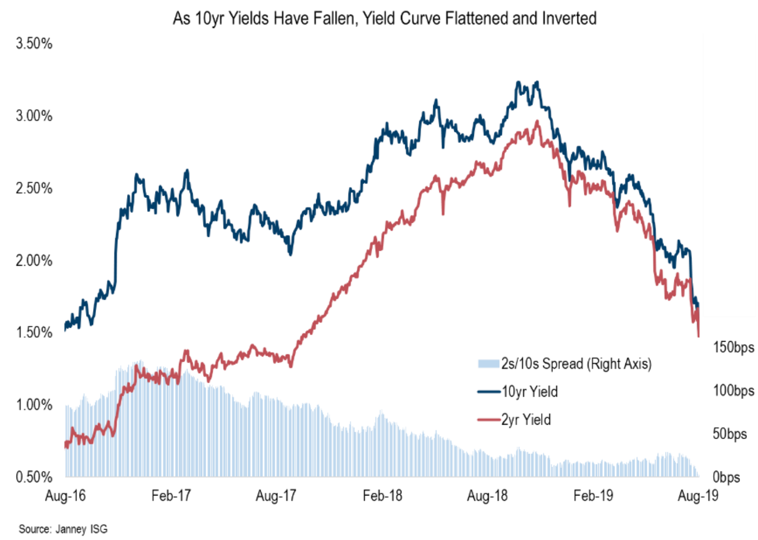
MEMOS FROM THE RATES MARKETS

August 16, 2019

- US interest rates have declined rapidly in the last several months and the yield curve has flattened and even inverted
- A combination of weaker global growth, falling foreign yields, and risks to the market plumbing systems are the cause
- The most likely resolutions to market plumbing risks are sharper Fed rate cuts, mini-QEs, or dealer sales of risky assets
- Should US economic data paint a more negative picture, we'll almost certainly retest all-time low yields from 2016

In October 2018, we published our last "Special Comment" on the interest rate markets amidst what was heavy selling pressure. This note promises to be a mirror image of that one, as interest rates have come crashing down amidst heavy buying pressure across the globe. Since the end of April, 10-year Treasury yields are now lower by nearly -1%, in what amounts to the biggest four-month bond-buying spree since 2011.



Simultaneously, the yield curve has flattened, with yields on shorter-maturity bonds falling less than those on longer-maturity bonds. While lower yields and a flattening curve are in and of themselves a boon to the performance of the bond markets, they also send some less-than-reassuring signals about the broader investing and economic climate. We will evaluate the drivers of this recent buying, compare the results to our expectations from the beginning of the year, and share what the bond markets imply for other investment sectors and the broader economy.

1) **Global Economic Deterioration:** While contemporaneous economic data in the U.S. have trended well in recent months, there is plentiful evidence of economic deterioration across the globe. Much of this deterioration appears trade related, with heavily export-reliant countries such as Germany and China experiencing the most obvious slowing. Slower economic growth (or even a global recession) reduces corporate profitability, spurs central bank rate cuts, and increases demand for low-risk assets, all three of which have the impact of encouraging demand for bonds.

2) **Federal Reserve:** The Federal Reserve has executed a complete U-turn in policy over the past 12 months, going from raising rates in a lock-step quarterly pattern to cutting them almost haphazardly. Signals from the U.S.' central bank have the markets pricing in additional rate cuts in September through December 2019. When the Fed cuts, longer-term interest rates tend to fall and, if the markets believe the Fed is not cutting rates fast enough to avoid recession, long-term rates tend to fall faster than short-term rates, and the yield curve inverts. Most maturities are currently inverted, meaning that shorter-term bonds yield more than longer-term bonds.

3) **Foreign Influence:** Yields on overseas bonds—particularly German bunds, Japanese Government Bonds, and UK Gilts—have an influence on Treasuries. Bund yields in particular have been on an incredible run, going from about 0.00% at the end of April to -0.71% today. Intraday trading action suggests buying in bunds has been leading buying in Treasuries quite consistently throughout this period. One common misconception is that Treasuries look attractive to Euro-based investors owing to their higher nominal yields (1.53% vs. -0.71% in the 10-year maturity). The reality, however, is that currency hedging

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costs more than eat up this differential, and the inverted shape of the U.S. yield curve actually makes Treasuries *unattractive* to Euro-, Yen-, and Pound sterling-based investors.

4) **Market Plumbing:** The confluence of many factors—tighter bank capital and liquidity regulations, heavy Treasury issuance to fund budget deficits, the inverted yield curve, and currency hedging costs—are creating problems in financial market plumbing. Plumbing refers to the flow of liquidity (money) on a short-term basis. Understanding how these flows work requires a high degree of financial system knowledge, and the complexities have been grown of late. Understanding these complexities is also how we reached the conclusion that the Fed's balance sheet reduction would end early. Complex systems fail in complex ways.

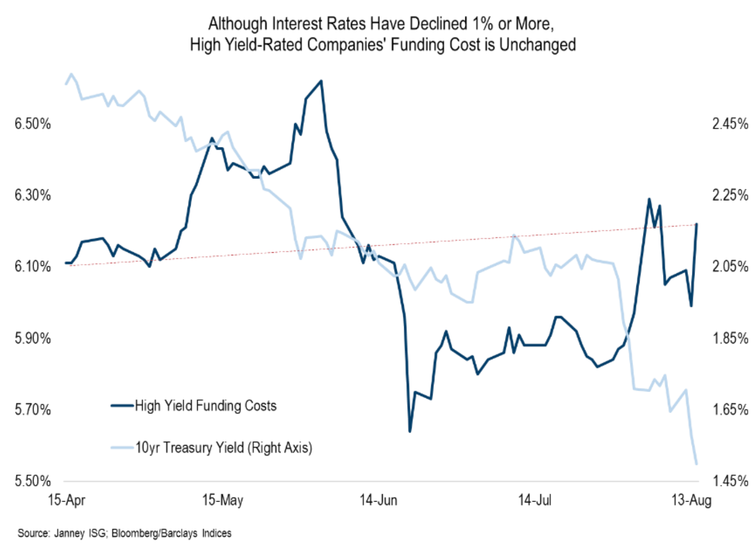
Essentially, it appears that primary dealers will reach capacity on how many Treasuries they hold right at the time when Treasury issuance to finance budget deficits is increasing. Foreign buyers are unlikely to pick up the slack for the currency hedging and curve inversion noted in #3 above. The only certain options to ensure smooth functioning of market plumbing is for the Federal Reserve to grease the pipes by restarting quantitative easing (QE) bond buying (perhaps mini-QEs) or for primary dealers to free up balance sheet capacity by selling risky assets, such as loans. This second option is a scary scenario for higher-risk corporate bonds, as it would cause credit spreads to widen—and widening spreads usually spell pain for equites as well. Intermediate term, the Fed may opt to execute very aggressive rate cuts to steepen the yield curve and spur foreign demand, but that process could take upwards of a year and could even bring overnight interest rate back to the zero lower bound.

$232bln of Net Treasury Issuance Will Crowd Out Dealer Balance Sheet Capacity Without QE

	3Q 2019	4Q 2019	2H Total
Treasury Issuance	$433bln	$381bln	
Maturities	$272bln	$310bln	
Net Issuance	**$161bln**	**$71bln**	**$232bln**

Source: US Treasury Dept.

Just as higher yields fed back into the financial markets and economic outlook 10 months ago, lower yields and a flatter yield curve are doing the same. Historically, falling yields coupled with an inverted yield curve has been a good predictor of recession (although a poor predictor of recession timing). Essentially, an inverted curve signals that the Federal Reserve is very likely to cut interest rates in the future, and the Fed typically cuts when there is an imminent economic slowdown. Markets already knew of a high probability of rate cuts, thanks to Fed commentary, so the inversion just doubles-down on that expectation.



Source: Janney ISG; Bloomberg/Barclays Indices

While funding costs for the corporate sector have come down somewhat, uncertainty created by global growth risks and a highly uncertain trade policy outlook have limited the pass-through effects of lower interest rates into the real economy. Moreover, the rapidity of the yield decline appears to be creating incremental uncertainty, as the business community is worried the bond markets "know something" about the economic outlook. The one positive exception to the transmission of Fed easing into the economy is, perhaps, lower mortgage rates, which should support housing sales short term and free up consumer income via refinancings.

Regular readers will recognize that we called for "peak interest rates" in late 2018 and came into 2019 modestly bullish on the bond markets, with the caveat that, if we were wrong, it was because rates would fall below our forecast. That caveat was borne out, although the recent rapid decline means that yields are below even the downside range of our forecasts. As Nobel laureate Paul Samuelson—often errantly attributed to Keynes—once said, "When events change, I change my mind. What do you do?" Events are changing very rapidly. Fed action and market plumbing problems mean that overnight interest rates now have a chance of revisiting the zero lower bound as early as 2020, and long-term interest rates have a chance of pushing through their contemporary era lows. For the 10-year note, that would mean yields below the 1.36% reached in July 2016, shortly after the 2016 Brexit referendum. After all, we are trading less than 0.25% above that level today.

In conclusion, the recent downdraft in yields is reflective of a number of factors: A souring global economic outlook, a high probability of further Fed rate cuts, falling yields abroad, and risks to the market plumbing. Implications for the economic outlook from falling yields and a flatter yield curve are not favorable, as yield curve inversions frequently precede recessions. Finally, it is worth pointing out that yields have fallen well in advance of any large negative trends emerging in U.S. economic data. If those contemporaneous data do turn negative, we will almost certainly return to the record low yields reached in 2016, but the situation remains fluid.

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