Fixed Income Insights

Bond Avengers: QE Infinity War

In the second quarter, Avengers: Infinity War became the fastest film to gross a billion dollars. This movie united over two dozen characters, many of whom have been the protagonist in their own right in other films.

Interestingly, we see parallels between the Marvel universe and the state of the fixed income market. It is not just that the current incarnation of Marvel films began in 2008, at the same time as the current extraordinary monetary policy regime, nor that the first comics appeared in the early 1960s near the time of the Federal Reserve's (Fed's) original Operation Twist. The phenomenon that market themes can quickly transition from a contributing factor to a market driver, and just as quickly from a dominant influencer to background noise, resembles the recent Marvel story lines.

Since the start of 2018, the ephemeral prominence of Italian politics, an equity market correction and Chinese demand for Treasuries have played a role in fixed income market dynamics, each at some point a primary market driver before fading to become just one factor in a much broader cast. If the fixed income market were a movie franchise, the narrative arc connecting long disparate points in time would be economic growth and inflation, but as in the Marvel universe, at any given point in time, a new topic or lead character can emerge as the lead topic of focus. In this paper, we seek to examine some of the current featured players and see how they tie to the long narrative of fixed income markets.

An inverted curve—activating the infinity gauntlet?

With the yield curve reaching its flattest level in a decade, many questions have arisen about the implication of potential inversion of the yield curve. Concerns around inversion have been amplified by expectations of further tightening of monetary policy. Given the reputation of yield curve inversions as predictors of recessions, fears of such an event are understandable. But is yield curve inversion a portent of imminent economic doom?

U.S. Income

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In examining the history of recent yield curve inversions, there have been five distinct periods of inversion since 1990 (this includes the single day of inversion in 1999, but counts broad periods of inversion that included interludes of positive sloping curves as a single instance). Some of these periods were rather extended, with the curve inverted from February 2000 into the start of 2001 and from the end of 2005 until the middle of 2007. As several of these periods were prolonged, approximately 7% of trading days since 1990 closed with the curve inverted; while not common, this also means inversion isn't as rare as some might believe.

Recent yield curve inversions

Period of inversion	Days, start to finish	Recession
March 1990	21	July 1990 – March 1991
March 1998 – July 1998	126	
February 1999	1	
February 2000 – December 2000	334	March 2001 – November 2001
December 2005 – June 2007	525	December 2007 – June 2009

Sources: Bloomberg, BMO Fixed Income

Notably, when reviewing these dates, neither the 1998 nor the brief 1999 inversion led directly to recession (each being followed by at least one subsequent inversion before a recession began.) For those inversions that did directly precede a recession, there was a lag of three to six months from the end of inversion to the start of recession (though technical recessions are only known in retrospect). Interestingly, from the start of inversion, the period to recession is less defined, ranging from three months to two years. So it may be tempting to look to the end of inversion as a signal for the economy and markets, however, practically, this is less helpful because we do not know the end date except in retrospect.

Returns in recent yield curve inversions

	12-month returns from start of inversion		
Period of inversion	Agg returns (%)[1]	IG credit returns (%)[2]	IG credit excess return[2]
March 1990	11.93	10.93	Not available
March 1998 – July 1998	6.42	6.18	Not available
February 1999	1.09	0.17	+7 basis points
February 2000 – December 2000	13.00	11.97	-211 basis points
December 2005 – June 2007	4.27	4.20	+110 basis points

Sources: Bloomberg Barclays, BMO Fixed Income
[1] Agg is the Bloomberg Barclays U.S. Aggregate Index.
[2] IG Credit is the Bloomberg Barclays U.S. Credit Index.

Looking at the recent history, the data would suggest that the moment of yield curve inversion is an ambiguous signal about market direction. Far from the common perceptions of the imminence of trouble from inverted curves, this data suggests that near-term market reactions have been relatively benign for fixed income.

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Further, there are factors to suggest a yield curve inversion today could be more driven by mechanical factors of demand than fears of fading growth and inflation. Ranging from strong foreign demand for U.S. fixed income to structural demand from increasing liability-driven investing and passive investing to the shrinking, but still robust, Fed balance sheet, there are arguments to be made that the implications of inversion today are different than the past.

While there is technical merit to these arguments, they become moot if people believe yield curve inversion matters. If people believe inversion causes recession, an inverted curve can become a self-fulfilling prophesy whereby people slow business investment and hiring out of anticipation and bring about a slowdown or recession. Curve inversion though remains one factor among many to be considered in projecting market outcomes.

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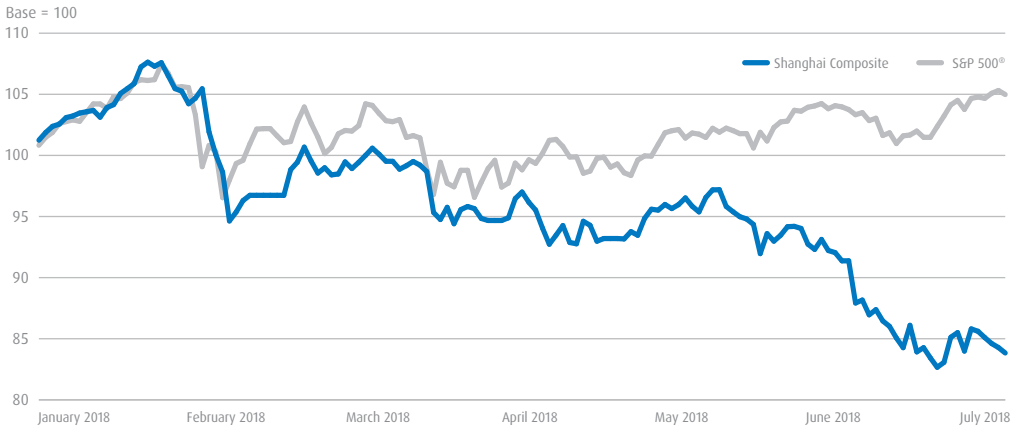
Power stone: How much power does China wield?

One of the other characters worth addressing is foreign demand for U.S. assets, which is particularly relevant against the backdrop of increased protectionist rhetoric and related tensions. Among the largest current holders is China, which most notably owns over $1 trillion in U.S. Treasuries. Given the ongoing tariff negotiations and fears of a trade war, does China constitute a threat to U.S. Treasury yields?

If equities are a gauge, the U.S. holds more leverage in the tariff dispute with China



Source: Bloomberg, BMO Fixed Income

There was brief noise to this effect in the first quarter as China suggested, possibly as leverage in the tariff negotiations, that it might curtail the purchase of Treasuries. Yields rose on the news, though this was against a backdrop of a jittery market. Nonetheless, one nightmare scenario for rates has been suggested as China dumping Treasuries to show its financial muscle and make a political point.

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While we cannot dismiss this possibility, we see it as extremely unlikely. John Maynard Keynes once commented that "if you owe your bank a hundred pounds, you have a problem. But if you owe a million, it has." If this observation is right, China has a problem. Selling off their Treasuries would result in a massive loss and further, given the nature of their economic reliance on developed world importation of goods and the developed market's reliance on the stability of the U.S. financial markets, we view this as an unlikely threat from China. Further, given the broader global reliance on Treasuries, other large players, including central banks, could step in to moderate the volatility.

China, or other sovereign buyers, stepping back from purchases could impact Treasury rates in cases when they represent the marginal buyer, but otherwise it would remain among a myriad of factors to consider. Ironically then, these buyers could potentially do more damage, rather than by selling Treasuries, if they unexpectedly and significantly increased purchases of Treasuries and triggered an inverted curve, prompting the fears associated with inversion.

Reality stone: Does Treasury supply matter?

Earlier this year, Congress passed a budget, which was projected to expand spending by $300 billion over the two-year deal. This increase in expenditures came shortly after tax reform passed last year. While the stimulative effects of tax reform could increase government revenue somewhat, this combination nonetheless suggests larger deficits and therefore more issuance of Treasuries. Indeed, through the end of June, the Treasury had already issued $480 billion in net new Treasuries after net issuance of $537 billion in all of 2017. Despite record tax collections in April, in July, the Treasury raised its estimate of borrowing for the year to $1.33 trillion.

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At its most basic levels, markets being the balancing of supply and demand, this should suggest upward pressure on rates. However, in examining the five years when the Treasury issued over a trillion of net new debt (2008 – 2012), it is somewhat counterintuitive to observe that in all of these years save 2009, interest rates actually declined (2018 is on pace to be the second). Is it that issuance is positive for rates? That seems unlikely, but rather to current markets, issuance is one among many characters in this narrative as opposed to the lead.

Nor is the debt issue new to the last decade. The famous debt clock in New York, which tallies the national debt in the U.S., goes in and out of favor as a novelty to highlight the country's fiscal woes. However, far from being a recent phenomenon, the clock was actually created in 1989 (an additional digit had to be added in 2008.) Indeed, the issue of fiscal deficits was acute enough in 1984 that President Reagan addressed concerns by quipping, "I am not worried about the deficit. It is big enough to take care of itself." Since 1981, when outstanding U.S. Government debt hit $1 trillion (not adjusted for inflation) for the first time, the U.S. government debt has grown by a factor of 20 (unadjusted) and debt as a percent of GDP has grown from 31% to 104% at the end of 2017. At the same time, Treasury interest rates—the cost to finance that debt—has fallen 80% despite what a 1984 New York Times article described as "a huge budget deficit that helps keep interest rates up."

While many continue to say this increase in debt is unsustainable, markets are yet to be especially concerned. Debt-to-GDP is likely to be a 'tipping point' type discussion, where markets do not care about debt levels until they suddenly care very much. It is unlikely to be predictable what that magic number is, broadly speaking, but it seems highly likely that whatever the ratio is globally, the U.S. dollar's status as reserve currency and Treasuries as the premier flight-to-quality asset make the ratio somewhat higher for the U.S. So, while supply must matter in an economic sense, it has yet to be more than an issue on the margin. Treasury bonds, much like Marvel movies, will continue to be produced as long as people keep buying them.

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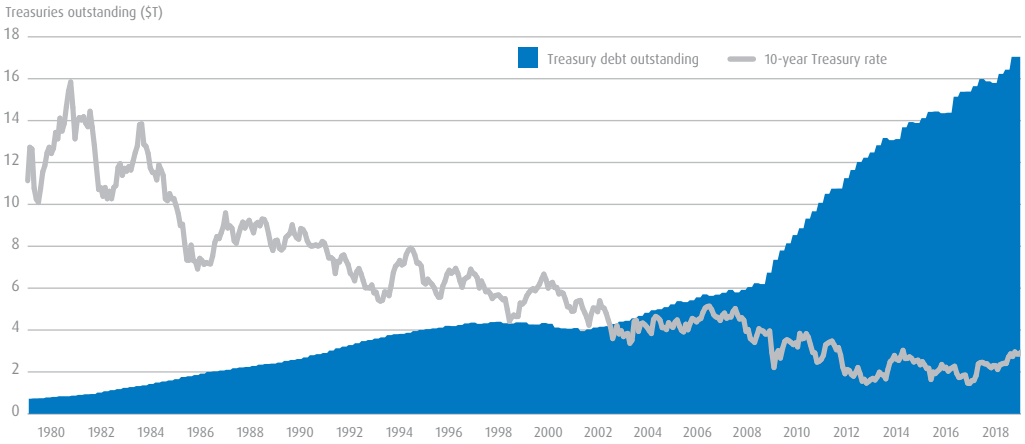
Treasuries outstanding vs. funding cost (10 year)



Source: SIFMA, Bloomberg, BMO Fixed Income

Mind stone: The self-correcting nature of rates

That "flight-to-quality" element was seen in 2018 as the march higher of rates was interrupted in both the first and second quarters by market volatility, which prompted a greater bid for risk-off assets and brought rates back down. Interestingly, what prompted that volatility was at least in part the increase in rates themselves. This introduces another factor into the discussions on what has capped rates, particularly the long-end, from rising. Rates have a self-correcting aspect to them.

This is true both on a market level and on an economic fundamental level. As rates decline, it serves as stimulus as borrowers can more cheaply borrow and then invest, leading to economic growth, which should push rates higher. As rates are pushed higher, the cost of capital increases, forcing businesses to cut back on investment, which slows growth and thus pulls rates lower. The lower rates are stimulative and cycle continues.

This is, generally speaking, true for economies with regard to their domestic rates. It is even more dramatic for U.S. Treasuries given the degree to which international assets price relative to U.S. Treasury yields and the role that Treasuries play as the premier risk-off asset globally.

This is not to suggest that rates cannot rise or that an absolute ceiling on rates exists in the range we have seen in 2018, but rather that rates moving higher kick off ancillary effects beyond the first order impact to bond prices. Indeed, the second order effects of impact to equity markets, emerging market debt or even the relative attractiveness of other fixed income sectors may be greater than the first order effect. Thus the most likely path for an increase in rates from here, absent the kinds of shocks previously discussed, is a gradual one that does not provoke a meaningful counter-reaction and reversal.

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Spoiler alert: Conclusions

As a movie franchise expands or markets mature, there will be an increasing cast of characters to keep track of, sub-plots to follow, and twist and turns along the way. Over the long-term, certain characters will emerge as the long-run heroes, though they will not be the stars of each film. For fixed income, growth and inflation are those long-term protagonists, but they are often overshadowed short-term by more transient concerns. Indeed, the main focus of fixed income markets fluctuates over time, sometimes bringing to prominence issues that had previously been ignored only to relegate them to obscurity shortly thereafter. Importantly, amidst all the other factors to consider, today's environment is one where underlying economic data, through the lens of corporate earnings, job market strength and broader economic growth, remains quite healthy.

We expect the factors we discussed to continue to attract attention, while simultaneously recognizing these could easily be supplanted by the next topic du jour. Given the unpredictability of the market's short-term focus, this furthers our long-held view of the difficulty of attempting to time interest rates. Even the most astute macroeconomic prognostication can easily underappreciate a seemingly obscure variable that becomes the most relevant topic for a period. And the converse is a risk as well, focusing too heavily on only sporadically relevant minutiae can lead to missing the forest for the trees.

While it may be difficult at any moment to project which characters rise as the next leading roles, we suggest reading the old comics to better venture a guess as to the outcome. Market history offers guidance for how various themes and concerns may develop; though ironically, often this history is at odds with the common perception of it.

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