OCM Asset Management

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Market Update: 11th September 2019

A Sharp Shift in Sentiment Hits Bond Markets

After rallying for months on recessionary concerns and deteriorating economic conditions, bond markets sharply declined this week as risk-on sentiment spread throughout financial markets, resulting in a rotation away from bonds. In a move which marked a significant shift in investor sentiment, market participants were seen to be returning to risk-on assets, despite mounting evidence of a further deterioration in global economic health. While we view this as being a temporary risk-on shift following recent outperformance within bond markets, it is key to articulate why this happened, and how it impacts our expectations for the bond allocation within the portfolio going forward.

What Happened?

Over the week, bond prices fell as investors sold bonds in favour of risk-on assets on the back of optimism over trade developments and uncertainty over central bank easing ahead of key central bank decisions. As bond yields move inversely to prices, a reduction in expectations for central bank easing and optimism over the economic outlook caused yields to increase, having a negative impact on prices. This was illustrated by a 27 basis point increase in the US 10 year treasury yield over the week from 1.46% to 1.73%.

On reflection, data suggests that this week's sell off came as a result of bond markets pricing in too much optimism over rate cuts. Bond markets have been rallying in recent months on deteriorating economic conditions as investors shift to risk-off assets amid recessionary concerns, pricing in significant central bank easing as a result. This week's movements suggest that markets got carried away with expectations, before rebasing forecasts this week on new developments.

Stimulus Expectations

After sentiment began to shift on Thursday as a result of more positive than expected ISM non-manufacturing data from the US and the announcement that face-to-face talks on trade between the US and China would resume next month, investors weighed up expectations for further US rate cuts, triggering a sell off in US treasuries. The sell off then continued into this week, driving Treasury yields higher and prices lower, as traders gird for a potentially pivotal European Central Bank decision on Thursday. US Treasuries came under pressure as the supply of government and investment grade bonds continues to expand, with the US government auctioning $38 billion of three-year notes. The key catalyst was concern that the ECB won't meet market expectations for a resumption of quantitative easing.

The ECB's bond purchasing programs tend to have a significant spillover into US and UK markets, and markets had been expecting a comprehensive stimulus package including a new QE programme, so it would be significant if it does not announce a QE program, if its smaller than expected, or if it does not expand the issues it can buy. Despite a clear case for further monetary stimulus, the ECB is debating the size and composition required, particularly given questions over the ECB's ability to materially effect the subdued and uncertain trade outlook. It was evident in the minutes of the last meeting and from recent ECB speakers that there is some pushback within the council against a new round of QE from hawkish central bankers such as the Bundesbank president Weidmann, but even the French council member Villeroy is not yet

convinced. For this reason, there is a risk that Draghi's term may end with a whimper rather than the bang first anticipated.

Trade Talks

Alongside central bank movements, investors are also watching trade developments closely, after the US and China agreed to resume fact to face talks next month. Treasury Secretary Steven Mnuchin announced on Monday that the US and China had reached a conceptual agreement on the enforcement systems required on intellectual property. It remains unlikely that any agreement will be made before the end of this year, with both sides displaying little motivation to make concessions, however if we were to get a trade deal, the data indicates that the damage to the global economy has already been done, with deep and ingrained weaknesses already evident within key economies and sectors, supporting risk-off assets in the near term.

Is This A Bond Bubble?

The late 1990's saw a bubble in equity markets and the 2000's saw a bubble in housing. Today many see a bubble in government bonds, one that has been 30 years in the making. It's not hard to believe that bonds may be in a bubble following years of outperformance. Yields are exceptionally low, and prices have been rising for around 30 years, yet despite all of the talk of bubbles, the drop in yields has been largely justified by economic conditions.

The nominal yield of a government bond comes down to expectations for short term real policy rates over the life of the bond and expectations for inflation. These feed off one another, and both have fallen sharply over the past 30 years. While some of the decline in yields since the 1980's reflected the unwinding of deliberately tight monetary policy in order to keep inflation under control, much of the decline in yields has been due to structural forces. The advent of inflation targeting by central banks lowered and then anchored inflation expectations. This was then helped by the spread of globalisation. At the same time, there has been a steady fall in equilibrium real interest rates over the past two decades, as real interest rates have fallen while inflation has not increased.

These structural factors may not last, however there's not much evidence of the current bond conditions significantly altering imminently, particularly given the current exceptionally muted levels of inflation. The outlook for global growth is bleak, reflected by market moves over the summer, however interest rate cuts are still expected to boost bond markets given deteriorating economic data and recessionary concerns. This indicates that there is further room for yields to fall and bond markets to outperform in the near term, therefore we are not concerned about being caught in a 'bond bubble' despite the media dubbing recent movements within bond markets as indicating the unravelling of such.

What Do We Expect From Here?

It is our view that the bearish tone in bond markets will struggle to persist as economic data continues to show signs of deterioration on a global scale. We expect the downward trend in yields witnessed in recent months to continue as a reflection of increasing downside risks and weakening economic conditions. In line with our thesis, when equity markets decline on weaker global growth, lower corporate profitability and recessionary concerns, central banks will ease, supporting outperformance within bond markets.

The market is susceptible to a sell off in the near term if global risks ease or if central banks underwhelm on their policy response, however it is our view that the overall investor sentiment will become more risk off and supportive of bonds as the economic data continues to deteriorate. Yields have risen this week on a number of risks easing, while traders pare back bets on fresh bond buying from the ECB next week, however our view is that this is a short term shift rather than a long term rotation.

Positioning

Earlier in the year, we were of the view that the global economic cycle had peaked and that growth was likely to slow sharply this year, causing central banks to loosen policy and bond yields to fall. What has happened in recent weeks has vindicated this view, and we continue to see this as being a trend in the remaining months of the year. As a result, we retain our defensive positioning, favouring high quality, low duration credit within our non-equity exposure to reduce portfolio volatility over challenging market conditions

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