October 3, 2019

What a Difference a "Trade War" Makes

How to Invest in a Low and Highly Volatile Interest Rate Environment

*Can you believe it was a year ago (fourth quarter of 2018) when the Federal Reserve raised its benchmark interest rate for the ninth time and long-term U.S. Treasury yields were climbing to a seven-year high? The 10-year U.S. Treasury yield had finally broken above a long term down trend **(chart 1)** and savers were cheering about the higher interest rates they could finally earn on cash. One year and one trade "war," "squabble," "skirmish," later, interest rates have fallen back near historic lows and the Federal Reserve has reversed course by cutting short term rates. We want to explain why interest rates have shifted lower, what we see going forward and how to invest in this low but highly volatile interest rate environment.*

Why have interest rates declined?

The ongoing trade dispute between the two largest trading partners (i.e. U.S. and China) has weighed on an already weak global economy this year. The International Monetary Fund expects 2019 world GDP to grow at the slowest pace since the Great Recession **(chart 2),** China's growth is expected to be the weakest since 1990, Germany is approaching a recession and the U.S. manufacturing sector has officially contracted. Since interest rates are a function of economic growth, bond yields have moved lower with weaker growth expectations. Other factors driving yields down include:

- **Stubbornly low inflation:** Traditionally interest rates rise as the economy accelerates and a rise in economic activity tends to lead to a rise in inflation which reduces the purchasing power of bonds. Therefore, bond yields go up while prices down. However, a sluggish global economy, technological advances, demographics and weak commodity prices have kept inflation in the U.S. stubbornly low this year. The Fed's preferred inflation measure (core personal consumption expenditures) has been at or below the lower end of the committee's 2019 target range every month this year. This is not just a U.S. phenomenon. A weighted global

Chart 1: Was the Bond Bull Market Over?

Footnotes: Time period reflects January 1979 – December 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 2: World Growth Expected to be Weakest Since 2009

Footnotes: Data is as of July 2019 World Economic Outlook.
Source: International Monetary Fund, Verdence Capital Advisors.

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

inflation index shows global inflation growing at the slowest pace in four years **(chart 3).**

- **"ZIRP" -** Due to the weak global economic backdrop many major central banks are moving to an even more accommodative monetary policy. Some who had already adopted a zero-interest rate policy are cutting rates deeper into negative territory to stimulate growth (e.g. ECB). In Germany, yields with maturities out to 30 years are negative. However, the 30-year bond in the U.S. is yielding ~2.15%. Therefore, global investors are being driven to the U.S. sovereign market in search of yield **(chart 4).**
- **Exogenous factors:** Aside from trade uncertainty, there are exogenous factors that have driven yields lower. Hong Kong has been in the middle of the worst civil unrest in decades. The UK does not have a clear path to leave the European Union by the October 31st deadline. Additionally, Middle east tensions have increased, and impeachment has entered the U.S. political headlines. It is the combination of these and slower global growth fueling demand for sovereign bonds.

Chart 3: Low Global Inflation Suppressing Yields

Footnotes: Data is as of August 2019. Index is a weighted inflation index depending on country's weight in global GDP.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

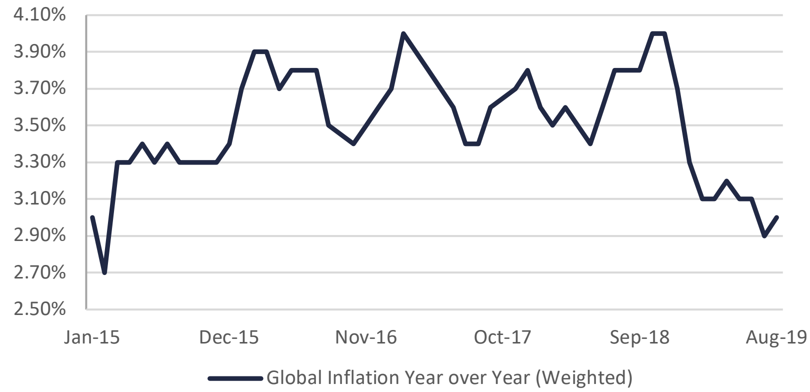
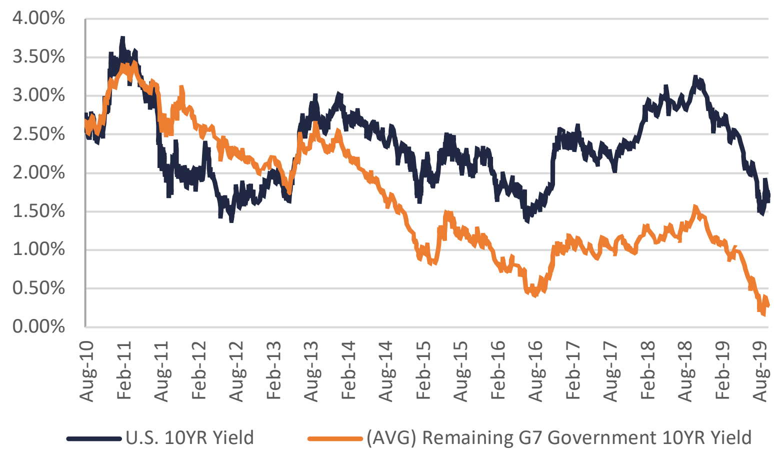


Chart 4: Limited Other Global Alternatives

Footnotes: Data is as of September 27, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

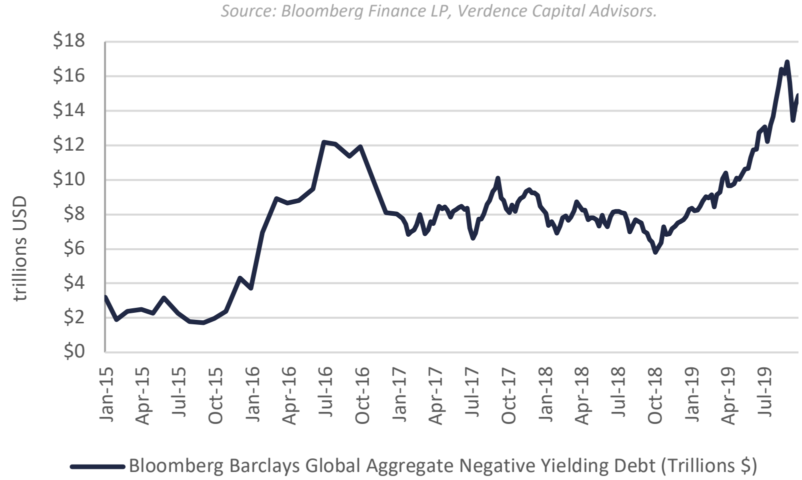


Are lower yields here to stay?

A 10-year U.S. Treasury yield at current levels (even with the modest rise higher in recent weeks) when economic growth and inflation are still positive (albeit slowing) is unwarranted. A world where central banks are adding excess liquidity with nontraditional monetary policy (e.g. quantitative easing) and pushing the amount of negative yielding debt to a record high is uncharted territory **(chart 5).** In fact, there are limited historical comparisons to be made to try to gauge how low momentum or excess liquidity can drive interest rates. Fundamental models (using growth and inflation) that value sovereign bonds have been broken and yields should be significantly higher than current levels. However, we believe for the 10-year Treasury yield to move near or below its cyclical low (1.36% in 2016), we would need a dramatic slowdown in growth and/or recession, which we see unlikely at this time.

Chart 5: Amount of Negative Yielding Debt Globally is at Unprecedented Levels

Footnotes: Data is weekly and as of September 27, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

Past performance is not indicative of future returns

How to invest in a low but highly volatile interest rate environment.

Volatility in the fixed income market is likely here to stay as we navigate through central bank policy (i.e. aggressive easing), growth remains uncertain and political news shifts investor risk appetite daily (i.e. trade deal on again and off again)! So, we stress discipline and caution with interest rate sensitive investments. We would recommend the following in this highly volatile and low interest rate environment.

- **Fixed income – Recent gains unlikely sustainable**: The 30YR U.S. Treasury bond posted its fourth best one month gain in the history of the 30-year bond in August. Investors should not get accustomed to these types of returns. It is important for investors to remember that the lower the yield, the more interest rate risk the investment carries as yields move higher. Therefore, we recommend the short to intermediate maturity range in the bond market to gain some yield but also mitigate interest rate risk, especially if yields move higher from current levels.
- **Equities – Dividend paying stocks and active management.** Relative to bonds, stocks are more attractive when looking at the extra yield you can pick up by buying stocks compared to an intermediate bond **(chart 6).** However, we recommend an active manager than can pick the best valued dividend paying stocks at this stage of the economic cycle. A strong manager can filter out the noise which may distort dividend yields and focus on those companies that have consistently been able to raise their dividends and/or are looking to start increasing dividends.
- **Alternative investments.** With bond yields unjustifiably low in the public market, investors that have a long-term time horizon should consider income producing alternative investments. Since bond investors are typically buy and hold investors, tying up principal for a specified period in an income producing private equity investment may offer diversification, low correlation, less volatility and better income potential.

Chart 6: Dividend Paying Stocks Attractive Relative to Bonds

Footnotes: Data is weekly and as of September 9, 2019.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Verdence View

Interest rates are artificially low, and volatility should remain heightened. Be conservative.

At this time global interest rates are being driven by outside forces beyond our control (e.g. central bank policy, global risks) and not underlying fundamentals, especially in the US. We have seen in other asset classes that when momentum takes hold it may keep an asset either overvalued or undervalued for extended periods of time. While global yields have risen from the August "panic" lows, when you see nearly a three standard deviation move lower in interest rates like we saw in August, at least some correction is likely. The most important thing to remember in this unique interest rate environment is not to chase momentum and not to get caught up in overvalued investments (e.g. long-term bonds). Like the equity market, we do not chase over valued sectors and the same discipline goes for the bond market. Instead we will remain in short to intermediate maturing bonds and focus on investments that can offer additional income and a solid risk adjusted return in this low interest rate environment.

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com