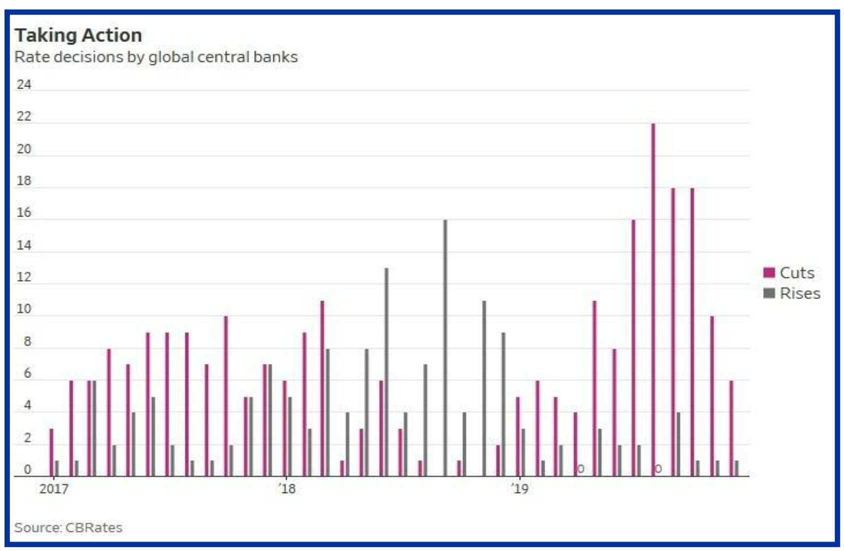
Redstone Advisors

Economic and Market Review

Fourth Quarter 2019

Global bond yields remained at or near historical lows in the fourth quarter. 2019 can be described as a unique year in the bond market, as all sectors performed well in a broad bond market rally. The financial markets this past year were marked by a worldwide surge of central bank rate reductions. 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. In fact, 56 central banks cut rates 129 times in 2019. Meanwhile, 10 central banks raised rates just 20 times. This is illustrated in **Figure 1**. There is not much optimism that the global economy can become less dependent on central banks' extraordinary easy-money policies. Over the past decade, the Bank of Japan, European Central Bank, and Swiss National Bank, among others, have cut their benchmark interest rates to below zero, attempting to fight off the menace of a deflationary spiral. Unfortunately, the experiment hasn't worked as intended and central banks that implemented negative rates expecting them to be a quick fix have been unable to transition back. *"Rather than creating or accelerating economic activity, negative interest rates basically just lead to the zombification of the economy over time,"* argued the CIO of Fiduciary Trust.

Figure 1



For certain, this lengthy era of historically low rates has challenged many long-standing assumptions about economics and investing. For example, lately many economists have talked about how the so-called natural rate of unemployment, the lowest the U.S. can sustain without running out of workers or pushing up inflation, is perhaps much lower

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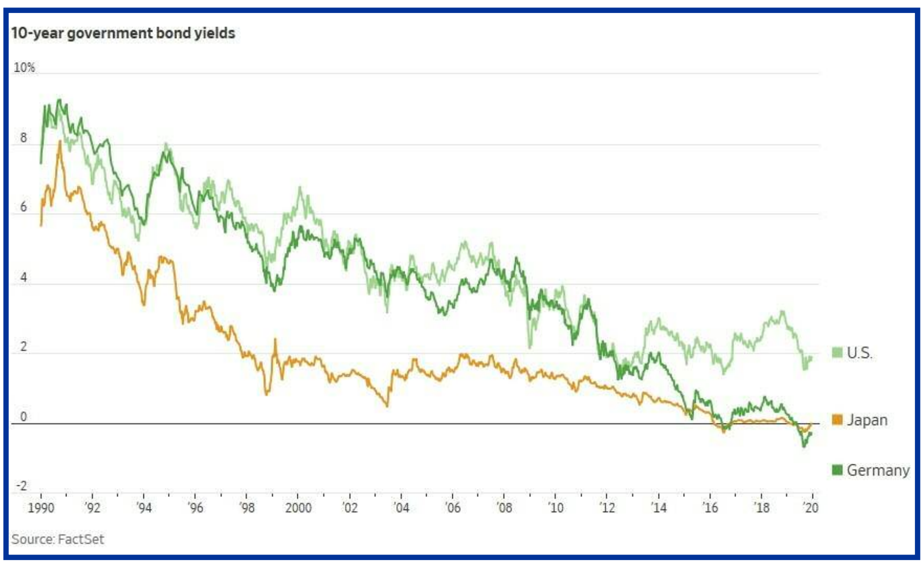
than previously thought. After peaking at around 10% in 2010, the unemployment rate has fallen all the way down to 3.5%, a fifty-year low. Jan Hatzius, chief economist at Goldman Sachs, put it this way: *"We fell into a deep hole so we had a lot of spare capacity, and it took a long time to climb out."*

Fed Chairman Jerome Powell suggested to US lawmakers in November that low interest rates might be a permanent part of the economic landscape. Mr. Powell told members of the House that, *"We're in a world of much lower interest rates. That seems to be driven by long-run structural things and there's not a lot of reason to think that will change."* The Federal Reserve also warned in its biannual financial-stability report that, *"If interest rates were to remain low for a prolonged period, the profitability of banks, insurers, and other financial intermediaries could come under stress and spur reach-for-yield behavior, thereby increasing the vulnerability of the financial sector to subsequent shocks."* 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. Many point to Japan as a case study, where the significant aging of Japan's population has driven up healthcare and pension costs and slowed productivity. *"Developed economies that are maturing that have demographic headwinds are going to face many of the same things Japan has been facing over decades. It's almost inevitable,"* said one chief investment officer. In the US, Europe and Japan, the ratio of workers to retirees is decreasing, and birthrates are declining. That crimps growth, in part by reducing consumption. It also boosts demand for bonds to fund retirements, keeping yields down even more.

Figure 2

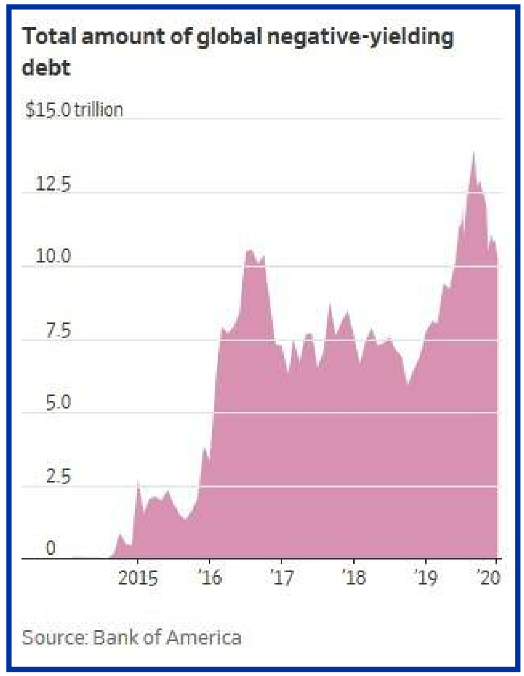


For some, the problems ailing Europe and Japan are a cautionary tale that indicate the US can't necessarily depend on monetary policy alone to support its economy. Dallas Fed President Robert Kaplan said, *"There have been substantial structural changes in the US economy since the 80s and 90s and even since the early 2000s.*

We talk a little bit too much about cyclical phenomena and maybe not enough about the structural changes." He added, *"We need structural reforms away from monetary policy if we're going to improve the level of potential growth."* At the end of 2019, the 10-year US Treasury had a yield of 1.93%. The 10-year yield finished the year down 77 basis points, its largest annual drop since 2011. While historically low, it is still about 200 basis points higher than the yield on comparable 10-year government debt in Japan and Germany. A history of US, German, and Japanese 10-year bond yields going back to 1990 can be seen in **Figure 2**. *"Unless something changes—and I'm not sure what that is—we're all gravitating toward the zero interest-rate policies and the miniscule bond yields long seen in Japan,"* warned Jack McIntyre of Brandywine Global Investment Mgmt.

Investors have added money into bond funds at an unprecedented pace this past year. Data from EPFR Global shows that cash has been added to bond funds for 49 straight weeks. That stretch has seen $468 billion in new money, the largest uninterrupted inflow since 2001. The global head of fixed income for JPMorgan said, *"It's been a surprisingly extraordinary year for the fixed income markets. Overwhelming monetary easing sent investors scrambling to put money into fixed income before rates came down further."* The yield on the Bloomberg Barclays Multiverse, one of the widest measures of the bond market, tracking $59 trillion in assets, declined to just 1.4 percent in September, equaling its lowest level last reached in 2016. Meanwhile, the total amount of negative-yielding debt in the world still exceeds $10 trillion, as seen in **Figure 3.**

Figure 3



The broad bond market rally has included some of the riskier corporate bonds. For example, non-investment grade or "junk" corporate bonds rated double-B (BB) yielded just 3.5% on average in mid-December, according to Bloomberg Barclays data. That level is the lowest on record and carries a spread of just 164 basis points more than US Treasuries. For some perspective, just over a year ago, some of the highest rated double-A corporate debt yielded around 3.6%, from companies like Apple, Exxon Mobil and Walmart. Last month the spread or difference between BB speculative grade and BBB investment grade yields was just 38 basis points, the smallest in about 25 years. Joe Davis of Vanguard warned that, *"For savvy investors, the tighter credit spreads become, the* *more guarded they have to be in their strategy."* Mohamed El-Erian of Allianz SE added, *"What I fear is that this is the prelude to something which is not going to be very comfortable for those investing in the lowest-quality segments of the credit market."* Many investment professionals might be content to avoid non-investment grade debt until "junk" bonds yield something that better reflects their additional risk.

In late October, the Fed lowered its benchmark rate to a new target range of 1.50% to 1.75%. This was the third rate cut of 2019, after the Fed raised rates four times in 2018. The Fed characterized these rate cuts as a "mid-cycle adjustment". Fed Chair Jerome Powell signaled that the Fed wouldn't reduce rates further unless the economy slowed significantly. Mr. Powell indicated that Fed officials were now comfortable entering a wait-and-see phase for a few months. *"Monetary policy is now well positioned to support a strong labor market and return inflation to the Fed's 2% target. If the outlook changes materially, policy will change as well,"* Mr. Powell said. At its December meeting, the Fed left rates unchanged and indicated that if their economic outlook holds, they are comfortable with keeping rates steady through 2020. A history of the fed funds rate going back to 1985 can be seen in **Figure 4**.

Figure 4