhaling – however even a scratch below the surface shows that the reality of these policies is starting to come to light. How will it look post April and the end of Fed QE once again.

Central Bankers have promised no more rate hikes, no more Quantitative Tightening. The question for the markets in 2020 is whether that will be enough to sustain their newly gained highs.



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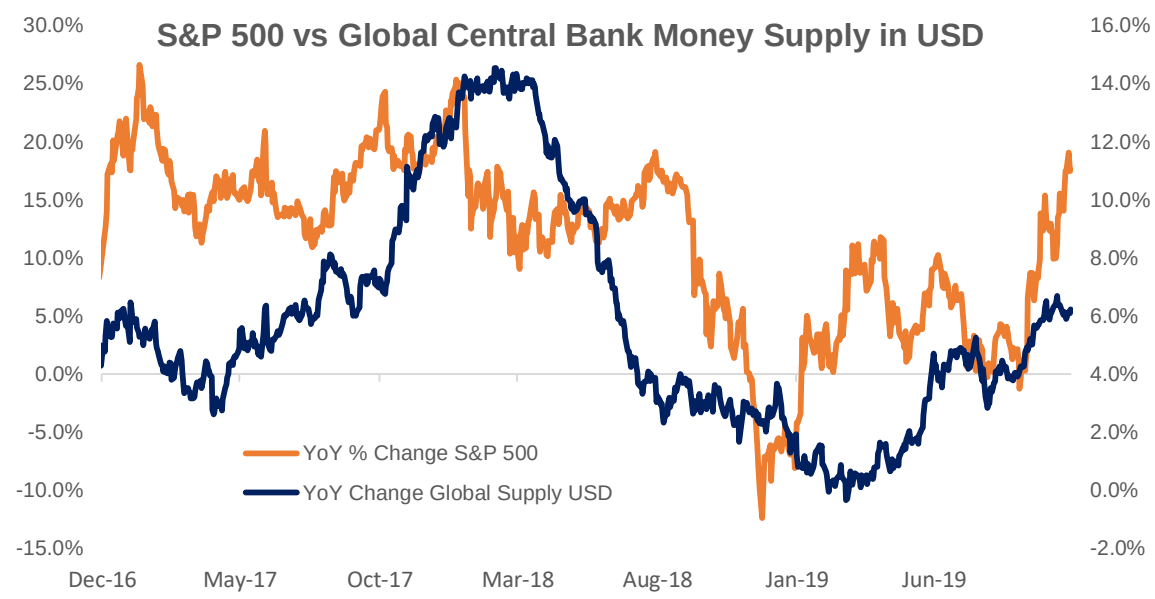

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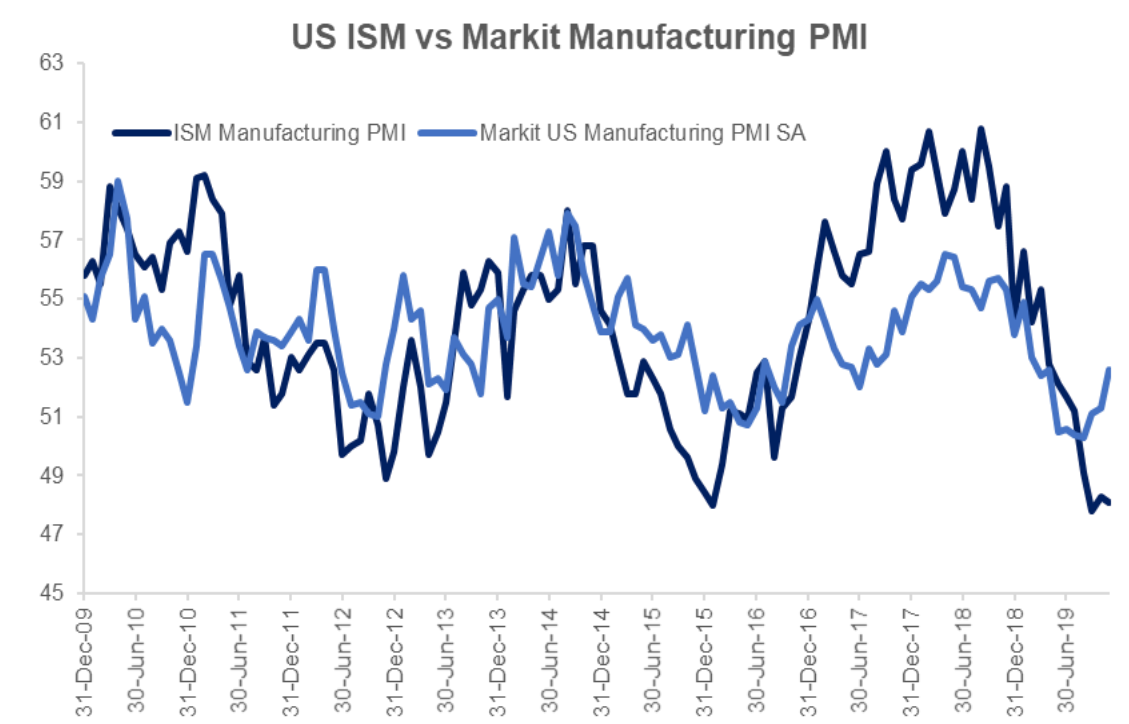

Source: Bloomberg as at 23 December 2019

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