Sparinvest

Monthly comment by
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New records in the fixed income market – again

This introduction is yet another repeat of recent monthly reports: interest rates have reached yet another record low and are moving towards a level that would have been considered impossible not so long ago. In August, German 30-year bonds rates fell significantly and ended at -0.175 percent.

What asset class has delivered the best yield this year? As far as I can see, it is ultra-long bonds from high quality issuers. At the end of August, Austrian 2.1 percent bonds expiring in 2117 delivered a yield of almost 80 percent since the New Year. This is striking, particularly since Austria's AA+ rating is not even the highest. This bond is extremely interest sensitive, with a so-called length of 58. In other words, investors in the bond can expect that if interest rates rise by 1.0 percent the bond's value will fall by 58 percent. At its current price level investors in the bond can look forward to an annual return of 0.6 percent in 98 years – if Austria does not go bankrupt. And this is called "security".

Although this might seem to justify the direction of interest rate developments in recent years, if almost two decades in financial markets has taught me one thing it is that no trend lasts forever. Bubbles often start because of sensible reasons that more and more investors take notice of. The trend then lasts so long that few can imagine that it will ever end. Finally, everybody thinks that IT shares or the housing market will always go up, or that interest rates will always be low or fall further. That is where we are now.

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If we look at the interest rate on 30-year German government bonds, although these have fallen over the past 20 years from around 6.0 percent to the current level of -0.2 percent from time to time they have risen abruptly. Over this timespan they have risen by more than 1.0 percentage point seven times. This is an average of one rapid hike every three years, and funnily enough it is three years since the last rise started.

Another reason that we might have seen the bottom now is the fact that there is a very vocal overly pessimistic view, which is particularly related to the German manufacturing industry. Admittedly, this has suffered greatly from weak demand for cars and overly optimistic expectations for growth in production in relation to overall consumer growth a year ago. However, right now we are seeing the opposite so my assessment is that there will be a significant growth in the German manufacturing industry over the coming 12 months. This will affect inflation expectations and interest rates.

Serious tension in the EU

August saw the creation of a new government in Italy comprising the Five Star movement (M5S) and the Partito Democratico (PD), who are one of the "old" parties that M5S was formed as a protest against. The government was a reaction to Salvini's desire for a new election (Liga were tipped to greatly increase their vote) and was also grounded in disagreements between M5S and Liga about major tax cuts that were hovering on the edge of what was permitted by the EU's budget regulations. The new government is therefore already on much less of a collision course towards the EU and an expected lower balance of payments deficit has already resulted in a significant rise in Italian government bonds.

In Great Britain, the new Prime Minister Boris Johnson is playing a dangerous game in the form of a controversial suspension of parliament that is intended to block the various factions' possibilities for preventing a Brexit that was planned to take place on October 31st. The chaotic political situation develops from day to day with an election looming in the horizon.

The euro continued to fall against the dollar in August and reached its lowest level in two years at the end of the month. The continued turmoil over the overall direction of EU collaboration, the prospect of even greater monetary policy easing and not least the large interest rate spread for U.S. assets will continue to weigh heavily on the euro over the coming months, although an acceleration in German industrial production (discussed below) can be a stabilizing factor.

A change in the leading indicators moves closer

Despite the doom and gloom prevalent in both the financial markets and various business surveys, we must not give in to group thinking. The majority of the negative expectations in the headlines are related to the major decline in the manufacturing industry, and the German manufacturing industry in particular. The resulting weakened exports is part of this picture.

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As in previous monthly reports, I must once again conclude that in all probability the worst is behind us. The coming 12 months with show a significant increase in German industrial production, which is currently at -5.0 percent. In my opinion we could easily see as much as +5.0 percent in the next 12 months instead. The same, though more modest, picture can also be drawn for the U.S., which is also looking at a greater acceleration in growth both for industrial production and order intake for durable consumer goods.

If Germany really is about to go through a recession, it is rather a schizophrenic trait one is seeing as the German consumer continues to appear quite unconcerned. Retail trade is at 4.4 percent and the German service industry is also doing well. In addition, unemployment rates have not yet risen.

With regard to the U.S., it is also worth noting that the volume of freight does not show a declining tendency, which has usually been a fairly stable indicator of an imminent recession. Don't get me wrong: I certainly think an inverted yield curve should be taken seriously but to me it seems that the bond market is worrying about a problem that is likely to arise later than initially assumed. In the short term (6-12 months), players might find themselves surprised that economies are showing signs of progress again.

China and raw materials

If we turn to China, we can see that the Chinese leading indicators continue to be low but have been rising for the past six months. Also, the country's so-called credit impulse (changes in debt as a part of GDP) have also been rising sharply since the end of 2018. The politburo answered Trump's trade threat by easing monetary policy and attempting to stimulate the Chinese economy.

As a consequence of this, for the first time in many months we have seen a change in prices of industrial raw materials in relation to other raw materials. Prices of industrial raw materials typically fall faster than other raw materials when the economy is in a downturn and it can therefore be an early indicator of a cyclic change when they rise faster.

The OECD leading indicators continue to show a declining trend but it now happening at a considerably slower tempo. As discussed earlier, this can mean that a bottom will be reached within the next two to three months. This is particularly the case for the U.S., as Europe's leading indicators are continuing to fall at a stable, though relatively slow, rate.

Can you get any interest at all on bonds?

Even though interest rates have fallen since the last monthly report, I must once again warn long-term investors against too much exposure to long bonds where the potential yield is extremely limited and where the risk is rising daily if we are about to see a change in the leading indicators.

If risk tolerance does not follow share exposure, there are several alternatives to consider that might do well even if interest rates start to rise. Global High Yield corporate bonds currently have an effective interest rate of approximately 5.4 percent (measured in USD), which corresponds to an option-adjusted spread for government bonds of approximately 4.4 percent. This is a not entirely unattractive return in an "all things being equal" scenario.

Another option is EM treasury bonds, which in hard currency currently have an effective interest rate of about 5.2 percent and an option-adjusted spread for secured government bonds of approximately 3.5 percent.

Share allocation

The regional momentum and volatility indicators (MomVol) show a decline over the past two months but they were still high at the end of August, which is why all things being equal we can expect strong stock markets in September. The OECD's leading indicator for the entire OECD region continues to fall, though at a slower pace than before. There is a real possibility that we have seen the bottom of the leading indicators within the next two to three months, which the stock market will try to meet. Against this background, I recommend that a neutral stock allocation be maintained in relation to long-term target allocation in the near future.

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