2% or 2% or -0.2%?

The bond market is currently a puzzle derived from an enigma influenced by an anomaly. Or is it? Here are some bullets.

1. Riskless overnight US government cash equivalents yield more than 2- or 5- or 7- or 10-year maturity instruments of the same credit risk. That means a market based forecast suggests that the average of all the daily rates for the next 2 or 5 or 7 or 10 years will be lower than the overnight rate is today. In other words the "term premium" is negative. The NY Fed says the 10 year term premium is lowest it's been in over half a century.

2. The spread in yield between the euro-denominated higher-grade credit equivalent (Germany) is about 2.5% at these same maturities. And the euro benchmark rate is negative.

3. One might surmise that the euro will appreciate against the US dollar at a rate of 2.5% a year for the next decade. Any other assumption requires hedging costs for any transaction or financing between the world's first and second largest regional currency blocks.

4. Both currency blocks are involved in a multidimensional tariff and protectionist dispute with the world's second

largest economic sphere (by GDP, that’s China).

5. Many smaller economies are similarly engaged. Sorting all this out requires three- or maybe even four-dimensional perception. Note those countries rates conform to their larger block neighbors. Swiss and Swedish rates are also negative.

6. In the US we can compare Treasury yields from June 2018 to June 2019. Three-month T-bill yields are almost a half point higher. One-year treasury yields are about the same. Ten-year treasury yields are over a half point lower. Hmmm?

7. Credit spreads tell a different story. Ten-year junk bonds versus Treasury have over a half point wider spread. High-grade bonds over Treasury yields is a little wider than a year ago but not as widened as junk. The spreads of Bank shorter-term paper versus Treasury yields are nearly unchanged.

8. We surmise that credit risk in lower and middle quality is deteriorating but hasn’t reached the default headline stage yet. Does that stage lie ahead? Maybe, and more and more likely as trade war effects unfold and international volatility increases. Will bank credit spreads widen against treasury yields? That would be a serious warning sign of trouble ahead.

9. Is the flat or inverted Treasury curve forecasting a recession in the US? Maybe. It certainly suggests a weakening economic outlook. The longer inversion continues the more recession risk rises.

10. Do negative bond rates in Europe distort US bond yields? Absolutely. How much? We all guess. At Cumberland we think the 10-year yield would be 50–75 basis points higher if European rates were normalized. But they’re not normalized now and are not likely to be normalized soon.

11. Is Cumberland buying 10-year US Treasury notes now that

they are down to nearly 2%? No. Are we buying 10-year German notes below zero? No.

12. What are we doing at Cumberland in our total-return high-grade bond accounts? We are respecting the component parts of term premium and expectations analysis. It is the real rate risk premium that is unusually low. The other components are very close to where they were when the ten year treasury yield was 3%. For a discussion of term premia models see pages 79-90 in the BIS Quarterly Review, September 2018. The researchers discuss both USD treasury yields and German euro yields. When you examine page 85 you can see the graphics depicting the decomposition.

Please contact my colleague John Mousseau, his portfolio management team, or research team members to discuss details. Out of our 17 series 65-licensed IA folks, we'll find an appropriate person to help those interested get a better handle on the complexities of the bond market. For Cumberland, the strategy today is a barbell with favoring weights in the front end and cushion bonds in the back end. We strongly favor high-grade credit.

We seek to preserve capital in these highly uncertain times. Of course, things can change quickly. Lastly, we avoid mechanical bond ladders. In today's world they can be a trap.

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