MARKET INSIGHTS

THIRD QUARTER 2019

> ***Zero has no meaning, beside being a certain level.***
>
> - Alan Greenspan

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Wait! What? Negative interest rates? You mean interest rates are now so low that depositors must actually pay their banks for the privilege of holding cash? That sounds absurd. While not yet a reality in the U.S., negative interest rate policies have already been adopted by several foreign central banks (European Central Bank, Bank of Japan, and the central banks of Denmark, Sweden and Switzerland), and there is an estimated $16 trillion of negative yielding bonds out of a global bond market that totals roughly $113 trillion, according to the Institute of International Finance. Germany recently issued 30-year zero coupon bonds with a guaranteed return to investors of -0.11%! Meanwhile, in an effort to lock in historically low rates, the U.S. Treasury Department is considering issuing 50 year bonds beginning in 2020. Locking in guaranteed negative returns and/or bond maturity commitments equivalent to more than half a lifetime are not investments most of our clients would want us to make, regardless of the rationale. A snapshot of the world bond market at month-end September reflects the global phenomena, with more major economy countries offering 5-year sovereign debt with negative yields than those with positive returns.

Regional | Export | Settings | World Bond Markets

91) Bonds | 92) Spreads | 93) Curves

Maturity: 5 Year | Data Range: 3 Months

Region	RMI	Security	Price	Chg	Yld	Chg	Yld	Low	Range (Avg / Now)	High	3M Chg
1) Americas											
10) United States		T 1 ½ 09/24	99-22¼	+ 02	1.564	-1.6		1.318		1.892	-20.6
11) Canada		CAN1 ½ 09/24	100.519	+0.00	1.390	-0.2		1.131		1.566	+1.2
12) Mexico (USD)		MEX 3.6 01/25	104.309	-0.00	2.725	+0.1		2.469		2.849	-12.2
2) EMEA											
19) United Kingdom		UKT1 04/22/24	103.175c	+0.23	0.298	-5.1		.261		.627	-31.4
20) France		FRTR 0 03/24	102.938c	+0.05	-0.644	-1.2		-.802		-.474	-13.9
21) Germany		OBL0 10/18/24	104.018c	+0.05	-0.778	-1.1		-.937		-.576	-12.3
22) Italy		BTPS 1 ¾ 24	107.279c	+0.21	0.209	-4.5		.209		1.387	-117.7
23) Spain		SPGB 0 ¼ 24	102.676c	+0.10	-0.299	-2.2		-.407		-.091	-14.7
24) Portugal		PGB5.65 02/24	126.317c	+0.03	-0.314	-1.0		-.386		-.088	-14.8
25) Sweden		SGB1 ½ 11/23	108.893c	+0.04	-0.626	-1.2		-.748		-.430	-9.1
26) Netherlands		NETHER2 07/24	113.260c	+0.07	-0.713	-1.5		-.856		-.529	-6.9
27) Switzerland		SWISS 1 ¼ 24	110.616c	-0.02	-0.950	+0.4		-1.215		-.855	-6.8
28) Greece		GGB3.45 04/24	112.250c	-0.06	0.678	+1.2		.659		1.263	-58.5
3) Asia/Pacific											
29) Japan		JGB 0.1 06/24	102.256c	-0.03	-0.370	+0.6		-.398		-.217	-11.3
30) Australia		ACGB 2 ¾ 24	109.122c	-0.00	0.711	+0.1		.655		1.064	-30.8
31) New Zealand		NZGB 2 ¾ 25	110.110	+0.06	0.876	-1.2		.764		1.293	-38.8
32) South Korea		KTB1 ⅜ 09/24	100.292	+0.01	1.329	+0.0		1.053		1.490	
33) China		CGB3.19 04/24	101.003c	-0.03	2.948	+0.7		2.853		3.043	-9.5

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While we are not investing in negative yielding bonds and your local bank may not yet be charging you for deposits, the latter certainly is not out of the realm of possibilities, and it seems probable bonds will be providing strikingly low yields for the foreseeable future. As a primer on the topic, negative interest rates are a technique by which central banks try to influence economic conditions like employment, inflation, business investment, and consumer spending. The conventional thinking is that by raising or lowering policy interest rates the shifts will correspondingly restrain

or stimulate economic activity. The problem arises when a change in the policy rate, such as the cutting of interest rates, does not have the intended effect. The theory of negative interest rates may seem a bit counterintuitive, yet it follows the concept of the carrot and stick approach to motivation. Interest rates are lowered to promote borrowing and spending. If the rates are not low enough to spur the desired economic activity, the theory holds that businesses and individuals are more likely to make capital investments if continuing to hold cash becomes increasingly and financially painful.

There's no need for U.S. investors to panic as the Federal Reserve has yet to resort to negative interest rates. In fact, even after the September Fed Funds reduction to a range of 1.75-2.00%, the U.S. remains a global outlier. It's no surprise that foreign investors are clamoring for U.S. denominated debt, placing further downward pressure on yields. It is becoming increasingly apparent lower for longer yields on fixed income investments may just be an investment fact of life. That, in turn, requires adjustments, not just to bond return expectations, but also ultimately to portfolio asset allocation. Expect to hear more about this from us.

What? Wait! The media has been all abuzz as short-term interest rates have persistently stayed higher than longer-term rates. And, as noted in our second quarter client letter, such inverted yield curve occurrences have typically been solid harbingers of imminent recession. That may, in fact, be the case, but more and more economists are suggesting an inverted yield curve may not be the reliable recession indicator it once was. We don't aim to be the ones jumping on the "this time it's different" bandwagon, but yields, yield curves, and government bond markets have clearly been distorted by unprecedented central bank actions, such as negative interest rates. In years past, issuers of long-term bonds had to offer higher yields in order to attract investors and to compensate them for the possibility of inflation. These days, it seems the biggest worry on every central banker's mind is not the potential for inflation, but the concern over deflation - price levels falling and people and businesses holding on to cash (instead of spending or investing) with the belief prices will be even lower in the future.

Besides the U.S. and un-investable basket cases like Greece and Italy, Australia is one of the few developed economies with positive yielding sovereign debt, and it is possible our former sister colony may be giving us an advance look at what we have ahead of us. The Reserve Bank of Australia cut interest rates in both June and July, and while the impact has yet to be fully gauged, their position on the front line of the trade war between the U.S. and China certainly appears to be showing evidence of collateral economic uncertainty, if not direct damage. With that as a backdrop, our next investment research trip will take us "Down Under" to get a firsthand look.

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