Redstone Advisors

Economic and Market Review

Third Quarter 2019

Global bond yields continued their slide lower in the third quarter as weakening economic data, geopolitical issues and trade tensions have weighed on financial markets. *"There can be few precedents since the 1930s of global growth prospects being affected so significantly by trade policy disruptions,"* argued the chief economist of Fitch Ratings. As we mentioned last quarter, 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 fading inflation expectations. The decline in global bond yields has diminished hopes that the global economy could become less dependent on central banks' extraordinary easy-money policies. This lengthy era of historically low rates has challenged many long-standing assumptions about money and impacted a generation of investors, traders, and savers.

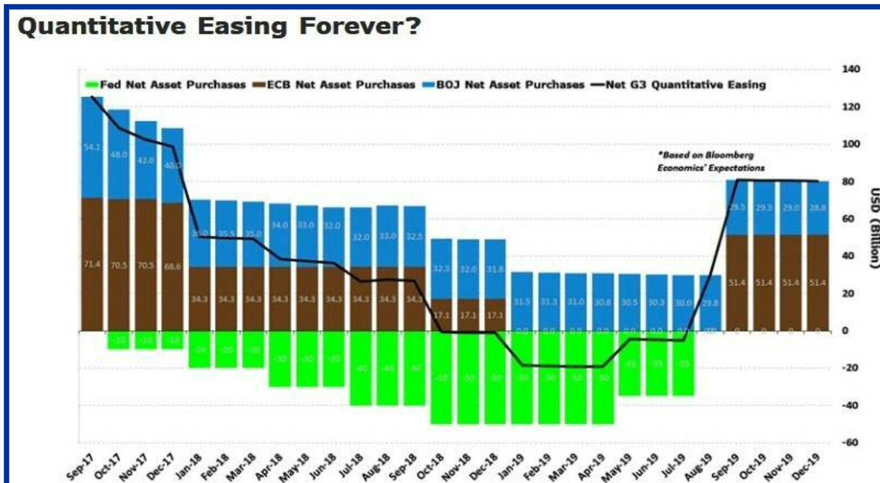
Lower long-term yields can be partly explained by a combination of technological innovation and cheap global labor that eases inflationary pressure and aging demographics that result in a savings glut as the populations of wealthy countries get older and live longer. Some analysts say that the traditionalist views of monetary policy are really being questioned, referring to the belief that central banks always have the ability to jumpstart the economy, or take away the punch bowl, when needed. The chief global strategist at JPMorgan Asset Mgmt said, *"This is the new abnormal. Normally when you are in this phase of an expansion, you have a rising inflation problem, a Federal Reserve overtightening to slow the economy, and businesses that can't afford to borrow. None of that is true right now."* Some might recall that Jamie Dimon, the CEO of JPMorgan Chase, just last year warned that the yield on the 10-year Treasury bond could go above 5%. As of early October, the 10-year yield is just 1.6%.

(316)687-2143 jyeskie@redstoneadv.com

Meanwhile, pension funds, managing trillions for workers' retirements, have been consistently lowering return expectations. It has been challenging for them as long-dated debt like the 30-year Treasury don't quite yield what they used to. The 30-year Treasury currently yields about 2.15%, a significant departure from its average of 6.5% since the 1970s. Anne Walsh of Guggenheim says, *"Institutional investors are out there in the great truffle hunt for yield. This is particularly true of large institutions, like banks and insurance companies and pension funds. These firms are searching for yield and potentially taking on unintended risk because that is what they need to do."* Chris Iggo, of AXA Investment Managers, sounded a similar note of concern. He said, *"In 2008, most people in the markets had no idea about the leveraged web of instruments that were ultimately linked to the housing market in the US. We should be worried about lower and lower bond yields…they may cause some, as yet not fully understood, tensions in the financial system with structural implications."*

In late July, the Federal Reserve cut rates for the first time since December 2008. Fed officials cited weak global growth, trade tensions, and a chill in business investment as reasons behind the move. The chief global economist at Citigroup noted, *"The real issue facing the global economy is trade uncertainty, and monetary policy is not well targeted to address that uncertainty."* The president of Titan Steel said, *"Uncertainty is the enemy of long-term investment decisions. Who's to guess what the trade-policy environment will be."* The Fed also announced they would end the runoff of their massive $3.8 trillion portfolio in August, two months earlier than previously scheduled. $3.8 trillion equals about 18% of GDP, which is a significant increase from where their portfolio was in 2007, at around $800 billion or just 5% of GDP. The Fed's decision to stop shrinking

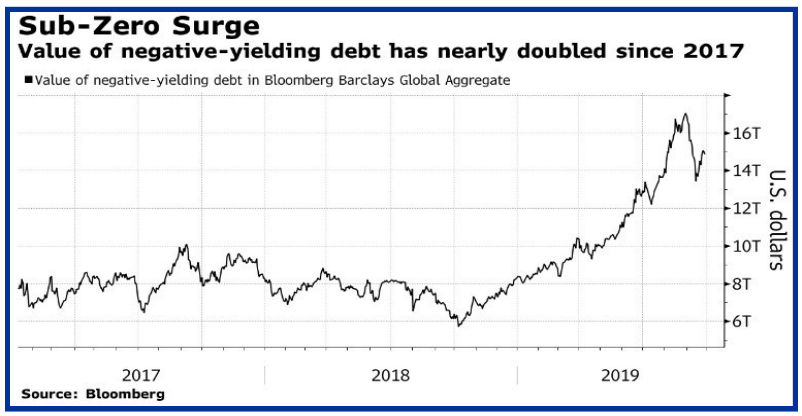
Figure 1



Source: Federal Reserve, Bank of Japan, European Central Bank & Bloomberg Economics Forecasts its balance sheet signifies that the short period of quantitative tightening by major central banks is over less than a year from when it started. Net bond purchases by the Fed, European Central Bank (ECB) and Bank of Japan (BOJ) are now turning positive. This is illustrated in **Figure 1**. In September, the ECB cut its policy rate to a record low of negative 0.5%. Many question just how effective renewed quantitative easing will be given its failure to spark powerful and durable recoveries from the previous recession.

In September, the Fed lowered its benchmark rate once again to a new target range of 1.75% to 2.00%. Fed officials see tighter connections than in the past between the US and global economies and think US rates can't climb much higher above those in other developed economies, which have lower or even negative rates. Fed Chair Jerome Powell said in July that he is worried about an "unhealthy dynamic" in which *"lower expected inflation gets baked into interest rates, which means lower interest rates, which means less room for the central bank to react to downturns"*. Mr. Powell warned, *"We've seen it in Japan. We're now seeing it in Europe. That road is hard to get off."* Speaking of Europe, in August the 10-year Spanish bond yield hit a record low of 0.13%. As recently as 2012 it yielded more than 7%. Meanwhile, 10-year German bund yields dropped to a record low of -0.6% as well. Remarkably, there are even some European junk bonds that have negative yields too. Roughly $15 trillion of outstanding global bonds, or about 25% of the entire market, now trade at negative yields. The rise of negative yielding debt over the past few years can be seen in **Figure 2**. Powell added, *"Pursuing our domestic mandates in this new world requires that we understand the anticipated effects of global interconnections and incorporate them into our policy decision-making."* Last year Mr. Powell compared the Fed's policymaking to navigating by the stars, saying, *"The stars are sometimes far from where we perceive them to be."*

Figure 2



Treasuries had another strong rally in the third quarter, as yields moved lower across the curve, particularly at the longer end, where the average decline in the 15-to-30-year range was 40 basis points (bp). This rally at the long end of the Treasury curve indicates that many traders and investors have little fear of a sustained rise in interest rates and many would be hard pressed to identify a realistic catalyst that would lead to such a scenario. A portion of the curve remained inverted, as the 1-year Treasury finished September at 1.83%, which was more yield than Treasuries maturing from 2 years all the way to 15 years. The 10-year/3-month yield curve was inverted for the entire quarter, it has consistently been inverted since late May. The benchmark 10-year Treasury yield fell to as low as 1.43% on September 3, rebounded to as high as 1.90% on September 13, before settling at 1.68% to end the quarter. In August, the yield on 30-year Treasury bonds plunged to 1.91%, a record low that surpassed the previous low of 2.08% set in July 2016 during the aftermath of the Brexit vote. By the end of September, the 30-year Treasury yielded 2.11%. The decline in yield of the 30-year Treasury going back to 2000 can be seen in **Figure 3**. The 30-year long bond is the part of the Treasury market over which the Fed has the least control. Buying longer-dated bonds can be viewed as a bet that any attempt of monetary easing will prove ineffective in stoking growth and inflation. In September, OECD's chief economist warned that, *"Our fear is that we are entering an era where growth is stuck at a very low level."* The OECD argued that the effectiveness of monetary policy could be enhanced by *"stronger fiscal and structural policy support."* Whether governments can agree and enact such policy is a big question, with many skeptical doubters. Just look at the dysfunction currently plaguing the American and British political systems.

Figure 3