CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

May 17, 2015

A Return to Normal?

How much does a ten-year bond pay one who buys it when it yields 0.05%, as the German bund did last month?

Assume that one invests €100,000 in such a bond. The interest one receives is €50 per year, or a whopping total of €500 over the ten years.

Those who bought the bund at yields like those presumably expected that the bund's price would keep rising (and its yield keep falling). The expectation was that the bund would soon be trading with a negative yield, because of the ECB's buying.

And that may still happen.

By

Jack Mayberry

The past several weeks have witnessed remarkably swift reversals in government bond markets, most notably in German government bonds, the *bund*. All bonds, including US treasuries, have been touched. To quantify the changes in prices and yields, note that at the time of the last *Core Comments* of April 19, 2015, the bund had risen in price to such a degree that its yield, which moves inversely to price, had touched 0.05%. This is, of course, an astonishingly low yield, never before seen. Since then, the bund's price has fallen and its yield recently touched 0.80%. This is still an extremely low yield, but it represents an exceptionally fast change in price and yield, especially since it appeared in April that the bund's yield would turn negative, a situation that obtained last month with Swiss government bonds, among others.

The ten-year US treasury yielded about 1.80% at the time the bund changed hands at 0.05%. In the intervening weeks, its price has also fallen and its yield moved up, but less remarkably, to around 2.37%. (As of this writing, the bund yields 0.62% and the treasury 2.14%.) The historically low yields and high prices for these and almost all bonds have arisen in the aftermath of the financial crisis and great recession. Economic growth has been far lower that in typical recoveries and economic expansions, for the many reasons discussed in these letters over the years: Major central banks, the Federal Reserve Board, the European Central Bank (the ECB), the Bank of England and the Bank of Japan, have engaged in a series of hitherto untried monetary policies, notably massive asset purchases (referred to as "quantitative easing"). Governments, especially but not only in Europe, have restricted government spending; these fiscal policies have further depressed economic activity. It is beyond the scope of this letter to explain how these various actions have wrought their changes on economies and bond markets; it must suffice here just to list some factors. The very recent increase in rates may be a sign that fixed-income markets now anticipate the ending of extraordinary monetary policies and the return to more 'normal' levels of economic growth and inflation. At Core, we have doubts about this thesis.

As 2015 began, the ECB was about to commence--at long last--its asset purchase program, by which it is purchasing about €60 billion of bonds of European Union governments each month. The ECB plans to continue these purchases until it has purchased more than €1 trillion of such bonds or until deflation risk has abated. This €60 billion per month is a rate roughly equal to the total issuance of such bonds. Meanwhile, the Fed ended its latest--and probably last--asset purchase program last autumn, after having increased assets on its balance sheet from the pre-crisis level of about $800 billion to $4 trillion in bonds and other securities. US job creation especially but economic growth generally appeared to have reached decent levels in the second half of 2014. The expectation, encouraged by the Fed itself, was that the Fed would begin to raise short-term interest rates, which have been essentially zero in the seven years since the crisis. As the year began, the contrast between still-weak economic growth in Europe and relatively strong US growth, and between the ever-loosening monetary policy of the ECB and the Fed's incipient monetary tightening produced the following effects in bond, currency and stock markets: The dollar rose against most currencies, but especially against the euro. European stock markets rose in anticipation of economic stimulus from the ECB's program, and European bonds rose in price as the ECB bought every bond in sight.

And so things proceeded during the first few months of the year. Core's portfolios were structured to take advantage of these market movements and we enjoyed strong returns. As the first quarter progressed, various economic reports began to show that US growth was slowing during the winter, until finally the March jobs report showed the lowest level of job creation in a year. Meanwhile, similar reports from Europe indicated faster growth there. The settled view of economic weakness in Europe and strength in the US was not being borne out by the facts.

Thereafter came rapid adjustments in currency and bond markets: the euro, having fallen from $1.40 to $1.05 in a year, stopped its seemingly inexorable move toward parity with the dollar, and began to march higher--to $1.14 at present. Yields of the bund, the treasury and other bonds changed as noted. As it happens, stocks have not been much changed. There have been sharp moves of a few days duration, first downward, then upward, but the results have been modest. The S&P 500 made a nominal new high on Friday; European stocks are only a tad lower.

A return to normal? Does the sudden and sharp change in direction in currency and bond markets in recent weeks mark a turning point in the long path to recovery after the financial crisis? Have we finally seen the lowest bond yields in human history? Is this the first step away from the era in which extraordinary monetary policies by the central banks so affected prices of stocks, bonds and other assets? I think not. Firstly, from times long before the financial crisis, Fed policies have driven asset prices. This will not change and the only new thing in recent years is that the Fed employed monetary policy tools it had never before used. (Well done, Mr. Bernanke and Ms. Yellen!) Secondly, the ECB is still in early stages of its massive quantitative easing program. The economic effects in Europe are still unclear; early reports are favorable but not conclusive. It remains likely, in Core's view, that the ECB's asset purchases will push stock and bond prices in Europe higher and its currency lower. Quite independent of the ECB's policies has been the slowdown in US growth in the beginning of this year, a phenomenon we have seen in recent years; another severe winter in the Northeast and the ports strikes in California explain some of the weakness. Thirdly, market dynamics themselves may explain much: There was little doubt, as the year opened and the ECB began its project, that the euro would fall, while the dollar and European stocks and bonds would rise. That did happen…until it didn't. It was what is called a one-direction trade and everyone piled in. In recent weeks, the direction changed. Swiftly.

Core's view is that the recent shift augurs nothing. It is simply one more example of a 'crowded trade' reversing suddenly. Volatility--large price swings--is simply a characteristic of modern financial markets. Let us not accord too much significance to short-term price movements; instead we must assess larger underlying economic movements and the monetary and fiscal policies of the major countries. We consider this to be our assignment. Our conclusion now--always subject to change--is that the shifts in asset prices in the last few weeks mean very little.

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CORE ASSET MANAGEMENT
PO Box 1629
108 Caledonia Street
Sausalito, California 94966
(415) 332-2000 • (800) 451-2240
fax (415) 332-2151
www.coreasset.com
info@coreasset.com