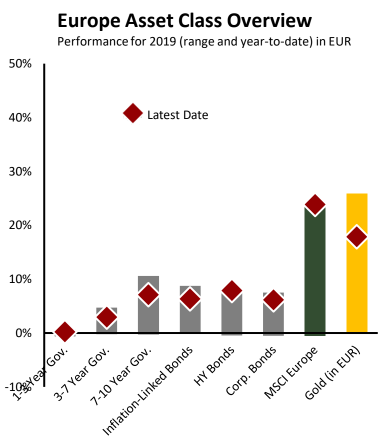
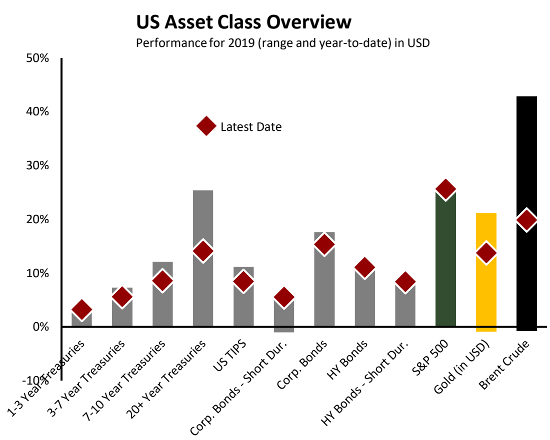
Omba Advisory & Investments Limited

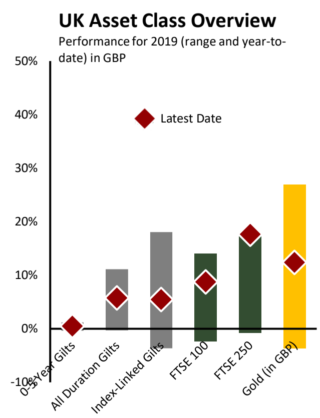
Fixed Income & Rates Update

19 November 2019

Fixed Income, as an asset class, has experienced a strong 2019 as yields have continued their multi-decade trajectory downwards driven by both global economic uncertainty and a *search for yield* with the Federal Reserve and ECB turning particularly dovish at the start of the year. Some risk appetite returned to global markets in early September 2019 and as a result, yields (particularly in longer duration bonds) have moved higher, resulting in fixed income year-to-date returns coming off their high, as shown in the below charts.







Source: Refinitiv, 2019. Data as of 8 November 2019. Total Return data has been used for Europe and US returns.

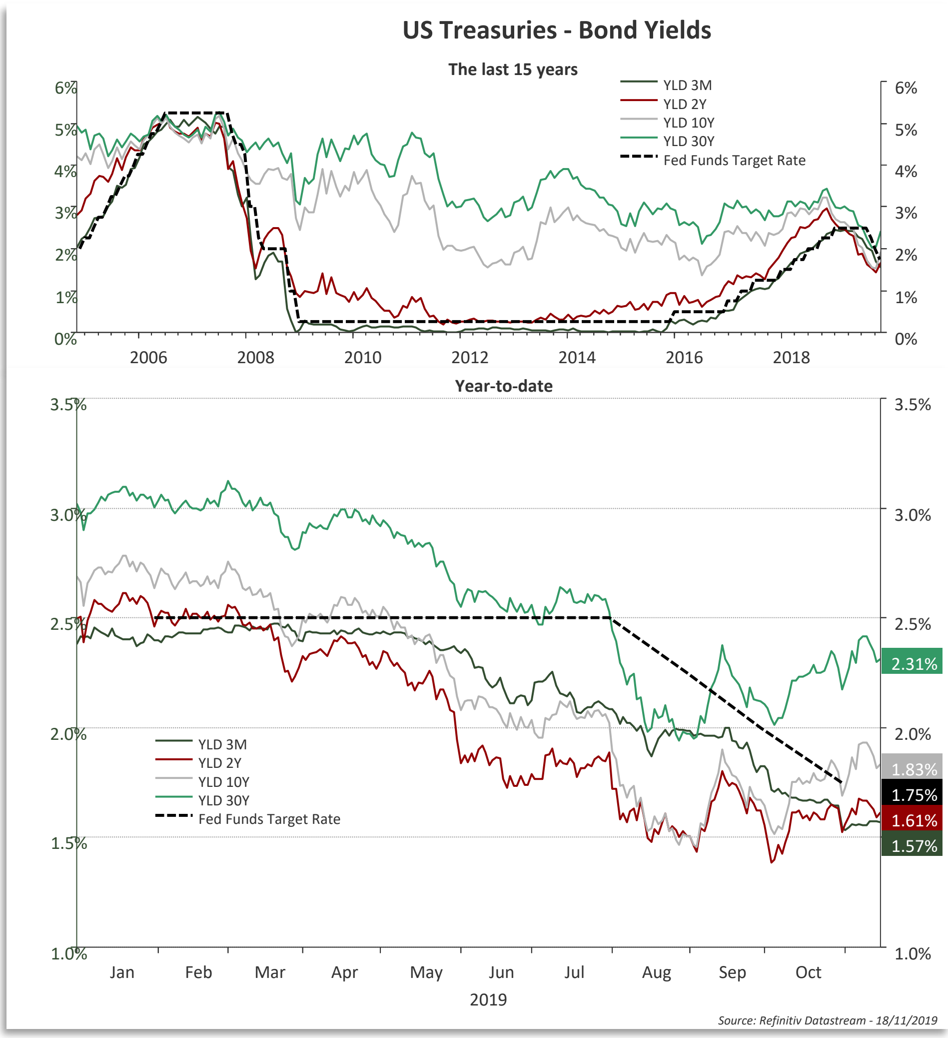
- **Equity markets** are at a high for 2019 (and in the case of the S&P 500, at all-time highs) with strong year-to-date returns despite coming off a low base on 1 January 2019 following a strong Q4 2018 pull back.
- **Fixed income** yields have continued their multi-decade trajectory downwards (with more than 25% of global debt now having a negative yield[1]). Driven primarily by the Fed and ECB's dovish rhetoric this year, fixed income yields have largely moved lower from early this year but have ticked up a little higher since September as some risk appetite has returned to the market (particularly in longer dated US bonds).
- **Gold** too is off its high with this return of risk-on sentiment.
- **Brent crude** is well off its high of approximately $74 a barrel in April 2019 and has had a volatile year – driven by demand concerns due to slowing global growth and increased supply of US energy but with Middle East tensions surprisingly not driving up the price significantly, although causing short term intra-month volatility.

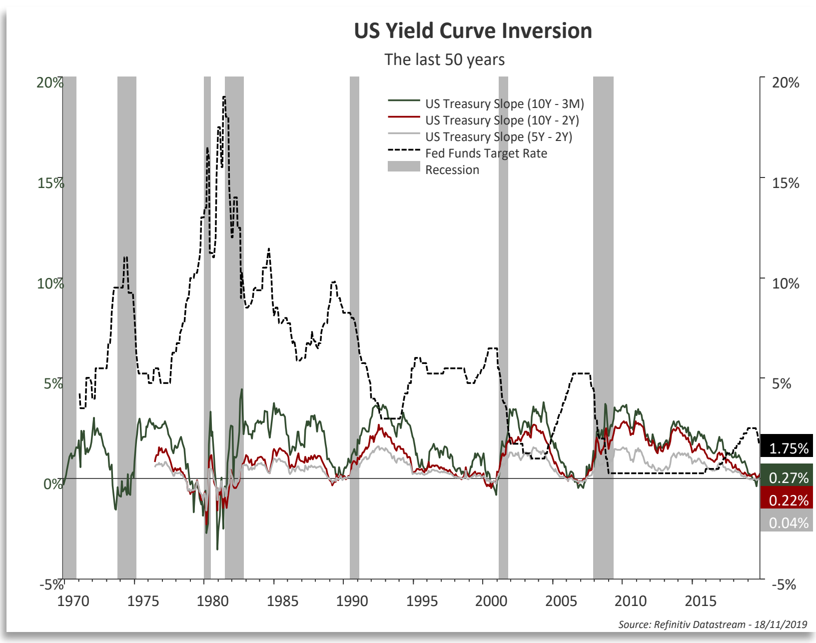
We discuss some interesting fixed income focussed charts on the forthcoming pages.

US Yields

As can be seen in this chart Treasury Yields have been falling this year across all tenors. The convergence of the yields, which can be seen in the top chart, is representative of the flattening and inverting yield curve.

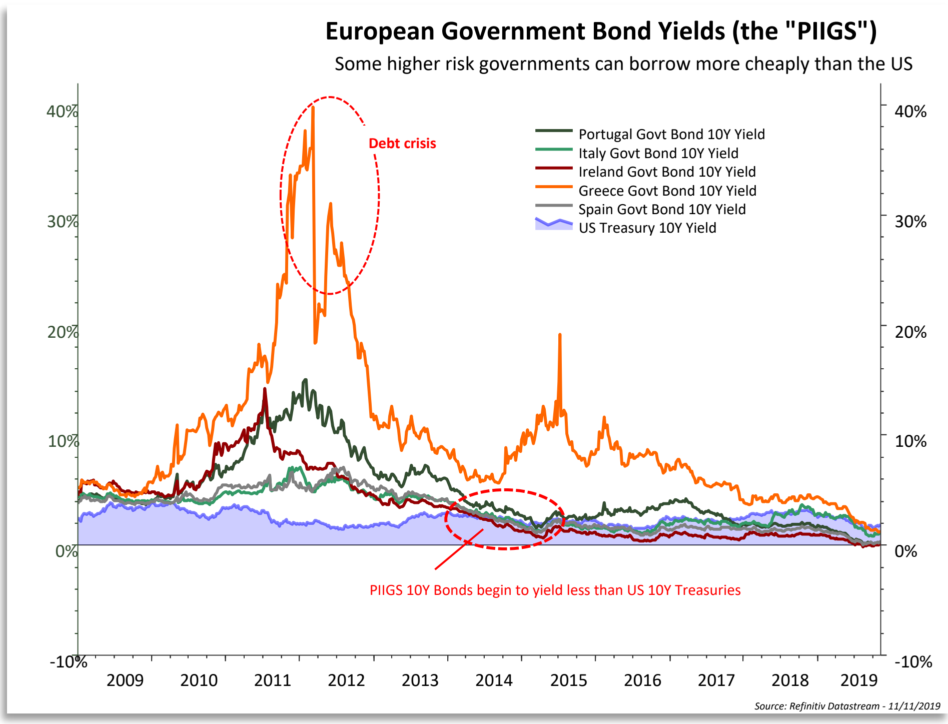
When looking at the 2009 to 2016 period it is clear that the longer end of the curve provided higher yields than the short end, mainly due to the Fed Funds rate being kept so low and a steeper upward sloping yield curve.





We consider the inversion of the yield curve, using three different measures, all of which were (briefly) inverted in August 2019. This has happened shortly before a recession on a number of occasions over the last 50 years. Except for the early 1980s, the inversion did not persist and the curve rapidly steepened. The recently launched Lyxor US Curve Steepening 2-10 UCITS ETF (amongst other similar product launches) shows some market expectation for the curve to continue to steepen following this flat or inverted period.

The US Treasury yield curve (10-year, 3-month) remained inverted from late May 2019 to mid-October 2019, where the market priced 10-year debt at less than 3-month debt for the first time since 2007. The inversion of the yield curve is arguably the most reliable indicator available for predicting a US recession within the next 12-18 months. Since the late 1960s, a US recession has followed an inversion of the 10-year and 3- month treasury yields 100% of the time (no false positives), whilst there has been only one recession which occurred without a prior yield curve inversion (only one false negative). As many risky assets are expensive on a valuation basis, this trend of safe-haven-seeking has kept German 10-year Bund yields in negative territory for much of 2019 as well as a further flattening across global yield curves. There is an argument that “this time is different” partly because there are negative-yielding bonds in Europe and Japan and thus some of the additional bid for the long end of the US Treasury curve comes from foreign investors seeking yield. This has contributed to compressed term premiums and lower rates at the longer end of the curve. So, the argument goes, not only does the inverted curve not signal any recession, but the long end of the curve could be stimulatory for the US economy.



What we see in this chart is that US 10-year yields have remained reasonably stable when compared to their European counterparts, and more recently European countries have been able to fund themselves at lower rates than the US. US 10-year yields have been higher than even some of the riskier European countries’ 10-year yields which has resulted in a strong dollar as many investors have preferred to own higher yielding US paper. The very low European yields are a consequence of low ECB policy rates and ECB quantitative easing programmes, which have been motivated by low inflation and tepid growth. This dynamic supports the theory that US yield curve inversion is partly a result of suppressed yields in Europe and Japan and buyers have shifted to long(er) US bonds. This begs the question – can US rates go negative too? With the recent communication by the Fed, the immediate answer may be – “no”. But if growth continues slowing we may see a further decrease in USD rates in time to come.

Global Central Bank Rate Expectations

(Source: Refinitiv, 18/11/2019):

US Federal Reserve

A 0.31% (on a probability weighted basis, a 31.3 bps to be exact) cut is expected over the coming 13 months. That would leave short term rates over the next 13 months relatively flat should expectations be realised. Longer term rates are more complex, but a steepening curve should be expected in time (even if we see lower long-term yields).

Implied Rates and Basis Point Drop from Current Levels		
Meeting Date	Implied Rate	Basis Points
US Federal Reserve		
11-Dec-2019	1.566	1.0
29-Jan-2020	1.503	-5.4
18-Mar-2020	1.467	-8.9
29-Apr-2020	1.423	-13.4
10-Jun-2020	1.385	-17.1
29-Jul-2020	1.348	-20.9
16-Sep-2020	1.303	-25.4
05-Nov-2020	1.279	-27.8
16-Dec-2020	1.243	-31.3
European Central Bank		
12-Dec-2019	-0.454	0.1
10-Dec-2020	-0.501	-4.6
Bank of England		
19-Dec-2019	0.680	-3.0
17-Dec-2020	0.561	-14.9
Bank of Japan		
19-Dec-2019	-0.069	-2.0
18-Dec-2020	-0.102	-5.3

European Central Bank

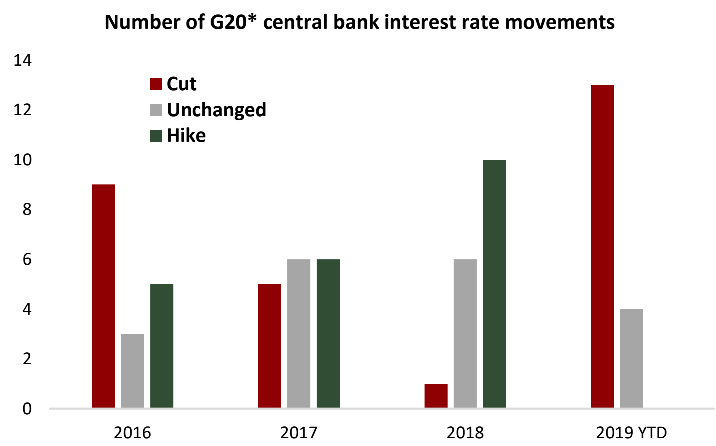
Despite already quite extreme negative rates in Europe the ECB policy rate is forecast to remain slightly more negative at -0.5% through 2020. The primary mechanism of monetary easing in the euro zone will come through increased levels of quantitative easing.

Bank of England

Expectations are largely muted for further rate cuts as inflation has not been completely contained. UK inflation is now below 2% (the BoE's target rate) after trending above the 2% level for much of 2017 and 2018. The ongoing Brexit saga and uncertainty around the outlook for the UK has meant the BoE has had to remain cautious in hiking rates.

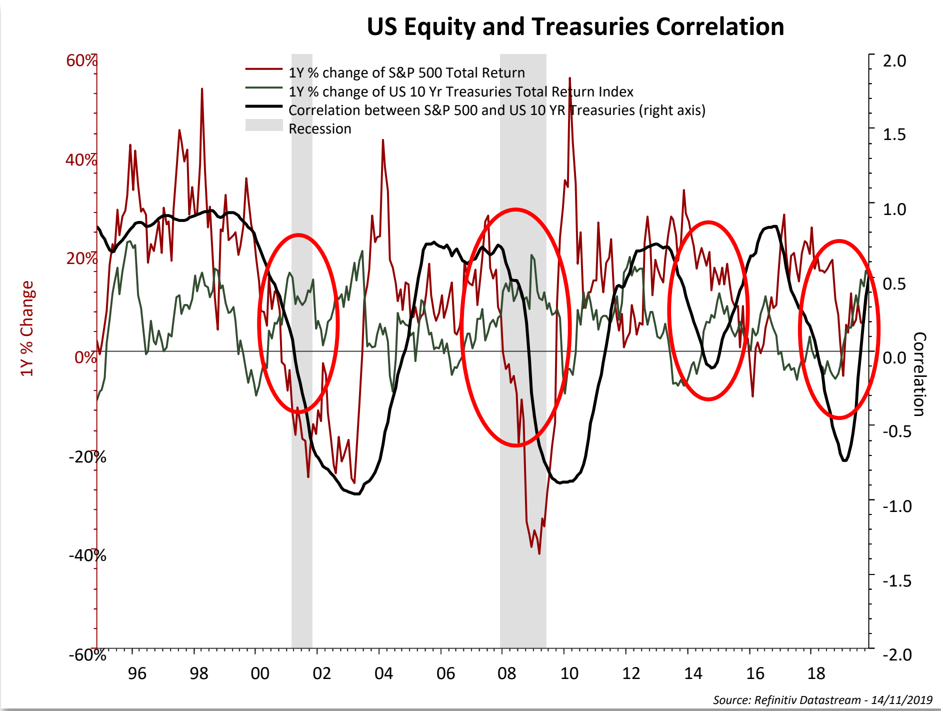
Bank of Japan

Japan has been in a very low inflation and rate environment for a long time (it's been just over 20 years since the BoJ first cut its policy rate to 0%). Yields on the 10-year JGBs moved up quickly from almost -0.30% in early September to -0.02% in mid-November – a large move by JGBs standards.



Source: www.centralbanknews.info

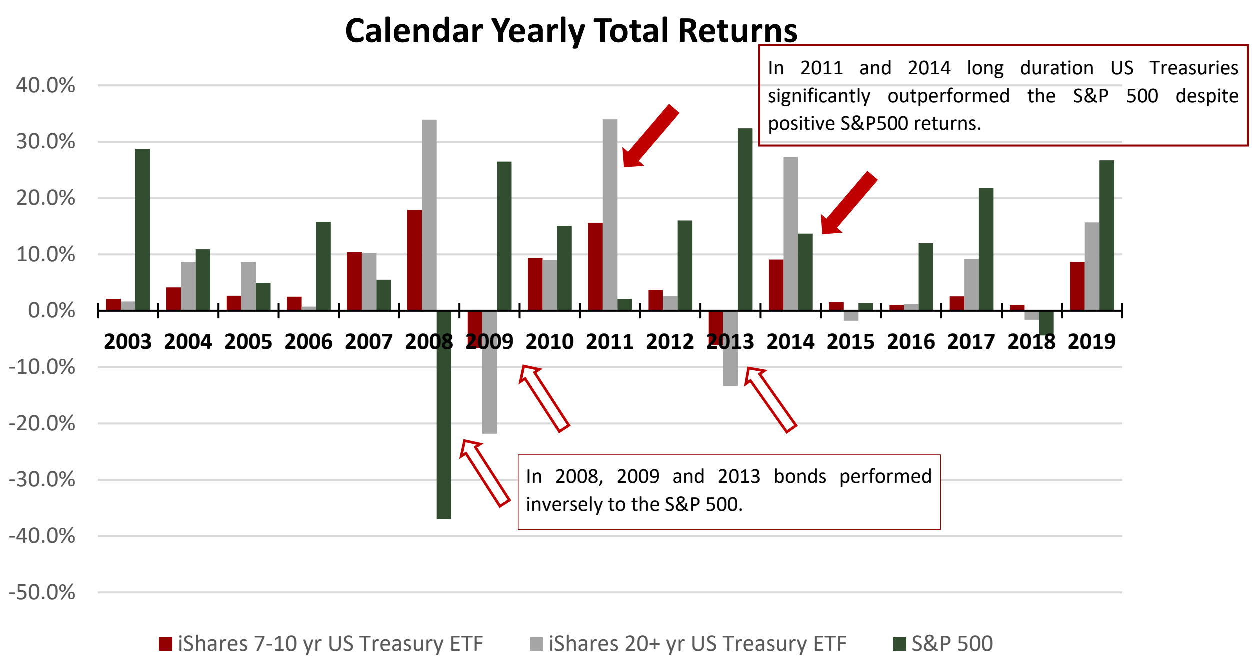
What is stark about the chart to the left is that in 2016 G20 central banks began to hike rates, with most hiking in 2018. In contrast, most central banks cut rates in 2019. Two perspectives can be formed from this about turn in policy. Firstly, one could argue that because global economic risk is increasing and data is weak (indicating an impending recession in many of the countries) the central banks have cut rates and we should be worried (glass half empty view). The alternative perspective is that central banks are ahead of the curve and acting early to avoid a recession and the global expansion can continue (glass half full). We tend to err on the cautious (half empty) view until there is more clarity on trade policy and the strength of the US and Chinese consumer.



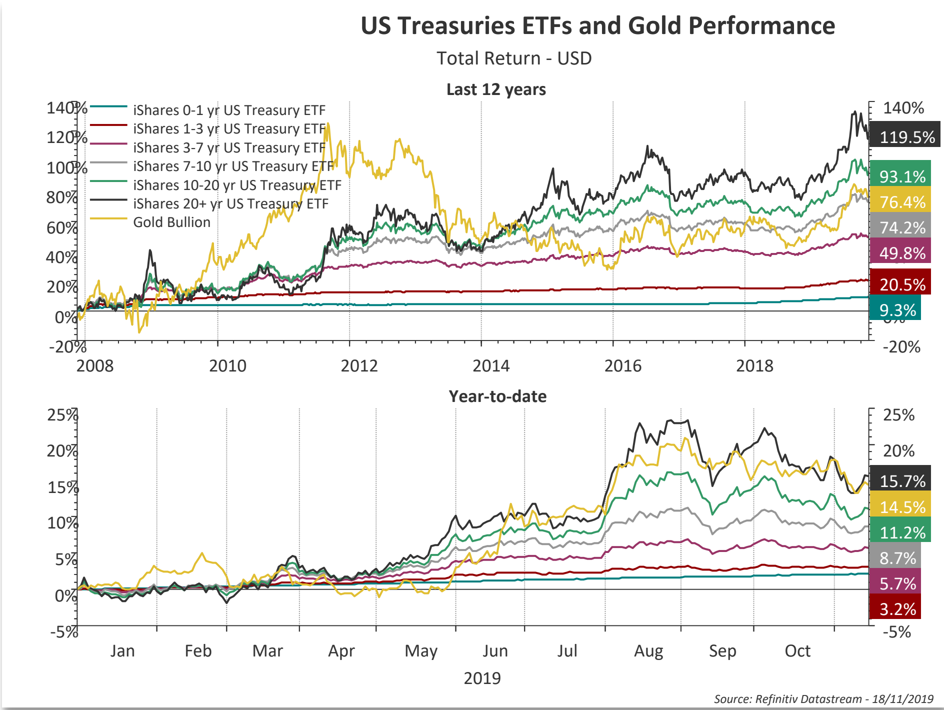
As can be seen in this chart the inverse (or lack of) correlation between US Treasuries (10 year) and US equities (S&P500) tends to hold during periods of greater drawdown i.e. flight to safety during equity market sell-offs, as shown in each of the four red circles. Interestingly the chart also shows positive correlation outside of those periods where both equities and bonds are moving in the same direction which is generally not the norm. This has been the case in 2019 with both equity and fixed income markets performing relatively well. This is clearly evident on the first page of this document.

This diversification benefit and lower/negative correlation is why it is important to hold high quality investment grade fixed income in a portfolio.

Correlation data has been based on 3 years of weekly data.



ETF Performance

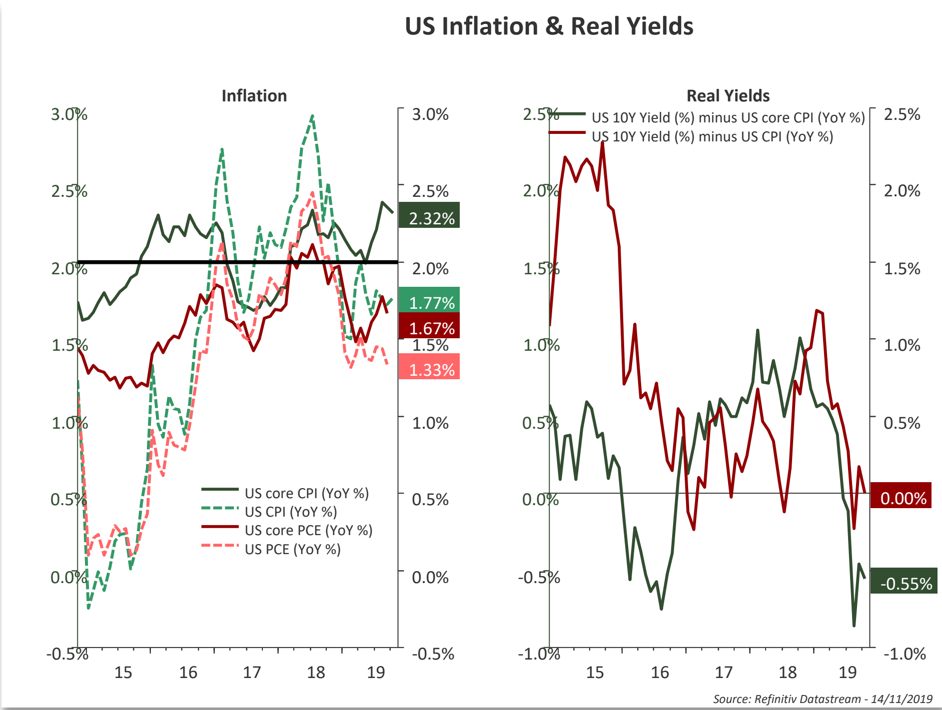


Longer duration US Treasury ETFs have outperformed short duration ETFs over the long-term. We observe intervals of strong outperformance followed by significant underperformance in subsequent periods (such as mid-2015 to mid-2016; 2014; 2011-2012). We have already seen a partial reversal in the strong 2019 YTD performance of long duration bond ETFs since early September this year.

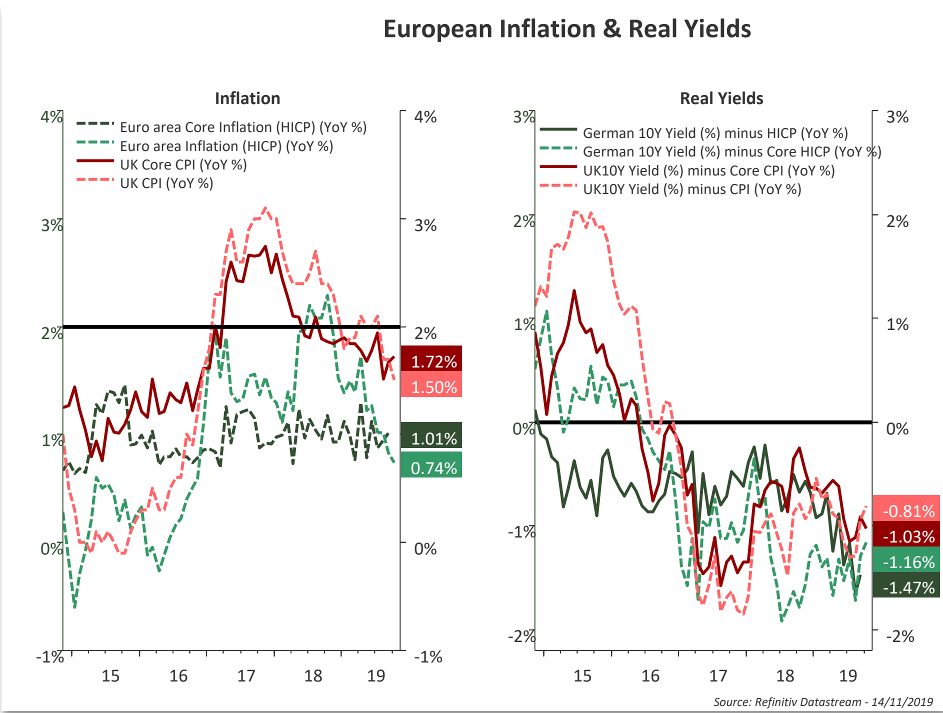
Biggest YTD moves occurred in March, May, August and October 2019. Gold, another risk-off asset, moved higher one month later than Treasuries in June 2019 but then largely tracked the performance of the longer duration US Treasuries. Gold often performs well in two scenarios, one of which is when risk-off sentiment and general market nervousness prevails, the second of which is when there are increasing levels of negative yielding bonds (i.e. the opportunity cost of holding a low (negative real) returning asset like USD cash or treasuries). Some of this year's gold rally could be attributed to very low nominal and real yields, not just nervousness. See below.

Inflation

Real bond yields (yield minus inflation) have recently declined substantially, meaning that investors in 10-year US Treasuries are earning very little real return. In the UK and Europe, real yields are even lower.



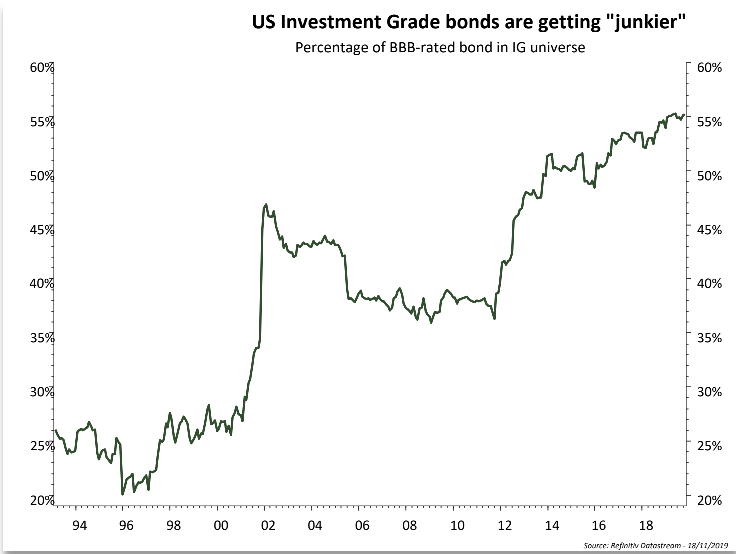
We show both CPI (Consumer Price Index) and PCE (Personal Consumption Expenditure Index) including CORE for both (CORE excludes Energy and Food).



Inflation in both the euro area and the UK has been decreasing over 2019. This may give further impetus to central banks to continue to loosen monetary policy.

Real yields (yields on 10-year government bonds minus inflation) are strongly negative – meaning one is effectively losing money in real terms for the benefit of the safe haven status of these government bonds.

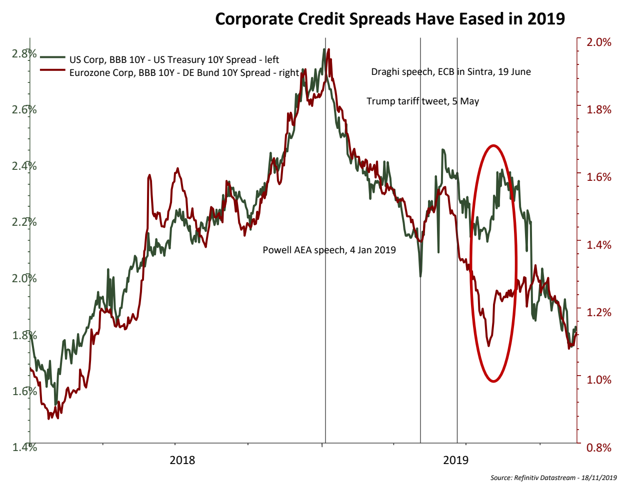
US Corporate Bonds

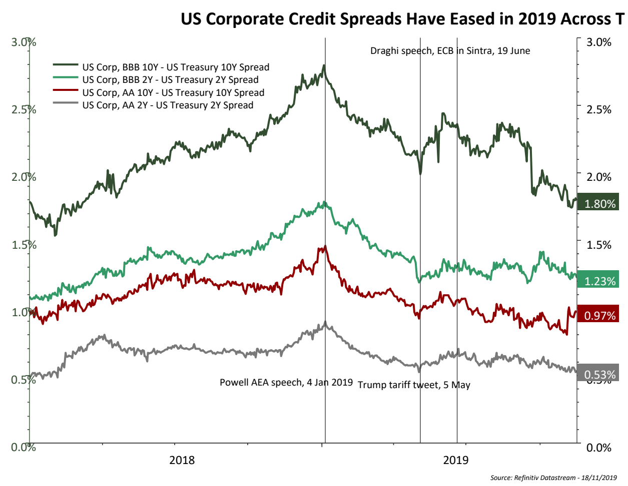


In the chart to the left we can see that the percentage of Investment Grade Bonds (higher quality debt) that is rated BBB (i.e. the lowest level of perceived quality before being classified as “junk”) is at the highest level in decades.

So, although the Investment Grade universe is safer than High Yield and Leveraged loans, their universe is facing the refinancing “cliff” sooner as overall quality is declining. Thus, there could be a scenario where Investment Grade issuers, when coming to market in a weaker economic and earnings climate, become High Yield issuers after facing downgrades which can cause further knock-on effects to other issuers.

The charts below show that corporate credit spreads in both the US and Europe have decreased strongly over 2019. This is in line with, on balance, a good year for equity markets and improved sentiment from late 2018. What is interesting to note is the general consistency of the change in the USD and EUR BBB bond credit spreads. In early 2019 there was a greater compression in EUR BBB spreads than the USD ones. More recently, however, USD investors have had a keener appetite for USD BBB bonds as seen in the chart on the LHS.





Conclusion

Fixed income continues to play an important role in portfolio construction and as a diversifying asset class. However, the yields which investors earn from high quality fixed income securities is substantially lower than those of the past. The extent to which there is negative yielding fixed income is at unprecedented levels and the unwind of this in years and decades to come is unknown. We think low yields will persist for at least 12 – 24 months, if not longer, as the global economy cools, inflation in developed countries remains muted and central banks around the world become more dovish in their tone.

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Data is sourced from Refinitiv, 2019.

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[1] Invesco, Is now a good time to buy investment grade credit?, 15 November 2019, https://etf.invesco.com/gb/institutional/en/insights/content/is-now-a-good-time-to-buy-investment-grade-credit