Bond, Income & Defensive Strategies

Newsletter

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When zero is too tight

A GREAT deal of traditional and non-traditional stimulus has been thrown at COVID-19 since the gravity of the pandemic became clear.

Even the more reluctant central banks – concerned with preserving what little policy space they had – quickly capitulated and delivered as much as they felt they could.

At the same time, far greater fiscal firepower has been unleashed globally than was seen during the GFC. Even long-end yields are now at severely depressed levels across the world's major economic regions, and there is an uncomfortable asymmetry that greets bond bulls like us.

Naturally, there is a need to search for yield elsewhere. For most composite-style fixed income managers it is tempting to revert back to their previous modus operandi of going overweight (to massively overweight) credit, coupled with short duration.

While we agree with the move into credit – with some fairly important caveats – the move out of duration may be dangerous. This is especially the case if approached with dogma and inflexibility, where the only reason is that yields are very low.

At times over the last few months, we've taken tactical yield curve steepener positions to protect our portfolios from adverse price moves in bonds. At low yields it's reasonable to expect more volatility in bonds – and to be armed with a framework and tools to allow flexibility so some volatility can be reduced in your portfolio.

However, to structurally and meaningfully position for a sustained rise in yields or steeper curves, it is premature at this stage of the crisis in our opinion – even if equity market lows have been reached for now.

History warns of steepening

Regular readers will be familiar with our team's quantitative but intuitive framework of analysis. There are certain relationships between economic data and market pricing that have stood the test of time through various economic regimes. Some of the most enduring of those relationships seem to indicate that yield curves are about to steepen big time (Figure 1).

Figure 1: Hitting the slopes

Chart 1: US PMI & US Curve

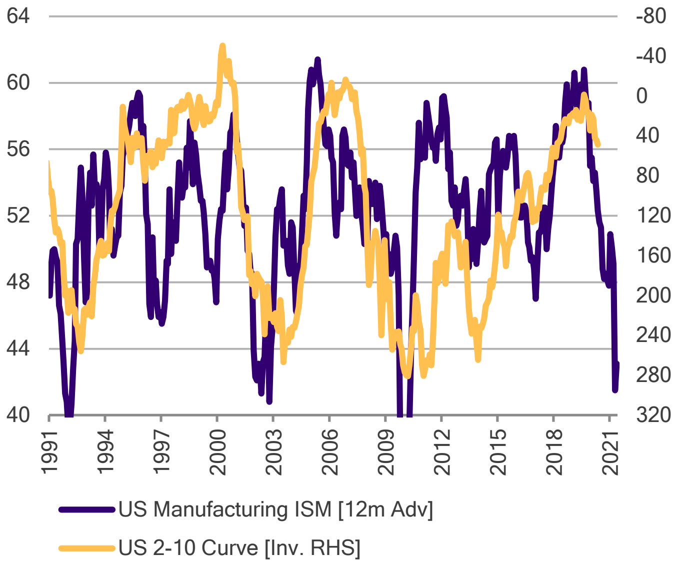
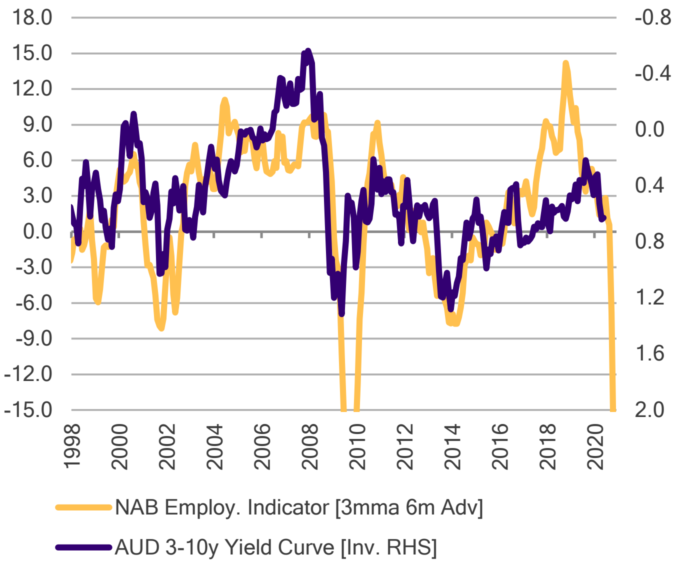


Chart 2: NAB Employment & AU Curve



Source: Bloomberg

We refer to PMIs and NAB indicators as "soft" data because they are collected from surveys and compiled into diffusion indices. The survey nature of this data, coupled with the sequential momentum they indicate for the economy, usually gives us early glimpses as to how the economy is going.

The intuitive interpretation of these relationships is that once the economy has slowed sufficiently, usually some kind of policy stimulus then takes place to steady the ship. The flattening of the yield curve eventually gives way to steepening as markets look towards recovery prospects for the economy.

However, it's not obvious from the above that these models are agnostic to zero or negative policy rates. Unlike the current central bank fixation with the idea of effective lower bounds and the need to keep policy rates in positive territory, the above relationships do not assume or impose any floor on how low rates can go.

The forewarned steepening assumes policy rates can move lower, and perhaps should have moved a lot lower by now. It is therefore quite backwards to argue that policy makers' aversion to negative interest rate policy (NIRP) ought then to mean that long-end yields need to rise. Quite the contrary. Too tight a policy setting at the front end will most likely constrain – if not prevent – the kind of momentum of economic recovery required to generate the reflation and growth. These are key conditions necessary to push long-end yields sustainably higher.

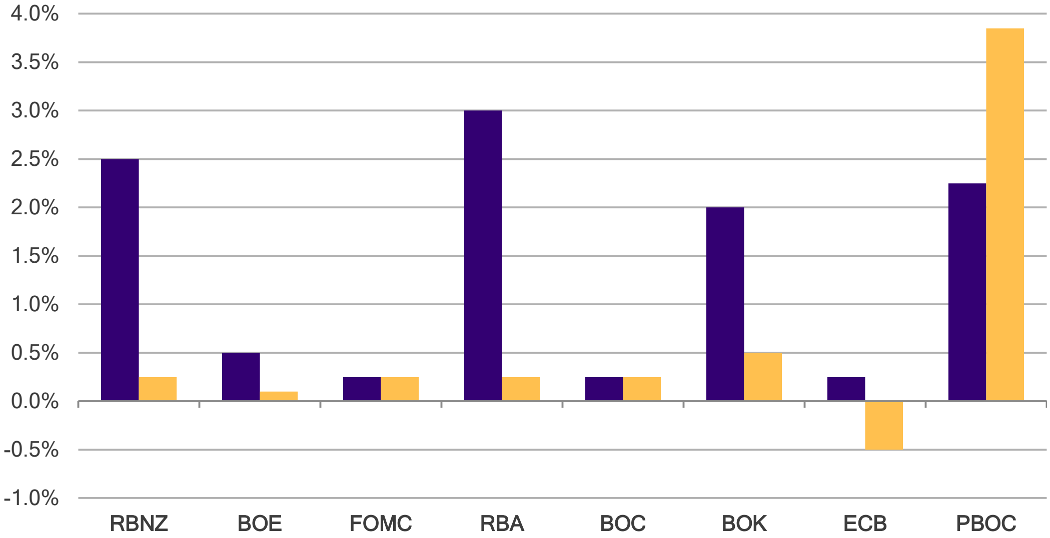
ZIRP is still too tight

Compared to prior crises, policy rates are now lower in most countries than they have ever been. It is not just the level of interest rate, but the extent to which borrowing costs have been slashed that matters for the amount of stimulus the economy receives.

With the exception of China, global policy interest rates are either on par with or through the lows visited in the GFC period (Figure 2). China's case has more to do with the re-referencing of the policy rate – although the willingness to slash rates there has been much less this time versus a decade ago.

Figure 2: Old lows revisited, new lows found

Chart 3: Lows in policy interest rates*, GFC and COVID-19 periods



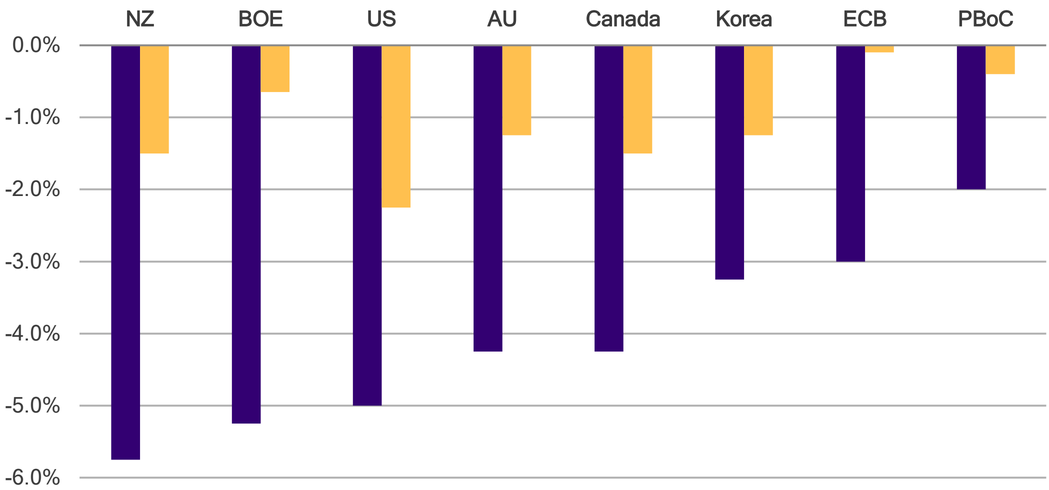
■ GFC
■ COVID-19

Source: Bloomberg, Pendal

Due to an inability to lift off concertedly from previous rounds of rate cuts in most of these jurisdictions, the magnitude of rate cuts from authorities have been far smaller when compared to the GFC response (Figure 3).

Figure 3: Pushed to the edge

Chart 4: Nominal rate declines, GFC and COVID-19 periods



■ GFC
■ COVID-19

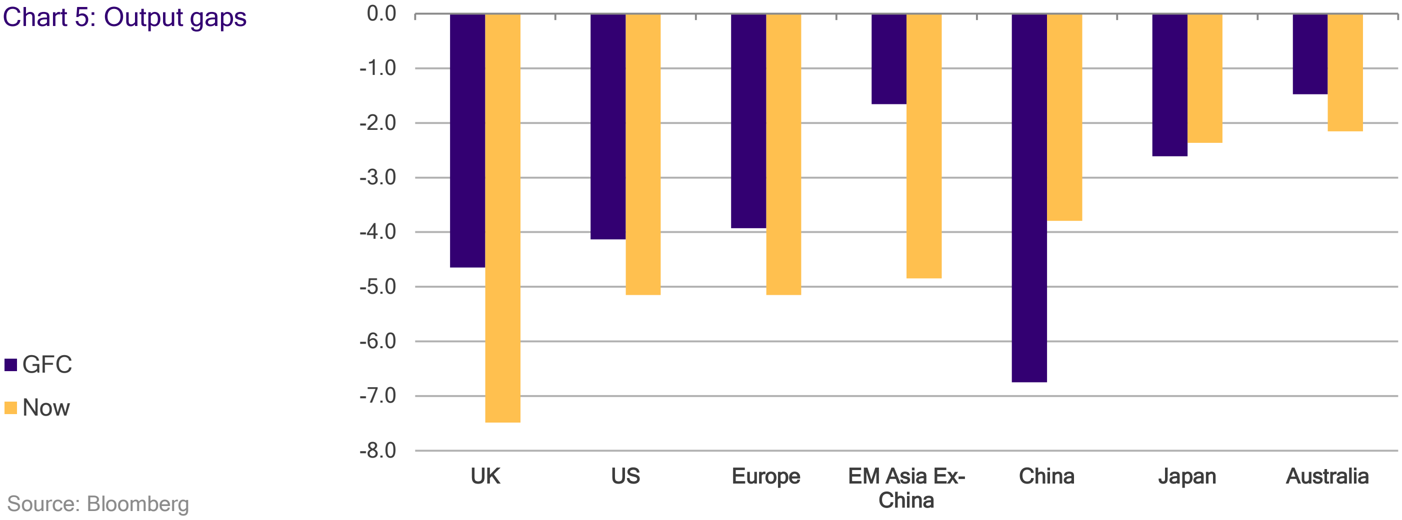
Source: Bloomberg, Pendal

*Policy interest rates refer to main policy rate or benchmark short-term money market rate; In China the policy rate during GFC was the benchmark deposit rate, and is now the 1 year Loan Prime Rate

While the GFC posed a sizeable shock to the economy, demand was able to recover once the financial system had regained a stable footing. The COVID crisis is about "Main Street". The types of monetary stimulus so far have largely supported a rebound in asset prices ("Wall Street"), and only indirectly supported demand through wealth and sentiment channels. The hit to demand has resulted in significant output gaps across most major regions when compared with the GFC period (Figure 4).

Figure 4: Zero doesn't mean "loose"

Chart 5: Output gaps



Source: Bloomberg

Partly because the perceived lower bound was reached on traditional monetary policy, other tools have also been unleashed since the start of this crisis. For some central banks these tools have not been previously employed. Keeping liquidity flush in the banking system and establishing lending or bond-buying programs all help. But none of these measures is as powerful a monetary stimulant as a direct reduction in the cost of funding.

The ubiquity of funds help to stabilise the financial system in times of crisis, but a reduction in the cost of those funds may be key in sustaining the recovery of the economy. If the magnitude of rate cuts matter rather than the level of interest rates – and considering the average rate-cutting cycle in the US amounts to over 400 basis points – only about half of that has been delivered so far. Even with the Fed's reassurance that rates won't lift off anytime soon, it still leaves the policy setting too tight for today's economic conditions. This will not only lead to a shallower recovery path to pre-COVID levels of activity. It also threatens to altogether derail the path of future growth from its lacklustre starting point.

The Japan argument

The arguments against negative interest rates are well known. Zero is not a random line in the sand. It represents a profitability hurdle for banking systems funded by deposits. For a world already laden with debt – where the credit intensity of growth rises structurally and falls only rarely and temporarily – any slowdown in lending is likely to cause a larger-than-proportional drag on the recovery out of the COVID crash.

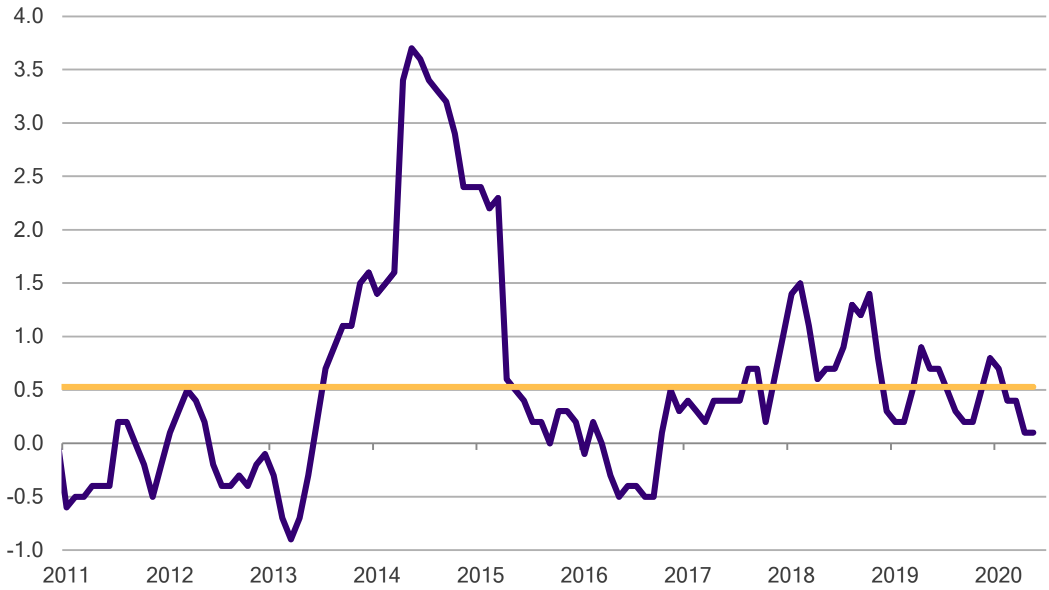
However, the slowdown in credit growth in recent years – and across most of Asia Pacific – isn't so much because of banks' reluctance to lend. It is rather from the lack of private sector demand for credit to spend and invest. Opponents of very low interest rates usually point to the Japan example – and more recently also Europe – citing a lack of sustained demand growth in spite of record low (negative) policy rates.

The Japan argument bears exploring in more detail. Unfortunately, the counterfactual is not available to us, but it is overly simplistic to argue that low or negative interest rates don't help, or in fact harm growth and inflation prospects. We need to also look at how Japan's non-conventional monetary policy has interacted with other policy tools over the years.

To begin with, Japan's demographic trends pose a significant growth headwind. The population is shrinking at a rate of 0.2% per annum. Unlike Australia (and for reasons outside the scope of this newsletter) Japan is far less willing to open its borders to help address its population problem. Against this adverse backdrop it is no small feat that Japan has achieved an average inflation rate – even in positive territory – over the past decade (Figure 5).

Figure 5: It could have been (a lot) worse

Chart 6: Japan CPI YoY %, 10 year average



Headline

10Y Average

Source: Bloomberg

The times when Japan has been able to drive inflation above the average line have usually seen a coordinated effort between monetary and fiscal policy. This willingness to embrace not only unconventional monetary policy but also sizeable fiscal stimulus only came after nearly a decade of fighting strong deflationary forces. By this time structural deflationary or disinflationary expectations had set in.

The times when Japanese growth and inflation teetered on or fell below the average line are largely tied to Japan's penchant for removing the (fiscal) punch bowl. As the charts below show in Figure 6, Japan has tried time and again since the early 2000s to reduce its budget deficit. The first attempt had to be halted and reversed due to the GFC, and it remains to be seen whether the most recent deficit expansion will be unwound as aggressively.

When the fiscal tightening takes the form of VAT hikes, consumer spending is guaranteed to take a hit every time. The key learning from Japan's experience is not that pursuing negative interest rates and other bold forms of monetary policy was a mistake. It is that those bold moves were not made soon enough – and have been undermined by a lack of consistent coordination from fiscal policy.

When understood in this context, it is easy to identify the heart of Europe's problem, where a lack of fiscal union prevents the type of cooperative fiscal action that can support Europe's current monetary policy setting.

Figure 6: The choke of fiscal discipline

Chart 7: Japanese budget balance

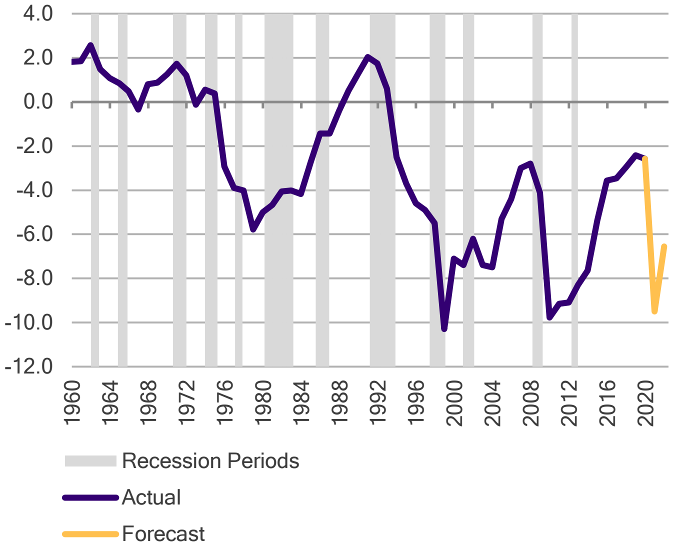
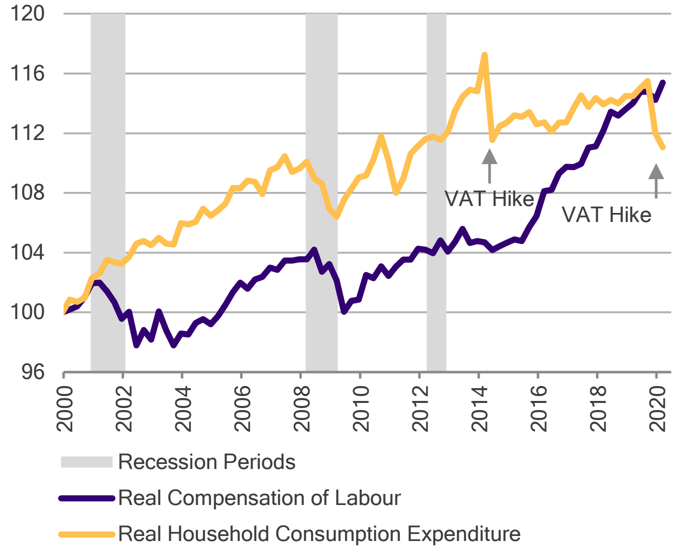


Chart 8: VAT hikes and real consumption



Source: Bloomberg

Is China out of ammo?

The People's Bank of China (PBoC) has set itself apart from other major central banks by remaining reluctant to unleash as much stimulus as the GFC period or even the slowdown of 2015-16. Some attribute China's reluctance to the economy's impressive bounce-back from the depths of COVID-related lockdowns in March. The latest PMIs point to not only the recent gains being kept, but the right-hand side of the V-shaped recovery continuing to retain positive momentum (Figure 7). Certainly against the backdrop of such improvement, there is an excuse at the headline level for the PBoC to lift its foot off the accelerator a little.

Figure 7: V – for victory?

Chart 9: China PMI vs retail sales YoY(%)

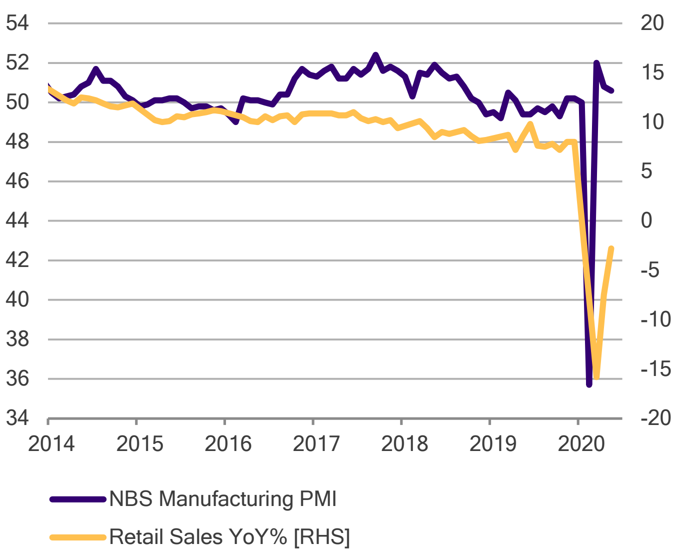


Chart 10: Pendal China household demand indicator

Source: Bloomberg, Pendal

As the charts in Figure 7 show, there is still a sizeable gap between the recovery in PMIs and that in consumer demand. This echoes much of the recovery seen to date across Asia. Due to the construction of diffusion indices such as PMIs – and their reflection of sequential, rather than year-over-year trends – a big downside shock is more likely to lead to a V-shaped recovery in these indicators. Moreover, the latest PMIs reflect a return of *production* capacity close to pre-COVID levels.

This is not necessarily a sign that end-demand has enjoyed the same extent of recovery. Far from it, if the depressed level of the liquidity preference gauge is anything to go by (chart 10 above). Add to this the employment component of China's services PMI, which despite its remarkable bounce in recent months, remains in contractionary territory.

For large parts of northern Asia including China, the peculiar circumstances surrounding the pandemic – which has caused a surge in demand for electronics and technological equipment – has cushioned steep falls in demand across a range of other products and services. Eventually the extra demand for equipment will find a saturation point. Unless there can be an offsetting growth in demand for other goods and services, we will likely see a second, albeit shallower, dip in activity. The early indicator in Korea's exports (Figure 8) foretell a strong demand drag that will be a challenge in coming months. Similarly, a significant gap remains between Chinese demand and the demand it sees from the rest of the world. Monetary policy settings cannot afford to stay tight indefinitely in the face of these headwinds.

Figure 8: Who's gonna buy our stuff?

Chart 11: Korean exports (YoY %)

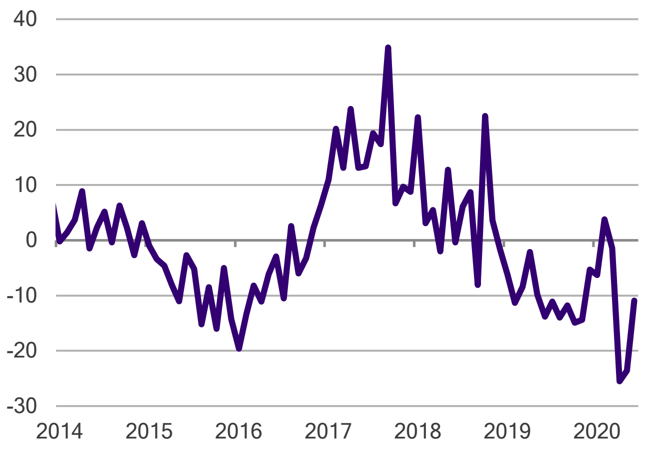
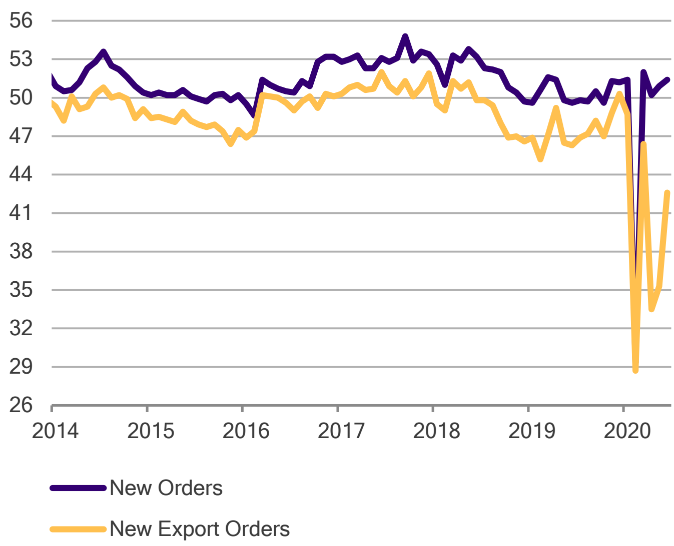


Chart 12: China New orders v new export orders



Source: Bloomberg

But equities say "it's all okay"!

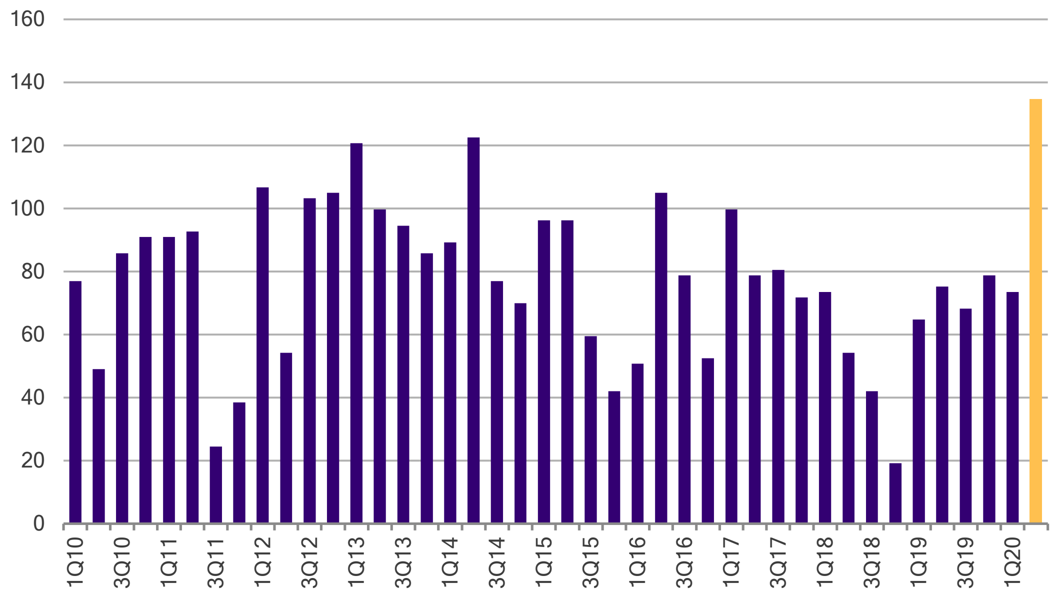
To put the equity market rally into perspective, the second quarter of 2020 has seen the strongest performance in the major US stock indices in two decades. Considering the depths to which these indices plummeted in the first quarter of the year, the key drivers of this performance are well understood.

The first was the announcement of major policy and liquidity stimulus from the world's major central banks. In addition to the measures delivered in the GFC, the Fed went on to pursue corporate bond buying programs, involving bond ETFs and allowing for non-investment grade rated debt to be included.

Once this circuit breaker was in place the market no longer carried the same degree of fear for an extension of the left tail. However, if the main purpose of such Fed actions was to address the functioning of markets (and funding markets in particular) much of that functioning has been dealt with. One only needs to look as far as the record issuance volumes for US junk-rated debt coupled with close to record lows on US investment grade bond yields. When concerns of income and wealth gaps are bound to grow rather than recede, the Fed may meet with a higher hurdle to keep the (equity markets) party going with more stimulus of this kind. This leads us to think the first major pillar of support for risk assets has run its course for now.

Figure 9: What funding stress?

Chart 13: Quarterly US HY bond issuance volume



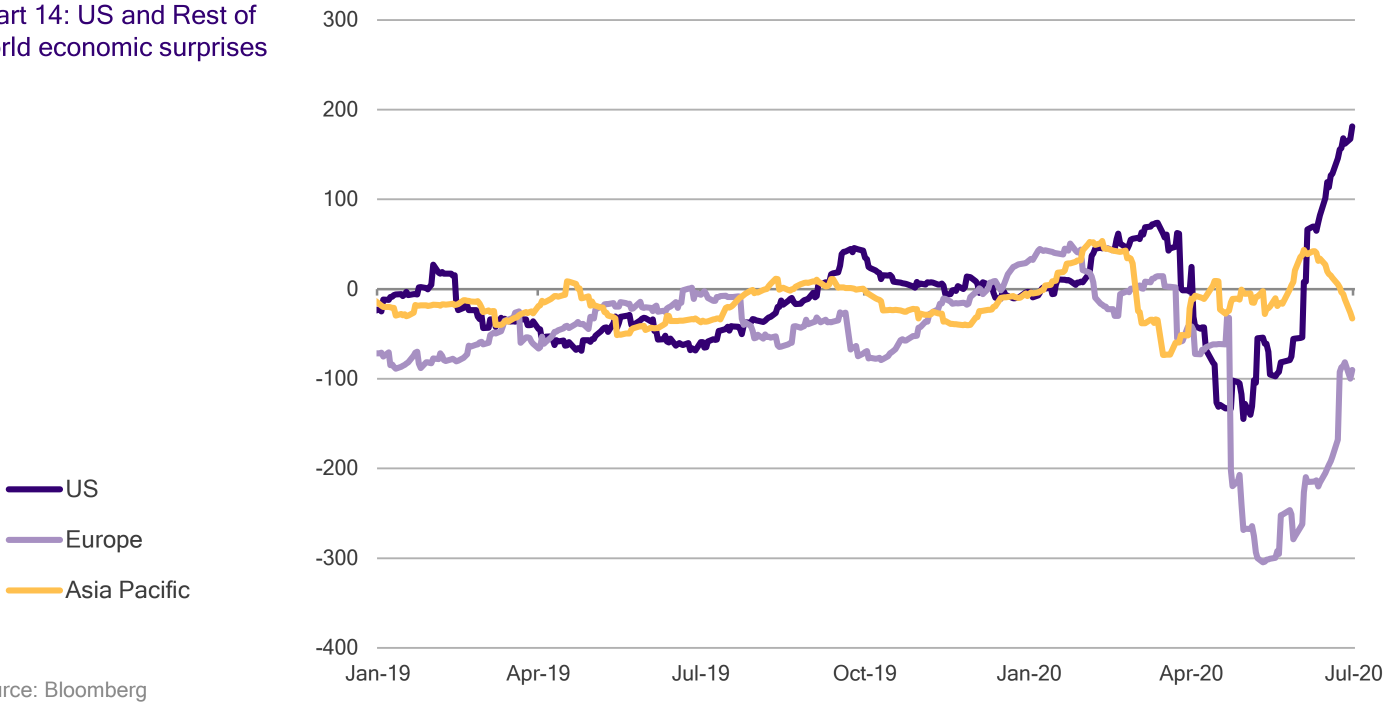
Source: J.P. Morgan

The other major support pillars for equity markets may also be coming into some issues. The flattening of the global COVID-19 curve and the re-opening of economic activity allowed the “shutdown” sectors of the stock market to lead a period of strength. But recent incidents of virus resurgence have highlighted the pitfalls of re-opening those sectors. Even if subsequent waves of virus outbreak are managed with less drastic measures, a higher degree of caution in human behaviour will slow spending and economic activity overall.

Strong recent economic data has helped fuel upside momentum in stocks. The degree of positive surprises have supported market sentiment. However, given the fall in data to Great Depression levels at the depth of the COVID crisis, positive surprises in the subsequent periods are relatively easy to come by. Moreover, surprises in their very nature have a tendency to fade. It is difficult to keep the surprise momentum going in either direction. The US has been responsible for most of the positive surprise in recent macro data. The pattern of COVID-19’s resurgence across the US suggest this pillar of support is also on its last legs.

Figure 10: Surprises to fade

Chart 14: US and Rest of World economic surprises

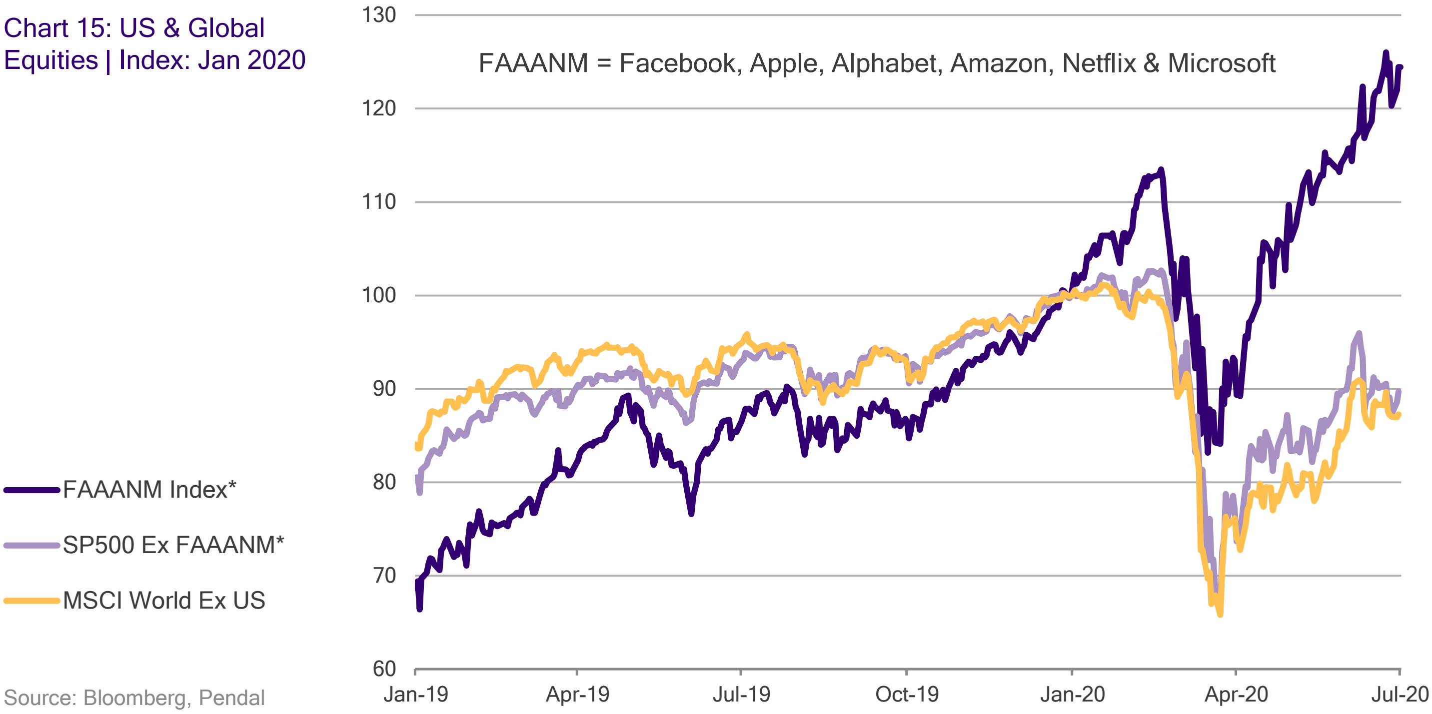


Source: Bloomberg

Far be it for a fixed interest manager to wax lyrical about equity markets, but the aggregates of indices do not tell the whole story for equities at the moment. Despite global deployment of stimulus, only US equities have led the charge (as Figure 11 shows). Taking the usual tech culprits out of the S&P 500, the remainder of the index does not seem to scream “it’s all okay!”.

Figure 11: What lies beneath

Chart 15: US & Global Equities | Index: Jan 2020



Source: Bloomberg, Pendal

Not out of the woods

For now, there is unequivocal agreement across the committee that negative rates should be avoided in the US. The risks of being the first of the non-NIRPers to venture into negative rate territory are perceived to be too high. Even the Bank of England, which seemed to debate the merits of NIRP almost as a way of paving the path, failed to venture quite so far when it came to the crunch earlier this month.

Conversely, the shadow risks of engaging in large bond-buying programs appear diminished in the eyes of these same central bankers, compared to the GFC period. As discussed above, the bar for even more of this kind of stimulus may be higher now, judging by the recovery in credit markets. But it's difficult to see that support being withdrawn in any hurry.

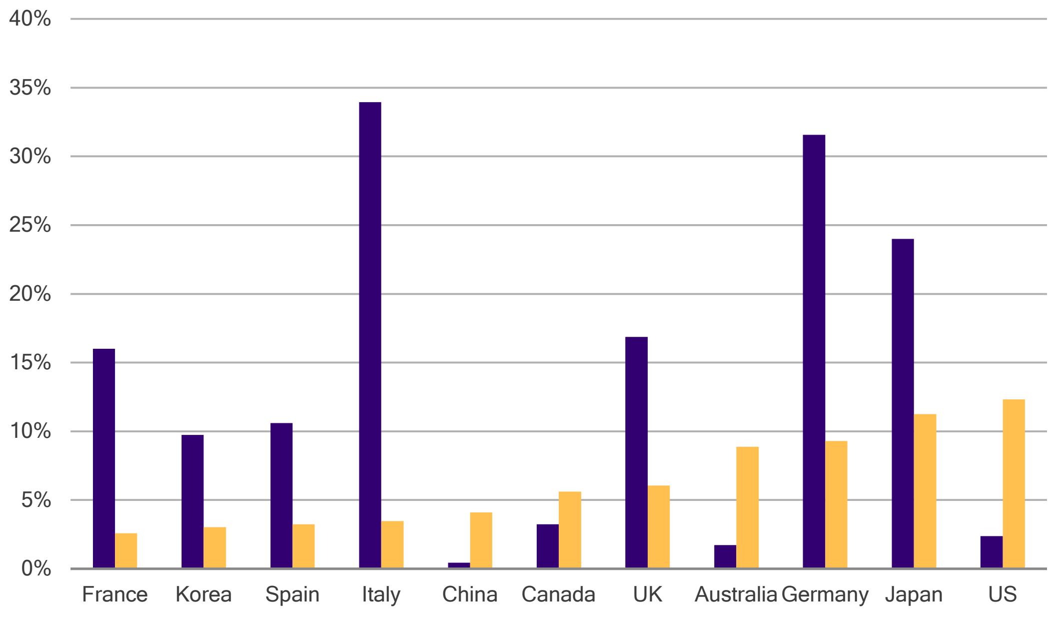
Despite recent positive momentum in data and markets, obvious risks still lie ahead. In the US 30 million people are receiving unemployment benefits. During the COVID-19 stresses, the CARES Act supplemented a $400 weekly benefit by an extra $600 weekly payment. This bonus comes to an end by July 31. Perversely, it can be argued this $600 bonus is keeping the unemployment rate from falling more quickly. For many households the economics are more favourable than returning to work. Nevertheless, the sudden disappearance of this bonus, without the offset of rapid job creation or more fiscal support, will likely exacerbate existing burdens in these households.

Other risks for the Fed to consider relate to the November elections and re-escalating tensions with China. The uncertainty of the former may be fleeting in nature. Markets generally do not price in a structurally higher risk premium for political risk in the absence of any obvious or imminent macro fallout. But the risk with Sino-US tensions carry clearer potential economic costs, especially if tariffs are hiked in the run-up to the elections.

While COVID, elections and geopolitical risks are of immediate concern, the more significant looming threat is the potential withdrawal of fiscal stimulus. As Figure 12 highlights, there has been an unprecedented amount of stimulus thrown at this crisis worldwide.

Figure 12: Giving it some welly

Chart 16: Fiscal and pseudo-fiscal rescue support (pctg of national GDP)



Source: IMF, Minack Advisors

In our earlier Japan example we highlighted the government's obsession with fiscal discipline as one of the key headwinds for the past decade. A strong desire to create a path back to budget balance may ultimately push reluctant central banks such as the Fed into areas of monetary policy that they are currently too uncomfortable with.

Where next for the Fed?

Until then, we expect to see bells and whistles added to the Fed's monetary policy armoury. This includes the possible use of yield curve control (YCC). This tool has been employed by the Bank of Japan for a number of years. The purpose is to add to the traditional policy tool of keeping short-term funding conditions easy through low (or negative) policy rates, by lowering and flattening the term structure of borrowing costs. While a headache for banking sector profitability, such a tool provides stability and predictability for longer-term funding. This could affect a business's decision to invest for the future.

We don't believe this type of YCC is likely to be rolled out in the US any time soon. Through its various corporate bond-buying and lending programs, the Fed has already significantly lowered the cost of term funding for corporates. Instead, the Fed may look to strengthen its forward guidance for interest rates through controlling the shorter end of the yield curve – similar to moves by the RBA. This method of capping how high yields can drift in the front end of the curve can complement a shift towards an average inflation targeting framework. Such a framework would mark a break from the status quo, and allow for a potentially prolonged period of inflation outcomes above 2 per cent to make up for the time that inflation has fallen significantly short of this target. This outcomes-based approach to forward guidance may be the direction that Federal Open Market Committee discussions have been leaning towards.

Of course, the door is always open for "more" should it be needed further down the line. But the absence of YCC right now at the longer end of the yield curve should not alone provide the green light for longer-dated bonds to sell off. The steepening of yield curves forewarned by traditional models signal a need for lower yields at the front end of curves, rather than optimism about the future that warrant a more sustained bond bear trend.

As long as policy remains sticky and bounded by an aversion to below zero, the harder it becomes for any yield rises to be sustained further out along the curve. It is easy to be sucked in to the momentum of the recovery after a steep fall, but let's not forget this focus on momentum is now centred around a much lower mean. In a post-crisis regime, levels ought to matter as well as momentum.

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