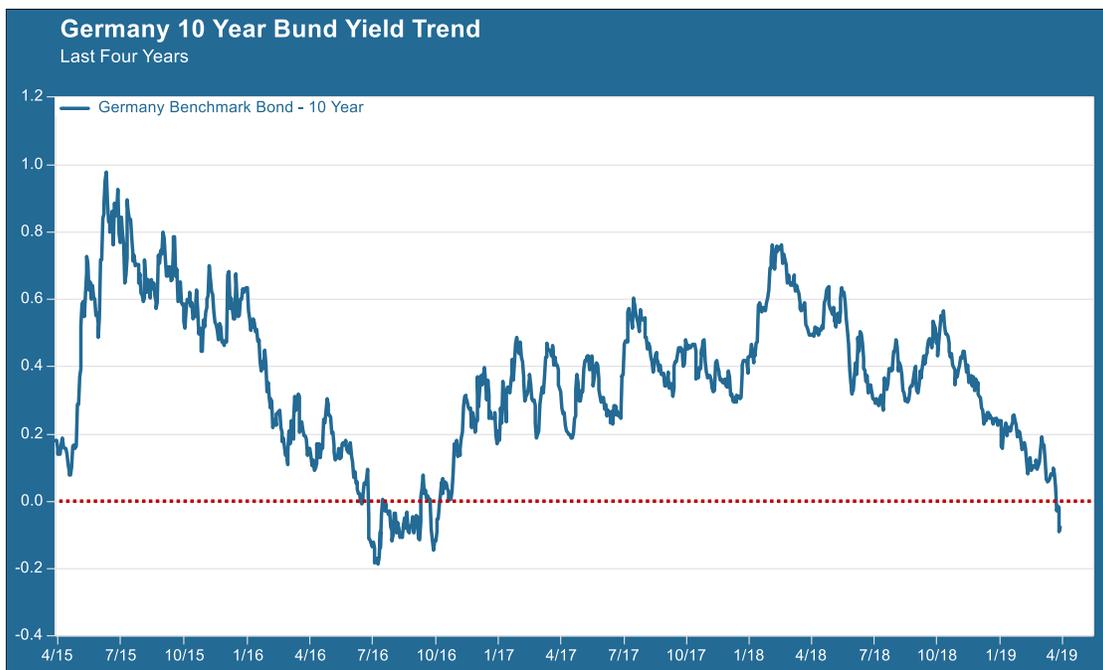


## Weekly Market Flash

### Back to Wonderland

March 29, 2019

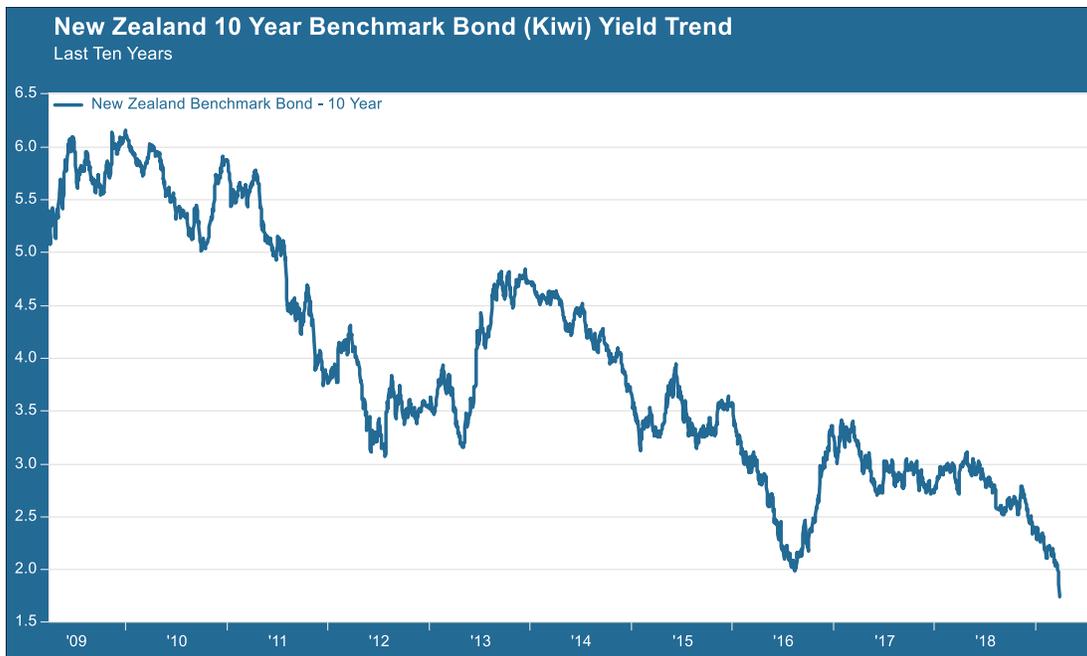
It's quite a world, this one we inhabit. Today is Brexit Day! Article 50 goes into effect at 11 pm Greenwich Mean Time...except, of course, that it doesn't, because our esteemed and honourable Members of Parliament are still having an existential debate regarding what Brexit is all about (real time update: the debate is over, again, with no agreement, again). The Monty Python sketch about Silly Upper Class Twits comes to mind. But no matter! We have nothing more to say about Brexit other than commiserations for the 48 percent of the citizenry of the Isles who never wanted this farce in the first place. We are here to talk about one of the other surreal features of our present day Planet Earth. Negative interest rates are back, and they are back with a vengeance. Here's a snapshot of the yield trend for the German 10-year Bund, the go-to safe haven asset for the European Union.



Source: MVF Research, FactSet

### What Don't We Know?

The German Bund's fall back into negative rate Wonderland is, of course, just one part of a massive global rally in bonds. Last week we talked about the inversion of the US yield curve and what that may mean for fixed income and equity investors in the weeks and months ahead. Elsewhere in the world the same trend is playing out. Take, for example, New Zealand. The 10-year Kiwi, as the country's government bonds are known, hit record low yields this week. Not "52 week low" or even "five year low" but actual record low. The Kiwi's 10-year journey towards Wonderland (it has not yet gone through the looking glass to negative rates) is shown in the chart below.



Source: MVF Research, FactSet

The sharp rally in Kiwi prices (bond prices move inversely to their yields) has much to do with the effects of a China slowdown on economies in the Asia Pacific Region. It's not the directional trend as much as the speed of this global bond rally that is surprising, however. After all, we have known for many months now that growth in China was slowing and that further potential negative risks lurked in the form of a worsening US-China trade environment. We knew this in September and December of last year, when the Fed pronounced a robust bill of health on the economy enabling future rate hikes. What was it, starting in January this year and snowballing through the first quarter, that caused first the Fed, then the ECB, and then pretty much everyone else to out-dove themselves? What do they know that we don't?

### Data Not There Yet

The right answer to that last question may well be...nothing. After all, the central banks aren't directly responsible for the pace of this bond market rally. Traders are...and by traders we mean, of course, algorithm-driven bots primed to move whatever way the mass consciousness of the digital world seems to be going. Trading by Twitter. It is entirely possible that this rally is already overbought, with bond yields potentially set to return to less gloom-and-doom territory.

After all, the global economy is not in recession and the data still do not suggest it is heading towards one in the coming months. Here in the US we have one month of lousy job numbers and inflation still struggling to maintain a two percent range (the latest Core Personal Consumption Expenditure rate, released today, is 1.8 percent). Q1 GDP is expected to come in below two percent, but weak first quarters are not unusual. Not great, but not too bad. The IMF's latest projection for real global GDP growth for 2019 is 3.5 percent – down from earlier projections but, again, still comfortably north of zero.

### Postmodern Financial Theory

Yes, but what about the inverted yield curve we talked about last week? That hasn't gone away, and it remains the most prescient harbinger of forthcoming recessions, based on past instances. Is there something different about fixed income markets now that possibly makes this indicator less useful than it

once was? Well, yes actually. In no past recession, ever, was there the presence of unconventional monetary policy all around the world. No negative interest rates. These aren't even supposed to exist according to the conventions of modern financial theory. A dollar today is worth more than a dollar tomorrow, and the rate of interest that expresses a future value in present value terms is positive – that's why it is called the discount rate.

But we have negative interest rates today, in many parts of the world, and they have the effect of flattening curves in markets where rates are still positive (like the US). The real (inflation-adjusted) rate of return on a 10-year US Treasury note may be barely positive (as is the case today) but it is still a whole lot more attractive than actually paying the German government for the “privilege” of holding its 10-year debt in your portfolio. This is not normal – and it may well suggest that we should not be reading too many recessionary warnings into these tea leaves.

What to do, then? Well, this is Wonderland. Whatever emergent properties bubble out of the current soup of variables at play could go one way, and they could go the other way. Anyone who tells you they know which way that is, well, they probably also have a bridge to sell you. A little caution, without an undue reduction of exposure to growth, is how we have been positioning the portfolios under our discretion. That course of action still seems reasonable to us.

*Masood Vojdani*  
*President & CEO*

*Katrina Lamb, CFA*  
*Head of Investment Strategy & Research*

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