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MARKET UPDATE: BONDS IN 2019

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BOND MARKET OVERVIEW

Making an investment that is guaranteed to lose money sounds like something that would cost you your job. But in bond markets, it has become the standard market practice. As of August 2019, one fourth of the global debt market, approximately $16 trillions, was trading at negative yields. As we can observe from the chart below, sub-zero debt volume started to increase towards the end of 2014 and is now at record high level.

Figure 1 – Volume of negative-yielding debt for the last 10 years

That implies prices are so high that investors are certain to get back less than what they paid, through interest and principal, if they hold the bond till maturity. Historically, negative rates appeared for the first time in Japan two decades ago. But, looking at the market now, many countries are characterized by negative interest rates. Even large chunks of corporate bonds now trade at sub-zero yields, including some sub-investment grade bonds (considered in junk territory). Emerging economies have not been immune either. Bonds issued by The Czech Republic, Poland and Hungary have joined the club. As a consequence, investors thirsty for yields have been forced to look somewhere else, pushing prices further down. As a result, oddities now abound. Danish lender Jyske Bank issued a 10-year mortgage bond at an interest rate of minus 0.5 per cent, meaning homeowners are being paid to borrow. As of today (Dec 24th, 2019) more than $11 trillions of debt continues to trade at negative yield.

GOVERNMENT AUCTIONS

On September 27th 2019, Italy sold €7.5 billions of new debt at record low borrowing costs. The debt was sold in two different tranches: a five-year one at a yield of 0.26 per cent and a ten-year one at 0.88 per cent. The sale came three weeks after the centre-left Democratic party and the populist Five Star movement ended weeks of political uncertainty by agreeing to form a new government. As a consequence, investors responded by piling into Italian debt, pushing yields to all-time lows. The recent decline in yields created a vicious circle for Italian debt, that then looked more sustainable even if standing at more than 130 per cent of GDP. The new coalition gave confidence to investors since the alternative would have been the new elections, that could have stregthened the position of League leader Matteo Salvini.

On October 9th 2019, Greece joined the club of negative-yielding debt issuers. In fact, Athens raised €487.5 millions of 13-week bills at a yield of minus 0.02 per cent. The previous sale, in August, offered a yield of 0.10 per cent. The reduction in yield was partially caused by the fact that ECB cut rates by 25 basis points at the end of September. On top of that, Greece even sold €1.5 billions of 10-year debt at a record low yield of 1.5 per cent. However, it is even true that investors have grown more confident about the prospect of Greek economy, which is forecasted to grow at 2.8 per cent next year (according to IMF).

Even Portugal auctioned €750 millions of 15-year debt at a record low yield of 0.49 per cent. Furthermore, the auction was 2.5 times oversubscribed. It was Portugal's first bond auction since the ruling centre-left Socialists (PS) won a general election at the beginning of October, increasing their share of the vote, but falling short of an absolute majority. The yield on the country's benchmark 10-year debt had also dropped below that of Spain, a rare occurrence since the Iberian neighbours became eurozone members.

EUROPEAN CENTRAL BANK

On September 12th 2019, the ECB cut interest rates further into negative territory and revived its contentious €2.6 trillions programme of buying bonds for an unlimited period, in the latest sign of concern over the health of the global economy. "Now is the time for fiscal policy to take charge" said Mr Draghi, who just finished his eight-year term as ECB president and handed over the role to the former IMF managing director Christine Lagarde at the beginning of November. The ECB cut its deposit rate from minus 0.4 per cent to a new record low of minus 0.5 per cent and even restarted its quantitative easing programme, buying €20bn of bonds every month from November until inflation expectations came "sufficiently close to, but below, 2 per cent".

Figure 2 – ECB deposit rate for the last 10 years

Ms. Lagarde has been defined as an unconventional choice to lead the ECB. Unlike most central banks heads, she is not an economist and she has never devised monetary policy. After studying law at Paris West University Nanterre La Défense, Ms. Lagarde did a Master in Political Science in Aix-en-Provence and she joined US law firm Baker McKenzie in 1981. Ms. Lagarde rose to chair its executive committee before leaving in 2005 to become a minister in the French government, under President Jacques Chirac. His successor, Nicolas Sarkozy, named Ms. Lagarde as France's first female finance minister. She won plaudits among western leaders for the way she went through the financial crisis and this made her an obvious choice to replace Dominique Strauss-Kahn when he was forced out as head of the IMF over allegations of sexual assault in 2011. There she won admiration for her diplomatic skills and ability to find a consensus. She has been defined as a more outgoing personality than Mr. Draghi, who left an eight-year legacy with one of the most worrisome problems for the Eurozone: inflation expectations to come sufficiently closed to, but below, 2 per cent.

As of December 19th 2019, top US rated companies flocked to sell bonds in Europe in 2019 in record amounts, taking advantage of record low borrowing costs pushed by a fresh wave of economic stimulus in October. The most creditworthy tier of American companies has sold the equivalent of $129bn in euros so far this year, according to Dealogic data going back to 2000. The amount represents more than double last year's tally of $56bn and much higher than the previous peak of $107bn in 2017.

FEDERAL RESERVE

"European Central Bank acting quickly," Mr. Trump declared on Twitter on September 12th 2019. "They are trying, and succeeding, in depreciating the euro against the VERY strong dollar, hurting US exports... And the Fed sits, and sits, and sits. They get paid to borrow money, while we are paying interest!".

However, on October 30th 2019, Federal Reserve cut rates by 25 basis points for the third time this year (after July and September cuts), but signaled it was done easing monetary policy for the time being. The US central bank said that uncertainty on the economic outlook justified its latest cut but chairman Jay Powell said that a preliminary US-China trade deal and lower risk of a no-deal Brexit had the potential to increase business confidence.

Given the easing monetary policies implemented by ECB and Fed, the hunt for yield has spread into every corner of the corporate debt market in 2019. In December alone, companies across the US rated triple C - the bottom tier of the sub-investment grade bond market - have returned 4.4 per cent, according to Bank of America Global Research; while US companies with a double B rating had posted returns of 15.6% so far this year.

Looking at the figure below, it is possible to observe the downward trend in riskiest junk bond spreads.

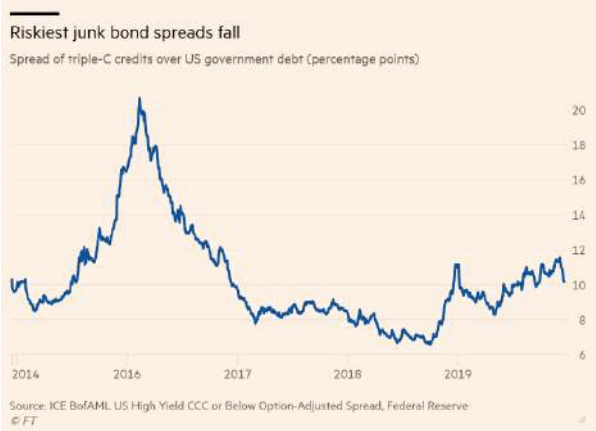

Figure 3 – Spread CCC credits over US Gov. Debt

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