What About Those Bond Yields?

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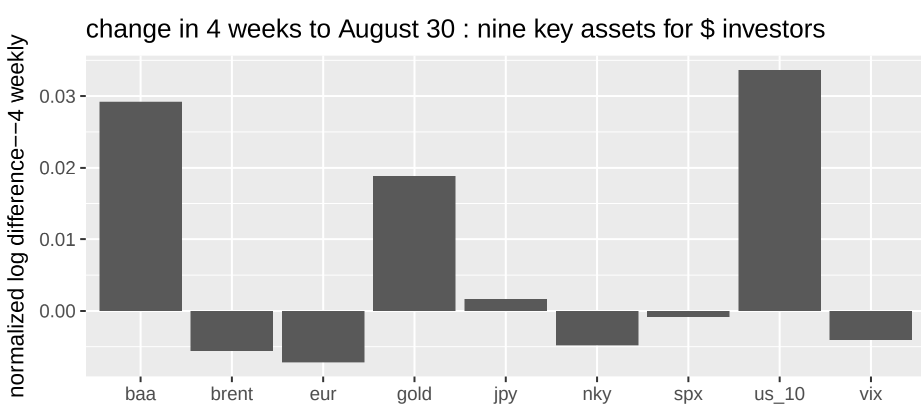
☐ *An intense bond market rally continued, taking us to new super-low yields.*

☐ *Assuming these super-low yields signify recession, equities have mostly turned down, veering away from risk in an important new development in the last few months.*

☐ *It was otherwise early in the year, when fresh central bank support was expected to lower yields to purposefully* **rescue** *stock prices.*

☐ *Gold, like cash a key safe haven in times of risk aversion, is up.*



Emerging Market Tell-Tales. Recession risk is also increasingly priced into emerging markets, often a key tell-tale of broader financial risk. Partly this is due to emerging markets' growing dependence on bond financing, where elevated risk premia now outweighed the attraction of lower risk-free rates.

Argentina's re-engagement with failed populist economics yielded frightening headlines, while a long list of other emerging market currencies sold off sharply as well. In this environment it was easy for China's leaders to let the yuan fall through the key level of 7.0 per dollar.

In contrast, bonds which look closer to core government debt surged in value. This included highly rated US corporate debt. Boosted by possibility of a less anti-euro government in Italy, Italian government debt yields likewise hit record lows.

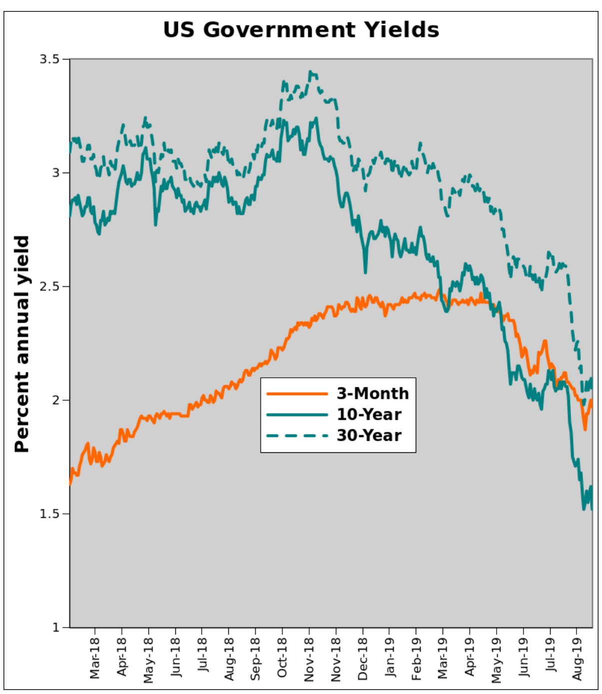
Bond Hedging. Regard for my readers and the scale of my error in looking for higher rates compels me now to look at how rates instead fell so far so fast. (See chart below, left.) I claim the severity of the move is linked to the inflated scale of global bond markets under prolonged, global, central bank manipulation, and the great hedging needs that creates.

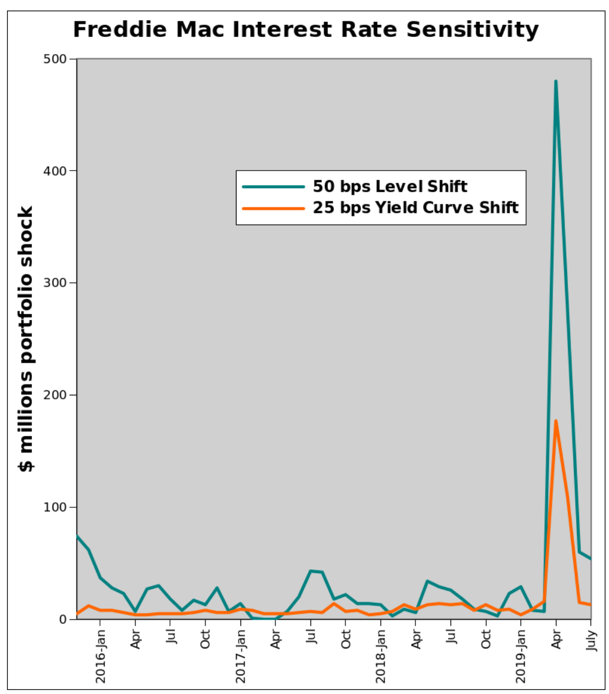
For some time, higher US yields have attracted investment refugees from the negative yields in Europe and Japan. For these refugee investors, the safest bet was to borrow in the US at short term to fund (or hedge) their bond buying, picking up the carry along the US curve. These flows helped to drive down US long yields and tended to invert our curve during 2018.

By 2019, the flattening of our yield curve meant that the cost of these hedges wiped out the return. So some offshore investors must have shifted to buy their US bonds unhedged, taking greater risk and also creating upside pressure on the dollar. A strengthening dollar then contributed to ease inflation on these shores, just as a delayed inventory adjustment hit. To top it off, completely unnecessary tariff disputes between our great leader and China added to the danger. Global recession, including in the US, suddenly looked possible.

Certain very large portfolios were obviously caught napping by the shift in apparent recession risk. One place where risk built up and had to be covered in a hurry was in the great mortgage portfolios of our now-nationalized mortgage agencies. These agencies hold over $5 trillion in mortgages directly and indirectly, all of which can be refinanced at will by borrowers, at which point the agency portfolios lose assets.

Trillions of dollars in the mortgage agency portfolios are normally hedged, and those hedges have to be reduced as rates come down and assets evaporate. If re-hedging is delayed, then the agencies will be forced to catch up, rushing to buy back bonds earlier sold as hedges. As they buy back bonds, yields fall further, forcing further rehedging, and initiating a cascade down in yields. In June, Freddie Mac's potential losses from a further drop in rates surged as someone was asleep at the wheel. In August, another jolt down in yields means something similar must have happened again at Freddie Mac or another comparable portfolio. (See chart below, right)

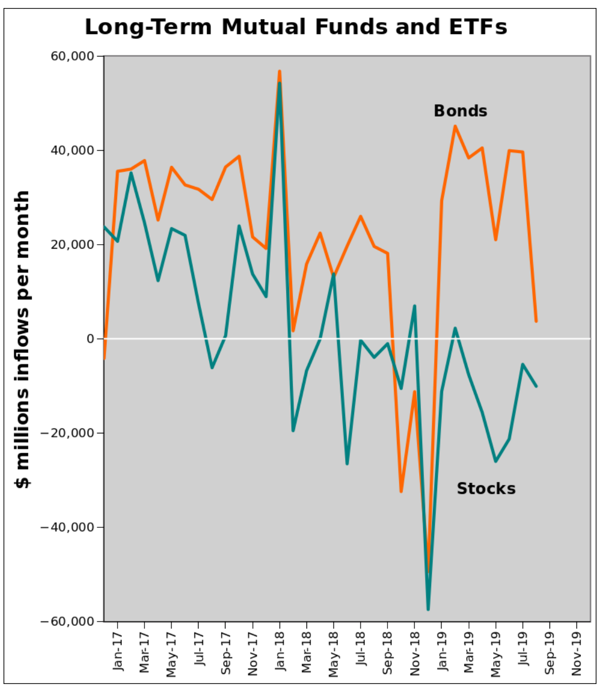


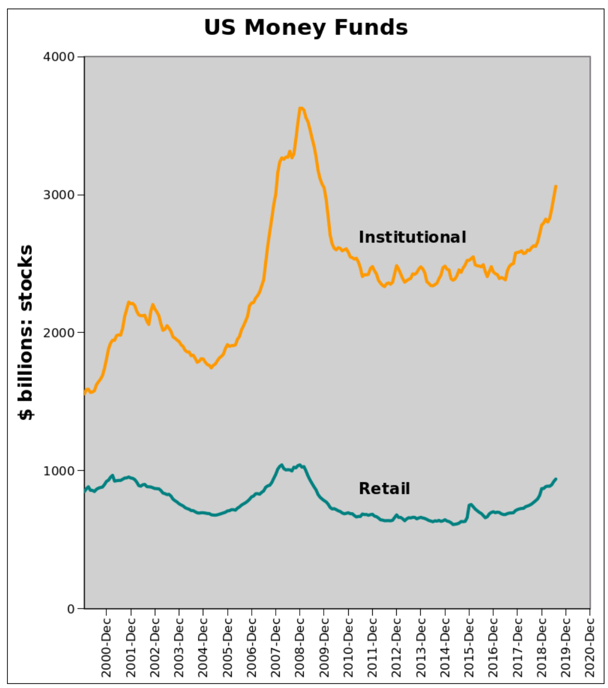


From Equity to Bonds to Cash. Portfolio flows have also been coming into bonds and out of equities for some time. Apparently, the sharp run-up in US equity values since 2017 has looked increasingly dodgy to investors. Mutual fund and exchange traded funds in the US show equity outflows since the beginning of 2018, spiking at year-end. Even after a sharp sell-off and rebound, mutual funds and ETF flows have kept flowing out of stocks all year. (See chart below, left.)

Some long-term investors may also have been shifting from equity to bonds. Norway's sovereign wealth fund, for example, moved its equity share to 70% in 2017 and has found itself right at this level all year. A bounce in equity values through April will have forced equity sales to rebalance the value of its portfolio back into bonds. Other less transparent funds around the world are likely to have been following something similar to this best practice. [1]

So the central bank game of systematically driving up asset values to bolster demand has bad side effects. Just as with drugs offering apparently wonderful effect at first, hangovers follow. One way this happens is when exaggerated valuations in stocks, and now increasingly in bonds, creates justifiable caution on the part of investors. A symptom of this caution will be the gradual shift back into cash-like instruments such as gold, bank deposits, or money-market funds. Money funds hold short term paper with little risk of loss, and are treated by investors as cash-equivalents. My definition of a financial crisis is a rush for cash and out of riskier paper, which promptly collapses in value. It may have already started, because US resident money-market funds are beginning to ominously trend up. (See chart below, right.)





[1]Norges Bank Investment Management (2019), Government Pension Fund Global Quarterly Report (2Q 2019). Retrieved from `https://www.nbim.no/en/publications/reports/2019/2q-2019-quarterly-report`

Central Bankers Miss the Point. Central bankers spent some time discussing what they should do about the risk of a renewed economic downturn. For me, a renewed recession calls for public spending on a coherent list of socially worthwhile projects. In fact, only China actually has this fiscal tool operationally available, which it has been using aggressively. The US, bogged down in an oversized deficit and outlandish plans for a great wall on our southern border, cannot muster a useful discussion of any other spending. Europe's national deficit limits, which are sometimes binding, block any clear continent-wide fiscal response to recession. But these are man-made limits that can be lifted.

In their talk of renewed monetary policy ease, however irrelevant, central bankers always return to the idea that interest rates influence real world investment spending. In fact, it seems obvious to me that interest rates have their most certain effect on neighboring *financial* prices in an age of serial financial bubbles. Low rates do inflate asset price bubbles and that does create an illusion of well-being that may bolster demand for a time, but later bring bursting bubbles as the inevitable result. With financial prices already inflated, more monetary ease makes little sense here.

While central bankers talk, a global trade and inventory adjustment should be coming to an end. Unfortunately the added burden of now-substantial trade tariffs, might still tripped us into a broader downturn. So far the evidence is mixed.

In China, manufacturing earnings are weak, investment producing autos sold at home and exports headed for the US are down, just as a forced deleveraging is bringing out a steady stream of bankruptcies. Officials have responded, including with the deliberate decision to allow a measured devaluation of the yuan to offset US tariffs. Meanwhile, European news has been dominated by a drop in German capital goods orders and production that may be linked to the swing away from manufacturing investment in China. Ominously, German employers have finally begun to put workers on short-shifts and are beginning layoffs.

In the US, output clearly slowed around midyear, as the global inventory adjustment came late to our shores. Low oil prices are crimping shale oil investment, and Boeing production of 737 Max is all going into inventory. Worryingly, broader investment spending is also deeply disappointing, possibly because companies do not know how to handle a possible tariff war. Consumption jumped, but one wonders how much was merely an effort to beat import price increases due to impending tariffs. Meanwhile, housing sales are back with lower mortgage rates, but cautiously so far.

Today's super-low bond yields give a false reading of the macro picture. Several portfolio shifts and hedging errors seem to have cascaded into the latest bond market moves to produce something more like a flash-crash than a reasoned price.

Even central bankers have taken note of the low yields, and have loudly discussed their options to ease policies as in 2018. Some moves are possible as a precautionary matter, but mostly this must be a bluff. The real news will only come if Europe and the US find their way to effective fiscal policy, each surmounting its own political obstacles to get to this reasonable response, if needed.

My conclusions are unchanged from two months ago: the really big risk remains that we recover mostly unscathed from a trade and inventory adjustment, despite the added tariff risks. If needed, we find our way to effective fiscal support. If the facts start to fall my way, we can easily see new and wonderful one-way moves among our great and integrated global asset pools, over-inflated by years of monetary manipulation.