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What's Happening With Interest Rates?

There has certainly been no shortage of crosscurrents in the stock and bond markets this summer. Even with incredibly strong performance from the stock market in the first 7 months of the year, concerns dominate the headlines. Bouncing between China, trade tensions, the Federal Reserve, earnings or Brexit. This month we discuss the unusual global interest rate environment and how it plays out in client portfolios.

How is the low level of interest rates affecting your fixed income strategy?

Shifting factors are creating unusual conditions in fixed income markets.

- Inverted yield curve
- Changing Fed Policy Direction
- Money Market Funds yielding as much as, or more than, a 10-year Treasury Bond
- Negative Interest Rates in much of the Developed World, outside of the US
- Municipal Bonds yielding historically low rates relative to Treasuries

What does this mean for your bond portfolio?

As we discussed last month, the expectations for Fed policy have shifted dramatically since the fourth quarter of 2018. On July 31st, the Federal Reserve cut its benchmark rate for the first time since 2008. The 0.25% reduction lowered the Fed Funds rate to a range of 2-2.25%. By comparison, a 10-year Treasury Bond yields less than 2%, and 3-month T-Bills and Government Money Market Funds both yield around 2%. The adage "cash is king" comes to mind, as we are not being compensated for commensurate credit or duration risk.

Why did the Fed cut rates? Why the change in policy direction?

The Fed is watching moderating global growth, continued trade uncertainty and muted inflation. This rate cut was well-telegraphed by Chairman Powell who started to signal a pause in rate tightening in 1Q19 after the late 2018 market sell-off along with reports of weakening economic data. Some have referred to this as a "mid-cycle adjustment" instead of a longer rate reduction cycle, meaning that the Fed is likely to remain somewhat dovish, but is unlikely to lower rates for an extended period of time. Expectations currently call for another 0.25% cut in September, with 0.25% more possible before year end — putting the fed funds rate at 1.75% versus 2.50% in December 2018.

Source: digitexfutures.com

Lower short-term interest rates could bolster growth, boost inflation expectations and could in turn help the yield curve return to a more normal, positive-sloping shape. Higher growth and inflation expectations would lift longer term yields, giving bond holders more attractive longer term prospects.

Current economic data is not necessarily negative. In fact, real consumer spending is solid, recent revisions of wage growth were published at +5% year/year and the savings rate is up sharply to 8.1%. These factors, along with accelerating productivity, will put upward pressure on inflation. Core PCE inflation was +1.6% in the second quarter of 2019. Sustained core inflation over 2% will be necessary for 10-year Treasury yields to climb above 2.50-3% in the future. To be certain, the Fed will be watching economic indicators, trade and inflation expectations closely as will we.

Negative Rates Abroad

US investors may complain that there is little value in bonds today, but US fixed income remains attractive when compared to the rest of the world. As we highlighted last month, since 2014, when the ECB introduced a negative deposit rate to help boost economic growth, the value of negative-yielding bonds has grown to $15 trillion worldwide, almost triple the amount from October 2018. Nearly 25% of the global investment grade debt tracked by the Bloomberg Barclays Global Aggregate Index carries a negative yield. See Exhibit 1 for a comparison of current 2-year government bond yields by country. There is no end in sight for negative yields as many of the world's central banks, including India, South Africa and Australia, have all cut interest rates this year. Brazil and the ECB are also likely set to follow the US Fed's rate cut in the coming months.

Exhibit 1: 2 Year Bond Yields Around The Globe

United States	1.83%	Sweden	-0.63%
Canada	1.54%	Belgium	-0.68%
Australia	0.88%	France	-0.69%
United Kingdom	0.43%	Netherlands	-0.76%
Italy	-0.02%	Germany	-0.77%
Japan	-0.19%	Denmark	-0.80%
Spain	-0.49%	Source: Bloomberg 8/1/19	

How can a bond have a negative yield?

Negative yields happen when investors pay a premium for bonds with a zero coupon rate. We often buy premium bonds in our portfolios, but these bonds have coupon rates that are greater than the market yields. So bondholders are still making a positive (albeit smaller) return on their investments. By contrast, in Europe, investors buy a bond as a store of value. They pay a premium for a bond that pays no interest, and they effectively lose money when they get the face value back at maturity - not a great store of value, in our humble opinion. See Exhibit 2.

Exhibit 2: How to Get a Negative Yield

1) In July, investors paid €102.64 for German Bond with face value of €100.

2) If they hold it to maturity, in 10 years, they will get €100 back.

3) The bond pays investors annual interest of **0%**

4)Factoring in the price paid, the smaller amount received back, and the (lack of) interest payments, the yield is **-0.26%**

Source: Bloomberg

Municipal Bonds are expensive and scarce

So with abnormal conditions in taxable bond markets around the world, how are US tax-free municipal bonds fairing? In two words, expensive and scarce. Seasonal factors are at play. The months of June and July typically account for roughly half of all bond redemptions and coupon interest payments, meaning a lot of excess cash to reinvest. This cash is chasing already low yields and pushing prices even higher. In addition, more investors are seeking tax-free income since the 2017 tax code changes that capped or eliminated many deductions.

The problem is exacerbated by low supply -- municipalities have cut back on bond issuance and bond holders don't want to sell because there are no attractive alternatives. Changes in legislation in 2017 also eliminated advance refundings for municipalities. This means fewer new bonds are being issued to refinance existing debt with higher coupons. The Fall months typically bring a little more supply to the market.

1-Year Munis At Record High Relative Prices

Low taxable yields and a supply/demand imbalance have pushed 1-year municipal bond rates down near 1.1% tax-free. This yield represents only 55% of a 1 year Treasury bond that yields 2%. This ratio is important for bond traders to monitor the relationship between taxable and tax-free yields. It measures relative values and helps identify whether taxable or tax-free bonds are more attractive. At 55%, this ratio is at record low levels not seen since 2001. It usually averages around 80%, but was running over 100% for much of the last decade since the financial crisis. This low level further illustrates why we prefer money market funds over short municipals at this time.

Although the tax-free yield curve was never inverted, rates remain very flat. Investors need to stretch maturities to 15 years to see tax-free yields of 2%. Our client portfolios remain high-quality and positioned defensively with short duration of 1-3 years. Some anxious investors are reaching for yield with longer maturities or high-yield bonds with lower credit quality. Given where we are in the economic cycle, with tight credit spreads and a flat yield curve, we do not believe now is the time to make these bets. Bond holders are not getting compensated to take on extra risk.

So what's an investor to do?

We remain patient. Bond portfolios may see higher than normal cash allocations - including investments in money market funds that are currently yielding more than longer bonds. This also means we remain nimble while not sacrificing yield. We continue to monitor the relationship between yields on taxable, tax-free bonds, and cash equivalents so that we can allocate accordingly. The coming months will bring increased political rhetoric and continued policy uncertainty that could bring more volatility to the Treasury markets. We remain on the lookout for buying opportunities.

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