Redstone Advisors

Economic and Market Review

Second Quarter 2019

"Yields are going to be lower for longer, inflation is going to be lower for longer and growth is going to be lower for longer."
Colin Robertson, Northern Trust

Last year, the normalization of monetary policy was a dominant theme, as the shift from quantitative easing to quantitative tightening was in swing. The Federal Reserve raised interest rates four times in 2018, with the last hike bringing the fed-funds rate to the target range of 2.25% to 2.50%. Halfway into 2019, that normalization appears to have been quite short-lived, as the pendulum has swung back towards dovish monetary policy. Central banks in the major developed countries of the world are either easing or inclined toward looser policy as a result of weakening growth and tepid inflation. U.S. gross domestic product (GDP) has been tracking closer to the longer-term annual trend rate of 2% to 2.5% that has been prevalent since 2000. Lower than expected growth and inflation forecasts have persuaded central banks in the U.S., Europe and elsewhere to step back from any attempt to normalize monetary policy. Global bond yields have moved significantly lower this past quarter as weakening economic data, geopolitical issues and trade tensions have weighed on the market. Cautious central banks have indicated they are willing to keep their policy very accommodative. The steady decline in global bond yields has diminished hopes that the global economy could become less dependent on central banks' extraordinary easy-money policies.

For about the last five years, many European countries have attempted to spark their sluggish economies with what was designed to be an unorthodox, short-term fix—negative interest rates. Unfortunately, central banks have been unable to wean their economies off them. In fact, no major bank that implemented negative rates amidst Europe's debt crisis has been able to turn policy rates positive again. The CEO of a bank in Berlin lamented, *"Overall we are on a painkiller, and it's very hard to get off it."* The inability of central banks in Europe to increase rates has many concerned that there is scant ammunition to manage the next downturn with the conventional tool of interest rate reductions. Pimco recently put out a research note that warned; *"Markets have become used to an environment where central banks are really powerful in terms of taking volatility out of the market and pumping asset prices up. That era is coming to an end. The U.S. is about the only central bank that was able to normalize policy rates, but elsewhere, there's basically no monetary firepower left."*

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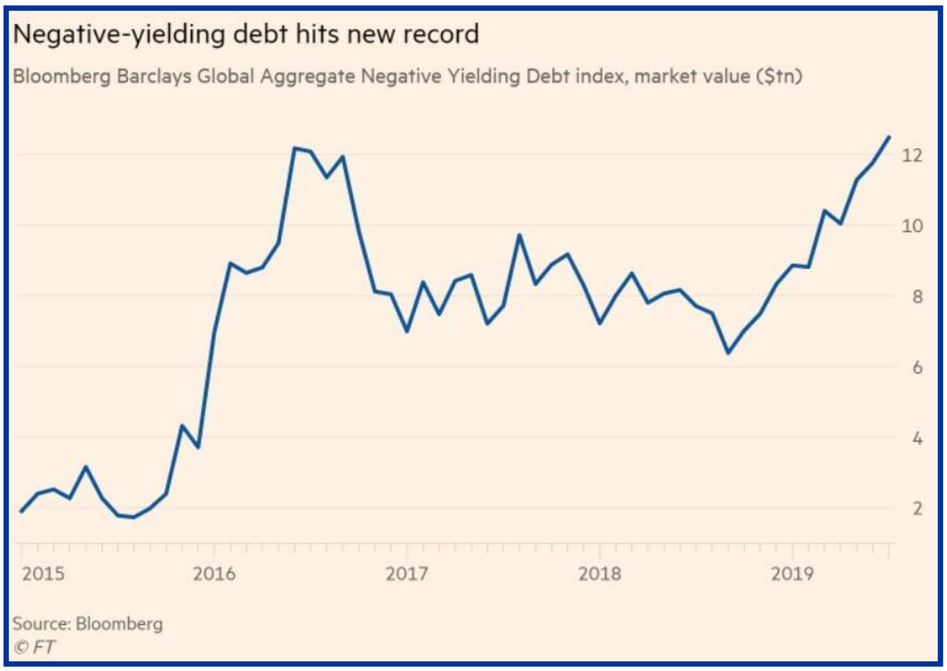
The European Central Bank's (ECB) deposit rate is currently negative 0.4%, about three percentage points lower than the Fed's. Britain's key rate stands at 0.75% and Japan's at negative 0.1%. When rates in the U.S. are too high relative to other major economies, the dollar strengthens on global currency markets, which then weakens American export companies. Tighter monetary policy by the Fed can affect emerging markets where many companies borrow in dollars. This means that when the Fed hikes rates, it can set off a chain reaction that slows down the entire global economy.

Figure 1

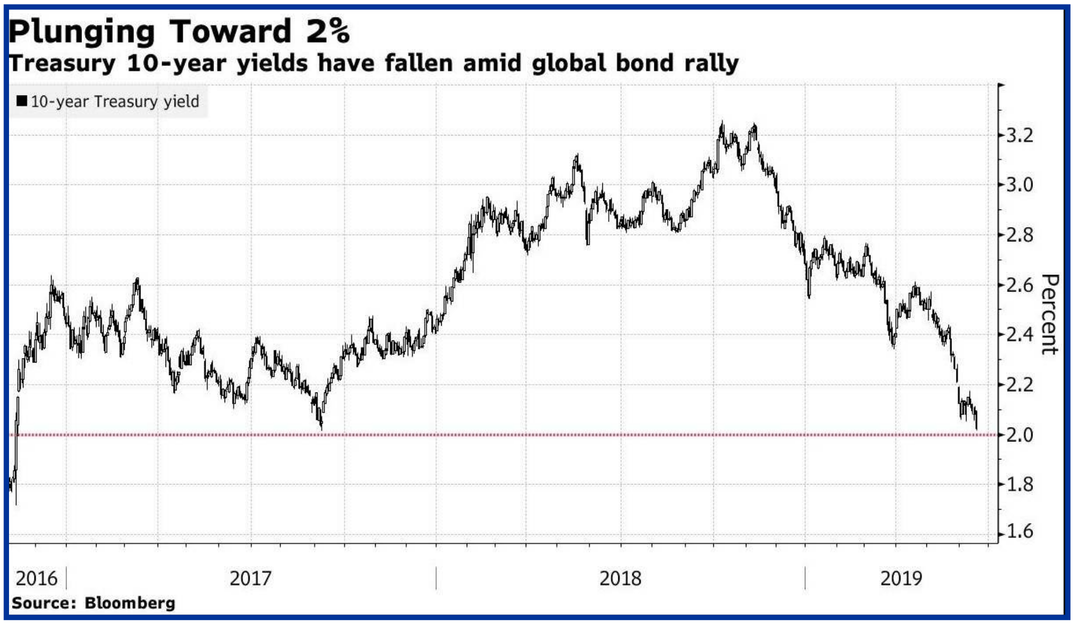


The ECB and the Bank of Japan have done essentially nothing to reduce their extraordinary stimulus measures and their current policies seem destined to continue for the foreseeable future. Last month, ECB president Mario Draghi said that additional stimulus may be needed if the economic outlook doesn't improve. Deutsche Bank estimates that as much as 20% of the $55 trillion in global debt has negative yields. Germany, Japan, France, Sweden, Denmark and the Netherlands all had 10-year yields in negative territory in the second quarter. Germany's 10-year bund hit an all-time low of negative 0.33% in mid-June, while French and Swedish 10-year yields dropped below zero for the first time ever. The market value of bonds trading at negative yields hit a new record of $12.5 trillion in late June, surpassing the previous peak in 2016. This is illustrated in **Figure 1.**

Low bond yields are a function of many variables, including growth and inflation expectations, the outlook for monetary policy, and how much extra compensation investors require to hold longer-term bonds (term premium). The 10-year Treasury term premium dropped to a record low of negative 0.84% as of late May. The declining term premium brought down the nominal yield, and the recent decline in the 10-year yield can be seen in

Figure 2

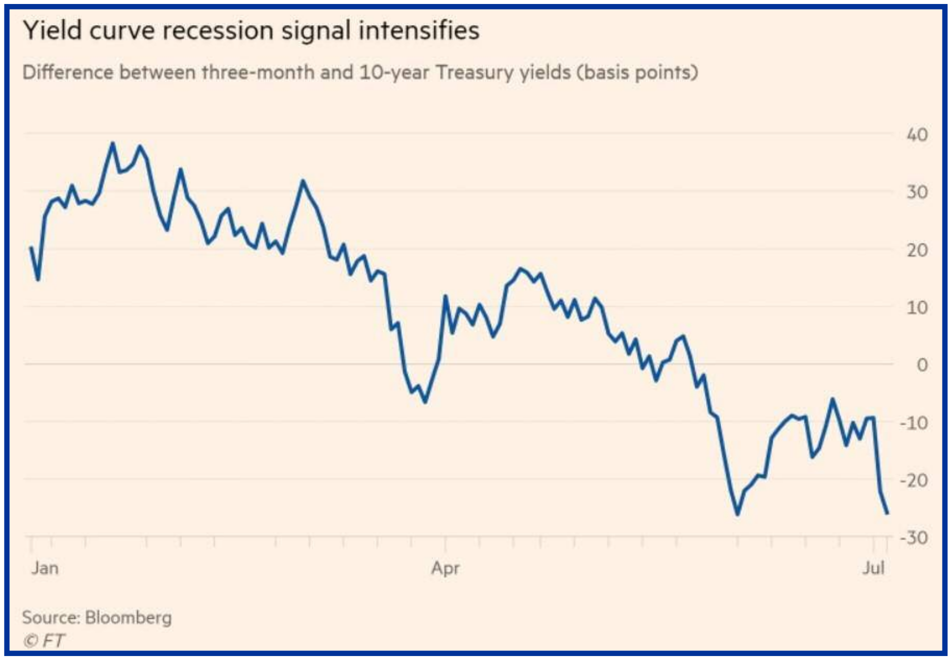
Figure 2. Global bond yields that have reached multiyear lows underscore the challenges central bankers confront in attempting to normalize monetary policy after a decade of extraordinarily easy money. The average yield of the global bond market in late June was just about 1.75%, a drop from about 2.50% in November of last year.



In June, the Federal Reserve kept the target range of the federal funds rate unchanged at 2.25% to 2.50%. In its statement, the Fed said it would "act as appropriate to sustain the expansion". Fed Chairman Jerome Powell said, "The case for somewhat more accommodative policy has strengthened" during his press conference afterwards. That along with other comments made by Mr. Powell were seen by many as a hint that the Fed could cut rates in the months ahead if the economic outlook weakens. The latest interest-rate projections showed that eight of seventeen Fed officials believe the Fed will need to cut its benchmark rate this year. Another eight forecast that rates would stay unchanged. Earlier in June, Mr. Powell called the proximity of interest rates to zero, sometimes called the lower bound, the "preeminent monetary policy challenge of our time."

Some question if rate cuts would necessarily lead to sustainably and substantially higher consumption and investment. If not, they wonder how long could markets maintain increasingly elevated asset prices that are decoupled from the underlying economic and business fundamentals. The point is that since the 2008 financial crisis and ensuing Great Recession, investors have been conditioned to expect central bank intervention to lift asset prices and reduce volatility, regardless of how much this divorces markets from the underlying fundamentals. The Fed, lacking the ability and authority to directly address the structural challenges holding back growth, has had to rely on using the financial channel to promote consumption and investment. The U.S. economy has become increasingly "financialized" over the past twenty years. The federal government and American companies have stepped up their borrowing, taking on growing amounts of debt. There is no unwinding that and the only way to avoid a serious reckoning is to keep interest rates at low manageable levels, which supports equity valuations and gives businesses the opportunity to borrow cheaply or refinance their existing obligations. Lower yields allow the can to be kicked down the road and delay any sort of moment of truth.

Figure 3



Treasuries had a strong rally in the second quarter, as yields moved significantly lower across the yield curve. A portion of the curve remained inverted, as the 1-year Treasury finished June at 1.98%, which was more yield than the 2-yr, 3-yr, 4-yr, 5-yr, and 7-yr maturities. The benchmark 10-year Treasury finished the quarter at 2.01%. For most of the quarter, the 10-year/3-month yield curve was inverted. This is illustrated in **Figure 3**. In early July, the 3-month T-bill is yielding 2.22%, which is more than the yields on Treasuries from one to ten years. Many investors with a pessimistic view of the economy are buying the 2-yr to 7-yr part of the curve, predicting that the Fed will be forced to cut rates in the near-term future. This 2-yr to 7-yr "belly" of the yield curve had the strongest rally in the second quarter, with yields falling on average 56 basis points. Some analysts see the combination of an inverted 10-year/3-month curve and a positive 10-year/2-year curve as evidence that the bond market believes any Fed easing cycle will be sufficiently shallow and proactive so as to avoid a serious downturn in the economy. One analyst put it this way, *"It feels like the bond market message is that the Fed can cut a few times, the economy stabilizes around 2-ish percent, and recession is avoided."*