VIEWS ON

US Interest Rates

June 2019

The first rate cut may not be the deepest

Ariel Bezalel, Head of Strategy, Fixed Income, has been positioning his strategy for the end of the economic cycle for some time. He explains why he is sceptical that US rate cuts can drive a sustainable rally, and why allocating to high-quality, liquid assets is more important than ever based on a number of recession warning signs.

Ariel Bezalel, Head of Strategy, Fixed Income

Yields come tumbling down

The direction of central banks could not be more different to last year, when rate hikes and balance sheet reduction was the order of the day. The US Federal Reserve has signalled it will consider lowering interest rates due to "uncertainties" in the economic outlook and continued subdued inflation. The European Central Bank has gone further, given negative interest rates, with Mario Draghi calling for additional stimulus if weak economic data and flagging inflation doesn't pick up.

Markets have been swift to react. Futures markets are pricing in a 100% chance of a Fed rate cut in July and are now pricing in a series of rate cuts by the end of 2020. With trade tensions exacerbating concerns over low inflation and worsening economic indicators, markets have flown to perceived safe-haven assets like gold and government bonds. The 10-year US Treasury yield dropped below 2% for the first time since November 2016 in June and has fallen a staggering 70 basis points over the course of this year. The most extreme low yields are found in Europe, where German 10-year Bunds are yielding minus 30 basis points and incredibly in Switzerland where the 30-year bond yield recently turned negative. In fact, the amount of negative yielding debt worldwide has risen to a high of $13 trillion, led by Europe where there are €500bn of corporate bonds on a negative yield. The incoming wave of monetary easing may mean that negative yielding debt could be with us for some time to come.

Recession clouds gather

In my opinion, there is a lot of complacency in risk assets as investors get sucked into a whole array of assets without understanding the true risks. It's been my belief for a while that the US economy is nearing the end of its economic cycle and is getting closer to the next recession. This is based on a multitude of macro and market warning signals, from the rise in "covenant-lite" credit and "zombie" firms kept alive by low rates, to persistently deteriorating trade data in key hubs across Asia and Europe, record household and corporate debt, and flattening/inverting yield curves. The global PMI for manufacturing has now registered 13 consecutive downticks, slipping into contraction territory in May.

Dovishness isn't enough

I would also highlight that the current economic expansion is now the longest in US history since records began in 1854, which by itself should be a sign for caution. The Fed has very little ammunition left to stimulate the economy, given they remain constrained by their huge balance sheet and rates that are still close to historic lows of 2.25% to 2.5%. Bear in mind that in post-war history, on average the Fed has cut rates by about 4.5% in the face of a downturn.

This is why I believe it's unlikely that mere dovishness will be substantial enough to drive a sustainable rally. The Fed appears to be framing the economy through a mid-1990s lens, when then-Chairman Alan Greenspan implemented so-called "insurance" rate cuts in 1995 and 1998 to sustain the US expansion. But I'm afraid I don't believe that this is a mid-cycle slowdown and I expect the Federal Reserve will end up having to cut rates aggressively. In fact, over the next 12 to 18 months I believe rates are likely to drop to zero in the US and there may even be another round of quantitative easing. The gold market may be starting to expect this, which has been reflected in the sharp rally in gold over the last month or so.

Race to Zero: Negative and sub-1% yields are now seen even out to 30-year maturities

COUNTRY	2-YEAR	5-YEAR	10-YEAR	30-YEAR
Australia	0.90	0.94	1.28	1.90
Austria	-0.68	-0.47	-0.04	0.66
France	-0.68	-0.50	0.01	0.94
Germany	-0.75	-0.65	-0.32	0.25
Italy	0.31	1.45	2.19	3.18
Japan	-0.24	-0.27	-0.16	0.34
Netherlands	-0.69	-0.63	-0.15	0.29
Portugal	-0.43	-0.14	0.49	1.40
Spain	-0.43	-0.14	0.39	1.36
Switzerland	-0.98	-0.88	-0.55	-0.03
United Kingdom	0.57	0.60	0.81	1.43
United States	1.73	1.74	2.01	2.54

Source: Bloomberg, as at 11am on 25 June 2019

I'm sometimes asked if fiscal stimulus could help boost the US economy but adding to the mammoth US government debt is unwise even for Donald Trump, and it's unlikely Democrats will sanction any legislation such as an infrastructure bill that bails him out ahead of the 2020 election. And by then, it may be too late. Any stimulus from governments or central banks appears to have only a transitory effect in such a highly indebted world.

"Japanification"

It's also worth noting that even record low unemployment figures have not been enough to trigger meaningful inflation in the US. We believe this is a long-term structural trend and that the factors behind this are reasserting themselves. There is undoubtedly wage inflation in some sectors but broadly speaking labour has very little power these days. We have long believed that the interlocking factors of ageing demographics, high debt burdens and technological disruption are likely to keep growth, interest rates and bond yields supressed for some time to come, which is supportive for fixed income assets. We have previously discussed how Japan can be seen as a template for the direction of bond yields and central bank policy in other developed economies, and our conviction in the "Japanification" thesis is rising.

Defensively positioned to high quality, liquid assets but alert to special situations

Going into 2018, my aim was to get ahead of markets and de-risk the strategy while still in an environment of market strength and strong liquidity. We raised the strategy's exposure to high quality, liquid AAA-rated government bonds in the US and Australia. We lowered exposure to riskier, less liquid credit, especially high yield in which we have the lowest exposure to in the strategy's history. Finally, we hedged all the strategy's emerging market currency exposure. Volatile market conditions this year have continued to strengthen my conviction in the strategy's defensive positioning.

Yet we remain nimble to opportunities. The advantage of our flexible mandate is that we can invest anywhere in the world across the credit spectrum. We continue to be constructive on Indian government bonds, where we expect to see more rate cuts over coming months as inflation is likely to slip lower there. We have also found compelling credit opportunities in US and Brazilian poultry and beef producers, which are benefiting from the unprecedented disruption in the pork supply loss caused by African swine flu in China. While I'm conscious of the risks ahead, I'm confident that my team have the experience and the tools at our disposal to steer the strategy through the next stage of the cycle, using a flexible approach to manage risk while seeking positive returns from across global bond markets.

Source of all market figures: Bloomberg

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