Redstone Advisors

Economic and Market Review

Second Quarter 2016

"Global demand for fixed income products, seemingly at any price, remains profound around the world."

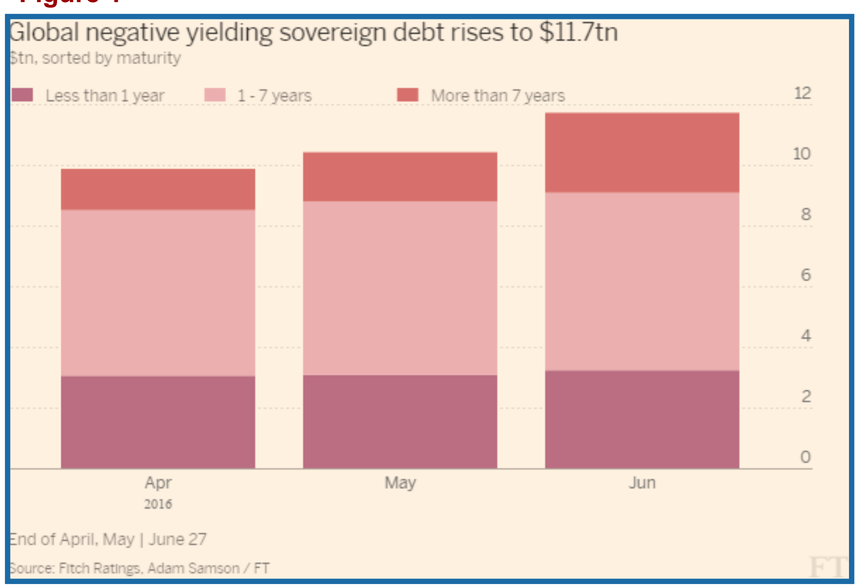
Thomas Simons, Jefferies Group

"The real elephant in the room is we'll have low and negative rates for a very long period of time."

Steven Major, HSBC

The second quarter of 2016 saw a continuation of the **modern era of low rates, weak growth, and extraordinary monetary policy**. A concerning trend was the notable increase in the total amount of global government bonds with negative yields. This quarter, the amount of **debt globally yielding below zero has climbed to a staggering $11.7 trillion**, largely due to a combination of unconventional monetary policies and a huge flight to safety in global financial markets after Great Britain's "Brexit" vote to leave the European Union on June 23. The increase in negative-yielding sovereign debt over the past three months can be seen in **Figure 1**. A simmering anxiety over the outlook for the global economy is **pushing investors into the safest and most liquid sovereign bond markets despite the historically low and negative yields they offer.** Fitch analyst Robert Grossman noted that, *"central bank actions are certainly a part of it, but the global search for yield, the desire to find high-quality securities, is part of what is going on here."* Global negative-yielding sovereign debt has increased markedly since Sweden became the first

Figure 1



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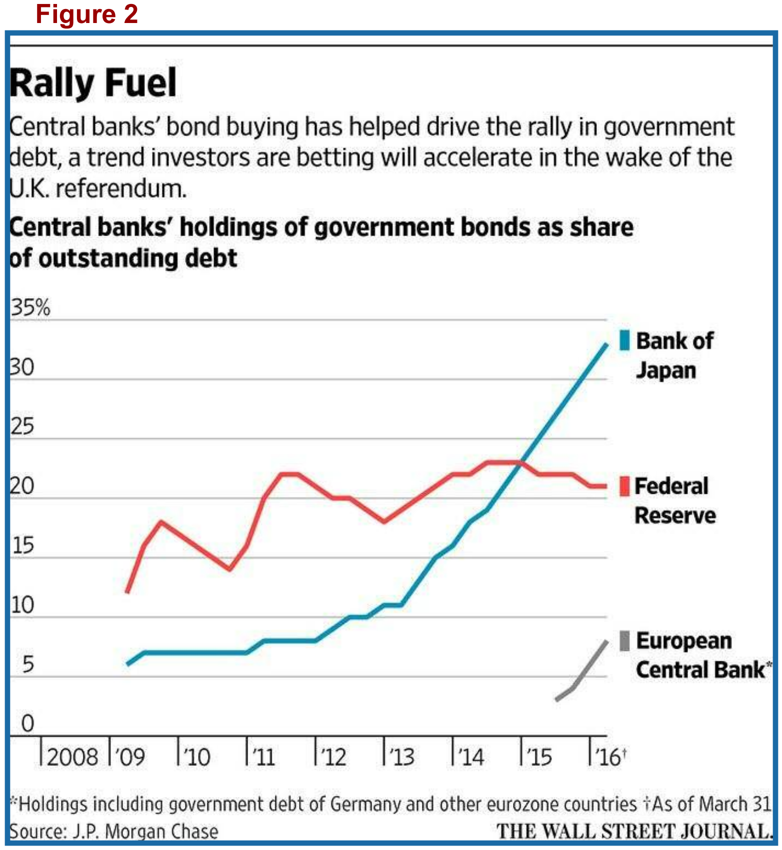
government to take its base interest rate below zero in early 2015. Numerous other central banks, including those in Switzerland, Denmark, Japan and the European Central Bank have since followed suit, and that has pushed up the sum of negative-yielding debt significantly. The amount of negative debt will likely increase in the coming months, as few of the central banks with rates below zero seem poised to move back above zero anytime soon. Many analysts see powerful forces pushing down yields in the bond market that can only be counteracted by broad changes in inflation and growth, which there just has not been evidence of for a considerable time now. In mid-June, the yield on the Bank of America Corp. Global Broad Market Index sunk to a new record low of just 0.67 percent. Larry Fink, CEO of BlackRock, the world's largest asset management company, wrote in his latest letter to investors that not nearly enough attention had been paid to the toll that low rates—and now negative rates—are taking on the ability of investors to save and plan for the future.

In early June, the Organization for Economic Cooperation and Development (OECD) warned that the global economy was falling into a self-fulfilling **"low-growth trap"** where ultra-loose monetary policy risks doing more harm than good. The group argued that rich world governments bear the majority of the blame for failing to revive demand and failing to overhaul their economies in the aftermath of the financial crisis in 2008. The OECD further added that monetary policy cannot revive near and long-term growth by itself, and that ultra-low and negative rates have stressed bank profitability and created financial challenges for pension funds and insurers, while becoming less potent in stimulating consumption. OECD Chief Economist Catherine Mann lamented that *"monetary policy has been the main tool, used alone for too long. In trying to revive economic growth alone, with little help from fiscal or structural policies, the balance of benefits-to-risks is tipping."* She warned that the longer the global economy remains in the low-growth trap, the more difficult it would be to break the negative feedback loops, revive animal spirits and boost economies to a more normal growth path. Many have argued that zero or negative real interest rates undermine the efficient allocation of capital and set the stage for bubbles, busts, and crises. Others have warned that over-active monetary policies have enabled weaker economies to borrow cheaply with the end result being they avoid implementing difficult but necessary structural reforms that lead to growth.

Japan's largest bank, Bank of Tokyo-Mitsubishi UFJ, expressed a message of frustration over negative interest rates to the Bank of Japan (BOJ) in early June, threatening to stop acting as a primary dealer of Japanese government bonds (JGBs). Bank of Tokyo President Nobuyuki Hirano in April became the first top Japanese banking executive to publicly criticize the BOJ's negative-rate policy, arguing it had actually caused households and businesses to rein in spending by creating a sense of uncertainty about the future. Primary dealers are required to bid on at least 4% of each planned government-bond issuance, a responsibility that banks may find increasingly unattractive as the BOJ's quantitative easing enters its third year and a staggering amount of Japanese bonds increasingly hold negative yields. In mid-June, the yield on Japan's benchmark 10-year bond fell to a record low of negative 0.185 percent. The BOJ has been buying 80 trillion Yen ($745 billion) of JGBs annually, roughly equivalent to all new issuance, and incredibly now owns about one-third of the outstanding market. Central banks' holdings of government bonds can be seen in **Figure 2**. JGBs account for roughly two-thirds of the total global negative-yielding sovereign debt,

Figure 2



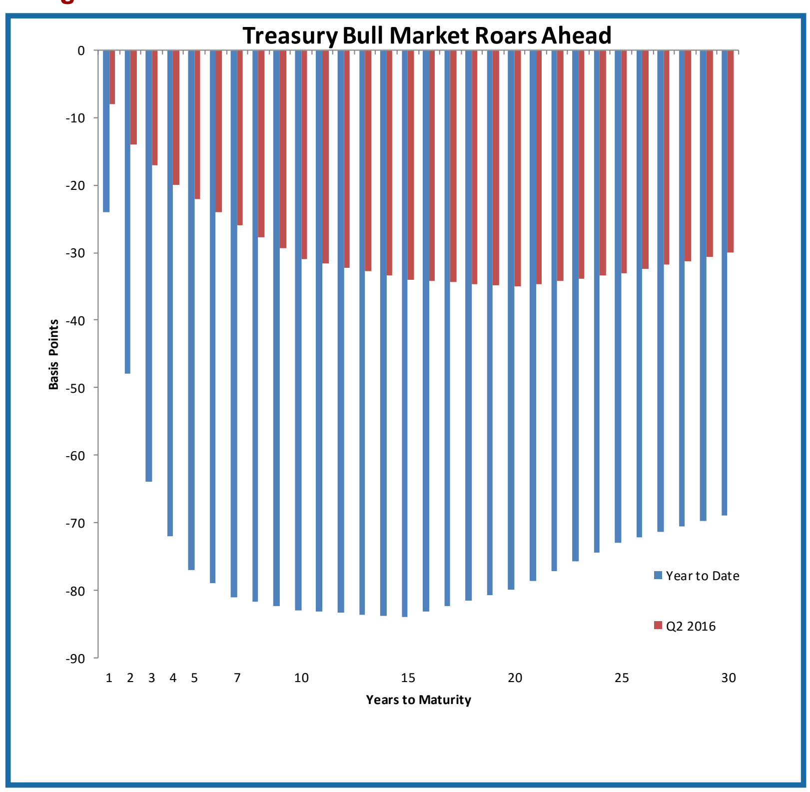
with $7.9 trillion.

Meanwhile, Commerzbank, one of the largest German banks, is exploring the option of hoarding billions of euros in vaults instead of paying a penalty charge for storing it with the European Central Bank (ECB). Such a move would represent one of the most substantial protests yet against the ECB's ultra-low rates and policy of charging banks on deposits. The ECB imposes a negative rate equivalent to 4 euros annually on each 1,000 euros lenders deposit with the central bank. It is designed to encourage banks to lend money, but many banks have argued that a bleak global economic outlook means there is tepid demand for loans on the terms they require, so they have little option but to hoard cash. In early June the average yield on all German government bonds fell below zero for the first time in history. The so-called **"umlaufrendite"**, the average rate across outstanding bonds published once a day by Germany's Bundesbank, hit a new low of negative 0.02 percent. That was followed by the **German 10-Year bund yield falling below zero for the first time in history** on June 14th. By the end of June, there was in excess of $1 trillion in German debt with negative yields.

On June 23rd, Great Britain voted to leave the European Union, in a closely watched referendum popularly referred to as **"Brexit"**. The vote was high-turnout, and "Leave" won by a narrow 52 percent to 48 percent margin. The result sets the stage for a **protracted breakup and prolonged political and economic uncertainty**. Two immediate consequences were the pound plunging 8 percent to its lowest level in 30 years and investors piling into the safe havens of government debt and gold. In the direct aftermath of the referendum, the benchmark 10-year Treasury note yield fell to 1.57 percent, the yield on Britain's 10-year gilt fell to an all-time low of 0.93% and the yields on Japan and Germany's 10-year bonds slid further into negative territory. One thing that many analysts agree on is that Britain's political earthquake will complicate the Federal Reserve's plans it had of possibly raising interest rates this year. The yield on two-year Treasury notes, the maturity most sensitive to Fed policy expectations, plummeted as much as 28 basis points, the most since 2008, in the hours following the Brexit vote. The current market-implied probability of a Fed rate increase by year-end was around 25 percent, down from a 50 percent chance assigned on Thursday before the United Kingdom voted.

The easing actions by the ECB, BOJ, and other global central banks have clearly had an effect on the US Treasury market. The collapse in bond yields worldwide has followed an escalation of stimulus policies from the BOJ and the ECB this year. Bond market analysts have been correct in their call that **super low and negative global yields would pull Treasury yields lower**. Yield-hungry foreign investors continue to flock to the relative value of U.S. Treasuries, driving up their prices and lowering the yields. **Treasuries are off to their strongest start in 21 years**, as Bank of America's U.S. Treasury index has returned 5.8 percent so far in 2016. In June, foreign demand for a 10-year Treasury note auction hit a fresh record high. The Treasury market is simply one of the few places left in the developed world where investors can get relatively attractive yields. Thomas Roth, executive director at Mitsubishi UFJ Securities sums it up this way: ***"the U.S. is the only game in town."*** Changes in the Treasury yield curve for the quarter and year-to-date can be seen in **Figure 3**. The decline in yields was largest at

Figure 3



the long end of the curve, in the 10-to-30 year range. Falling long-term yields in part signify that investors expect future growth to be weaker and for future inflation to be lower than was previously forecasted. An inverted yield curve, a situation where 2-year Treasury yields are above 10-year Treasury note yields, has preceded all five recessions in the past forty years.

In mid-June, the Federal Reserve kept the target range for the benchmark federal funds rate unchanged at 0.25 percent to 0.50 percent. Fed Chair Janet Yellen noted that recent economic indicators have been mixed, suggesting that the Fed will remain cautious in its approach to adjusting monetary policy. The Fed said it expected to raise rates more slowly in coming years, an acknowledgment that economic growth had again disappointed its expectations. The Fed has been consistently more optimistic than market expectations about the available headroom for raising interest rates. This has led some critical observers to conclude that many Fed officials might have an insufficient understanding of the economy. Back in 2013, the Fed predicted that annual GDP growth during the 2013-2015 period would average 2.9%. Instead, annual growth has averaged just 2.2%. That three-year period, starting in 2013, followed a three-year period in which the U.S. economy likewise fell short of the Fed's forecast. The failure of Fed officials to convey how their inability to make accurate predictions has prompted them to update their economic models is leading some to lose confidence in the Fed's capacity for sound decision making.

Interestingly, Yellen seems to be warming up to what her one-time rival, former Treasury Secretary Lawrence Summers, has been arguing for a while. That view, known as "secular stagnation", argues that some of the forces holding down interest rates may be long-lasting and secular (non-cyclical). In the past Yellen has ascribed the low level of rates mainly to lingering headwinds from the financial crisis and has suggested that they would dissipate over time.

After the June FOMC meeting however, she also **pointed to more permanent forces that could depress rates for longer, specifically, slow productivity growth and aging societies.** In a press conference, she spoke of a sense that rates may be held down by *"factors that are not going to be rapidly disappearing, but will be part of the new normal."* The Fed has long assumed it would raise short-term rates to some neutral level that is compatible with full employment and stable inflation. However, that number appears to be falling. Fed officials, who thought it was 4% in 2013, now think it's 3%, and Yellen just said it might actually be 2% in her latest remarks. Some Fed watchers say that persistently sluggish growth despite a very low level of the nominal funds rate and the fact that the financial crisis was now roughly eight years ago has led the central bank to be more open to the idea of a new normal with lower interest rates. On July 1, the **30-year Treasury yield fell to an unprecedented 2.18 percent**, and the **benchmark 10-year Treasury yield slid to a new all-time low as well, touching 1.38 percent**. Earlier this month, the annual Running of the Bulls was held in Pamplona, Spain, a tradition whose origin dates back to the 14th century. The running takes place during the San Fermin festival, which was popularized in Ernest Hemingway's *The Sun Also Rises*. Another historic bull run has been occurring in the U.S. Treasury market for over thirty years. The incredible bull market that began in the early 1980s, after 10-year and 30-year yields peaked above 15 percent, can be seen in **Figure 4.**

Figure 4