

The Economy, Bonds, Recession: How Should We Think About Fixed Income?



Bizarro Mortgages in Denmark



**More good news for homeowners:
Mortgages with negative interest rates**

**Yes, you read right.
this is almost absurd.**

How is that possible?

"Yes, I hardly understand it either. In fact, I said it can't be said. But we have figured out the extremes well, and it can be very possible to have a bond rate of minus," explains Jyske Bank's home economist.

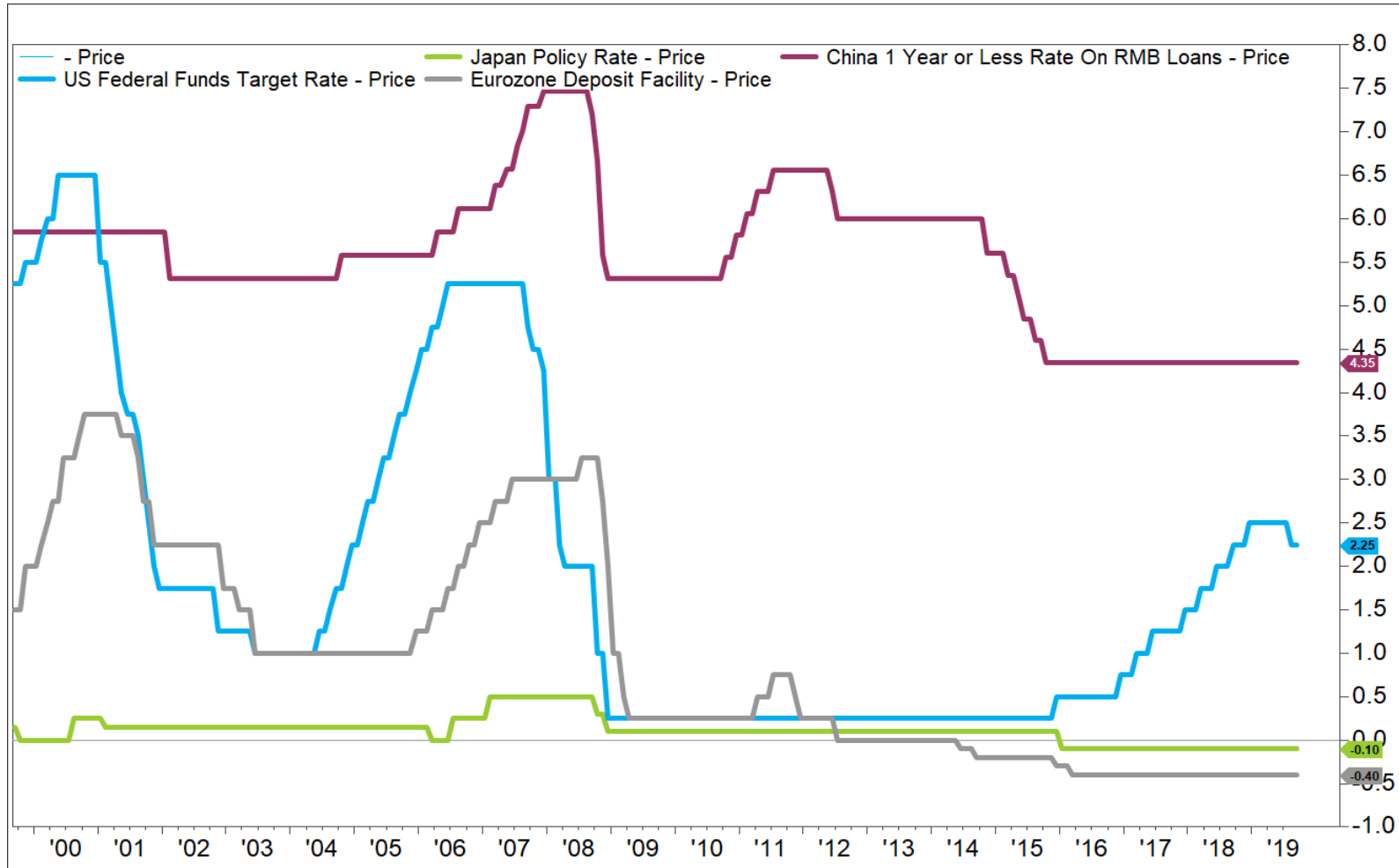
Mortgage loans as car loans

If you have a value in your home, a fixed-rate loan with -0.5% can be used. At par, interest rates are a particularly attractive alternative to other car loans on the market. There is no down payment requirement when you finance the car with a mortgage. We recommend that you choose a maturity on the mortgage that roughly matches the life of the car.



Source: Jyske Bank

Central Bank Policy Rates are Low

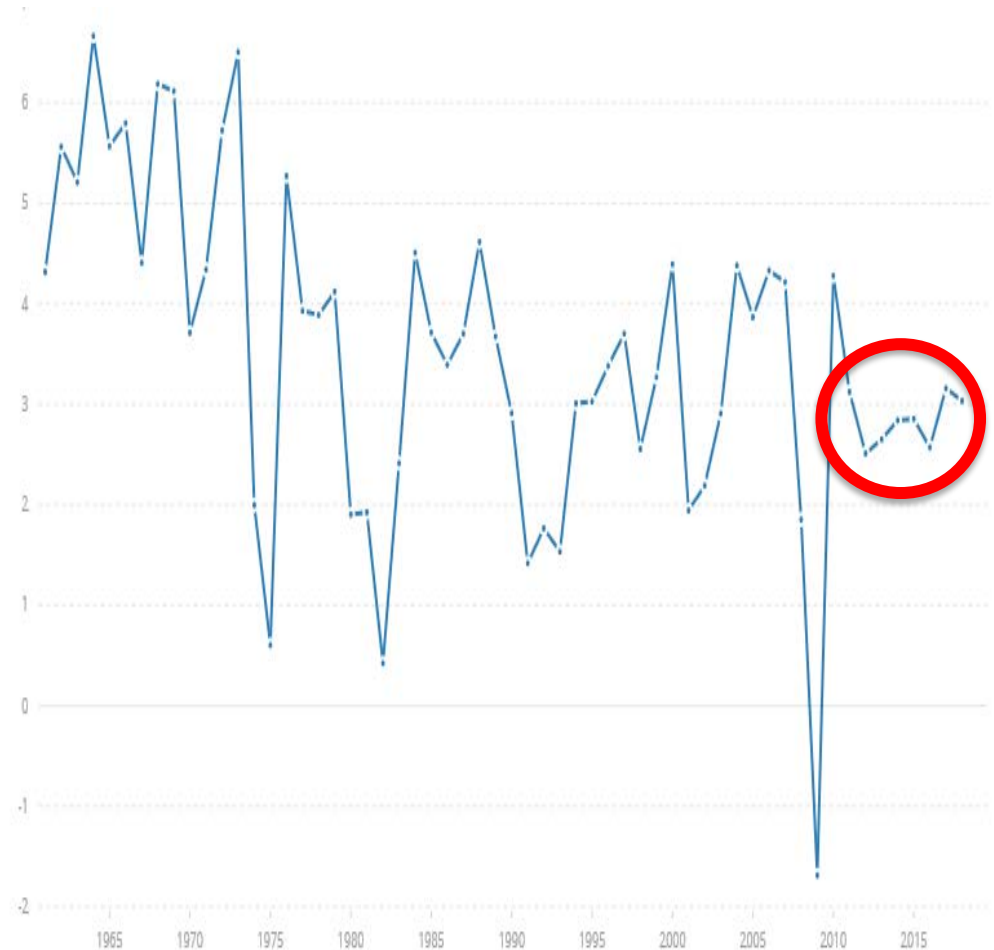


Source: FactSet



A Weak Growth World

- World GDP from 1961-2018
- From 2011-2018, growth was mostly below 3%
- Other than during the years above, growth fell below 3% only 30% of the time during the entire 57-year period

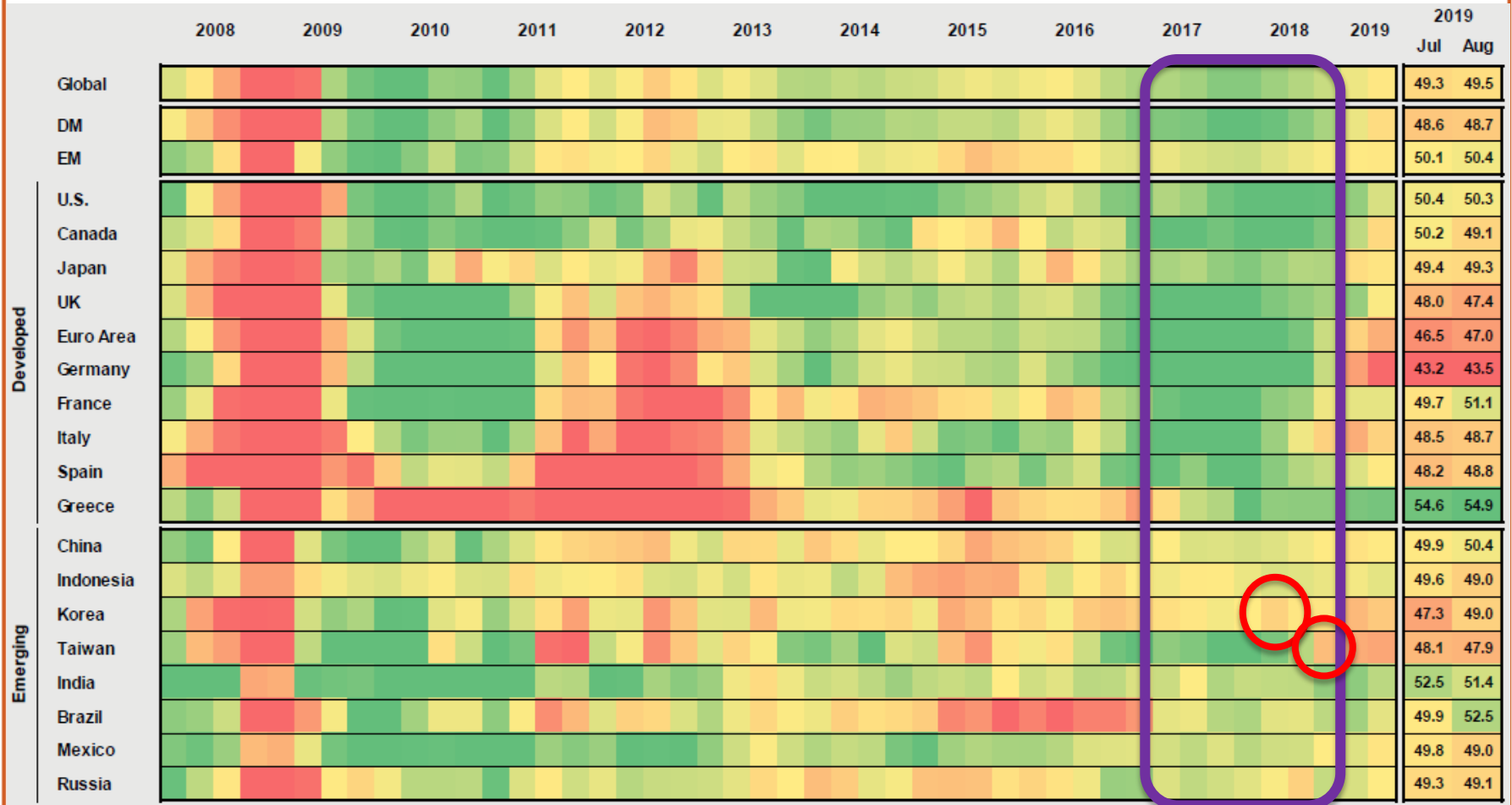


Region	Contribution to Global Growth	2011 - 2018	
		GDP Range	GDP Avg.
US	24%	1.5% to 3%	2.2%
EU	21%	-0.5% to 2.5%	1.5%
China	16%	6% to 10%	7.4%
Japan	6%	0% to 2%	1.0%
India	3%	5% to 8%	6.9%
Total	70%		

Source: World Bank and IMF



Synchronized Growth Was Fleeting



Source: J.P. Morgan Asset Management



The Terrible Timing of these Themes

Trump
Tweets

Trade tactics -> Tensions
Trade threats -> Tariffs

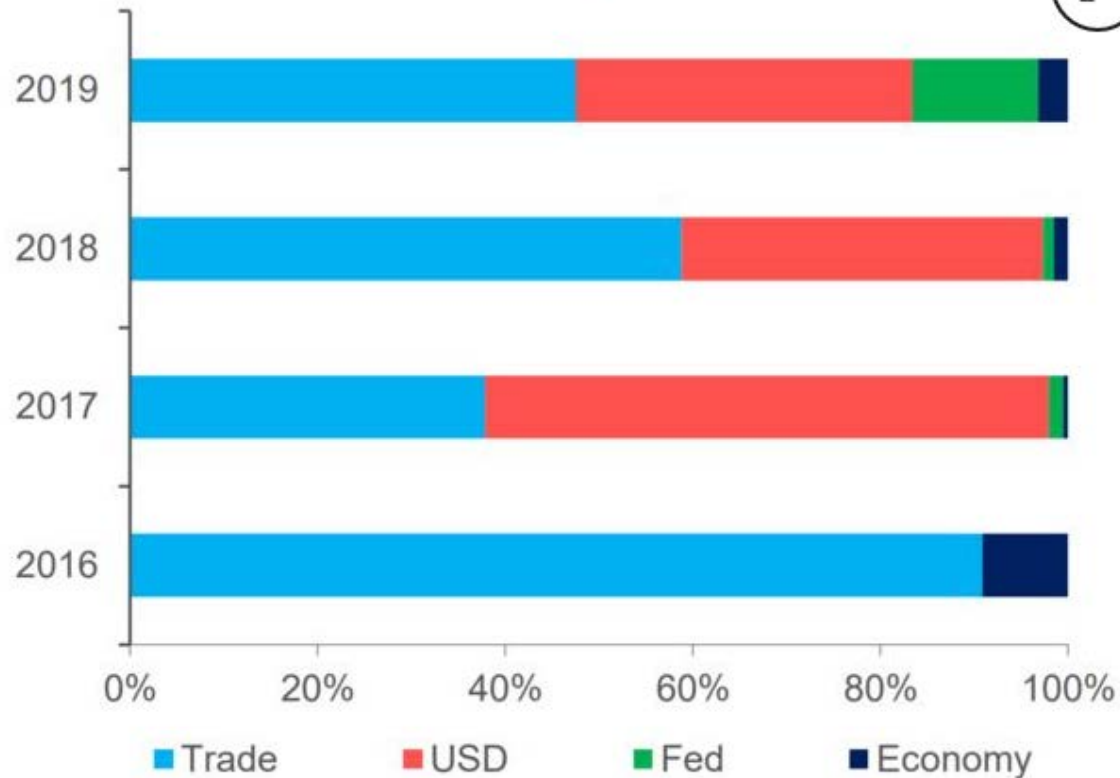
Turkey

Ten-year Treasury hit Three
Tax cuts (benefits to wane)



Trump's Focus on Trade Year-by-Year

Figure 2: Selected Trump Tweets by Year



Source: Citi, Twitter, Sample: Nov-16—Aug-19

Source: Bloomberg



Trade War Escalation

The U.S.-China Tariffs

Tariffs, by percentage rate, imposed by the U.S. and China on each other since March 2018

□ Imposed by the U.S. on China ■ Imposed by China on the U.S.

March/April 2018



Steel and aluminum products from most countries (10% aluminum, 25% steel)
Wine, pork, nuts, steel pipes, recycled aluminum (15% to 25%)

July 2018



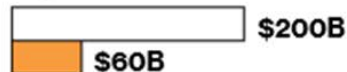
Aircraft parts, semiconductors, microscopes (25%)
Soybeans, wheat, electric vehicles, whiskey, seafood, cigars (25%)

Aug. 2018



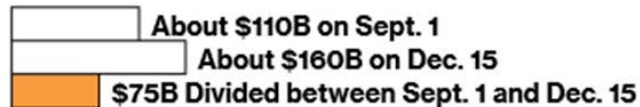
Motorcycles, steam turbines, railway cars (25%)
Beef, poultry, fiber-optic cables, motorcycles (25%)

Sept. 2018



Fabric, modems, chemicals, furniture, seafood (10%, raised to 25% in May 2019)
Cosmetics, vodka, reptiles, wigs, diamonds, video games (5% to 10%, raised to 5% to 25% in May 2019)

Planned



Sept. 1: Agricultural products, antiques, clothes, kitchenware, footwear (15%)
 Oct. 1: 25% tariffs on Chinese goods to go to 30%
 Dec. 15: Smartphones, laptops, children's toys (15%)
Crude oil, soybeans (5%) Pork, beef, chicken, wheat, sorghum, cotton and other farm products (10%)
Some vehicles (30% to 35%)

Sources: Office of the U.S. Trade Representative, Bloomberg

Source: Bloomberg



Fed Kept Hiking Due to Positive Data



"Nasdaq Crests 7000 as Tech Giants Roar Into 2018"

"Congress Passes Mammoth Spending Bill, Averts Shutdown"

"Trump Pulls US Out of Iran Deal"

"US Jobs Claims Hit Lowest Level since 1969"

"China's Trade Surplus with US Hits New Record"

"Eurozone Growth Stutters as US Economy Powers Ahead"

"Oil Prices Drop Sharply as OPEC Struggles to Agree on Cuts"

"US Imposes New Tariffs, Ramping Up 'America First' Trade Policy"

"Yield on 10-Year US Government Bond Hits 3% for First Time in Year"

"US, China Tariffs Hit American-Made Products from Chips to Cars"

"Profits Surge at Big US Firms"

"Fed Raises Interest Rates, Signals One More Increase This Year"

"Midterm Elections Produce a Divided Congress"

"US Indexes Close with Worst Yearly Losses Since 2008"

"Inflation Rate Hits Six-Year High in May"

"Nasdaq Crosses 8000 Threshold for First Time"

"US Unemployment Rate Falls to Lowest Level Since 1969"

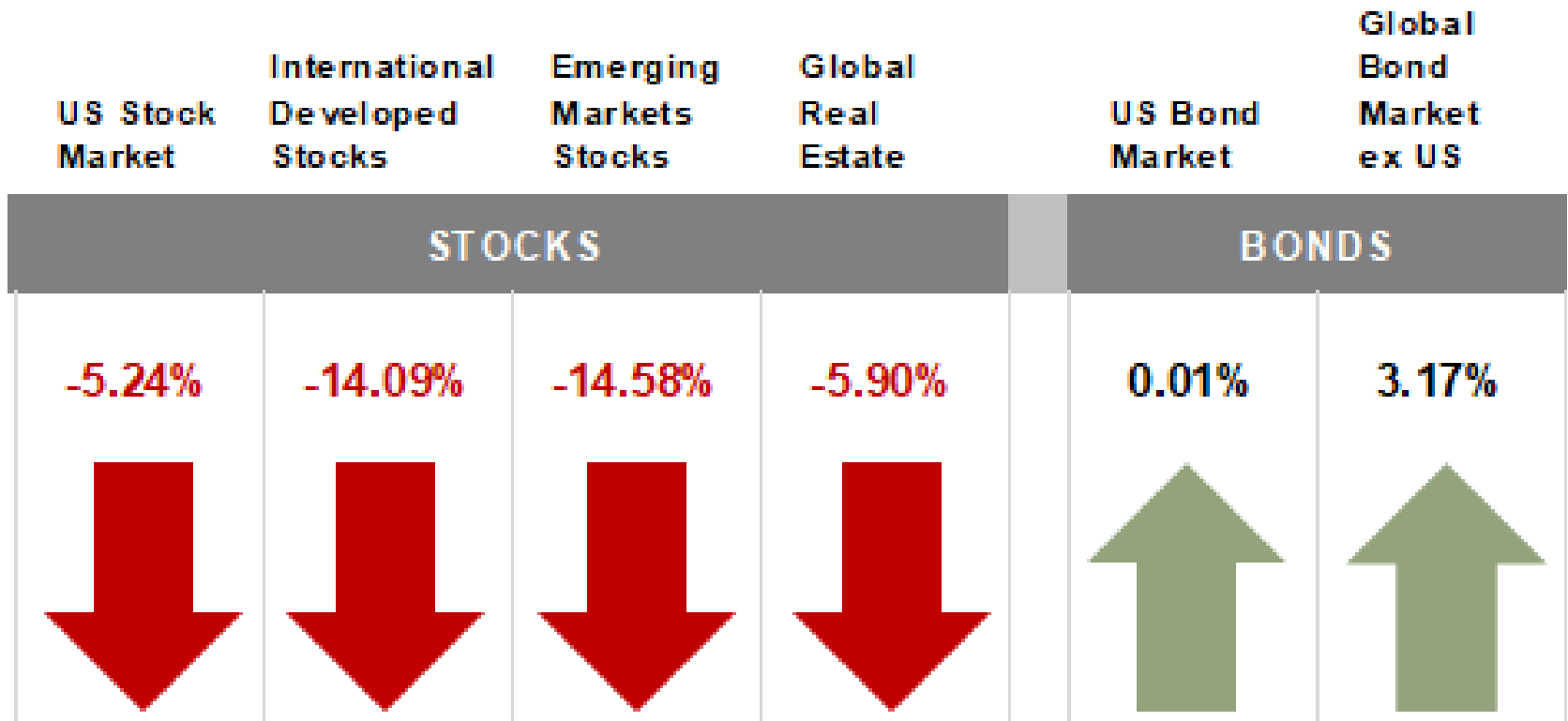
"Existing-Home Sales Suffer Largest Annual Drop in Four Years"

Source: FactSet, Dimensional Fund Advisors



Markets Disagreed with Fed Outlook

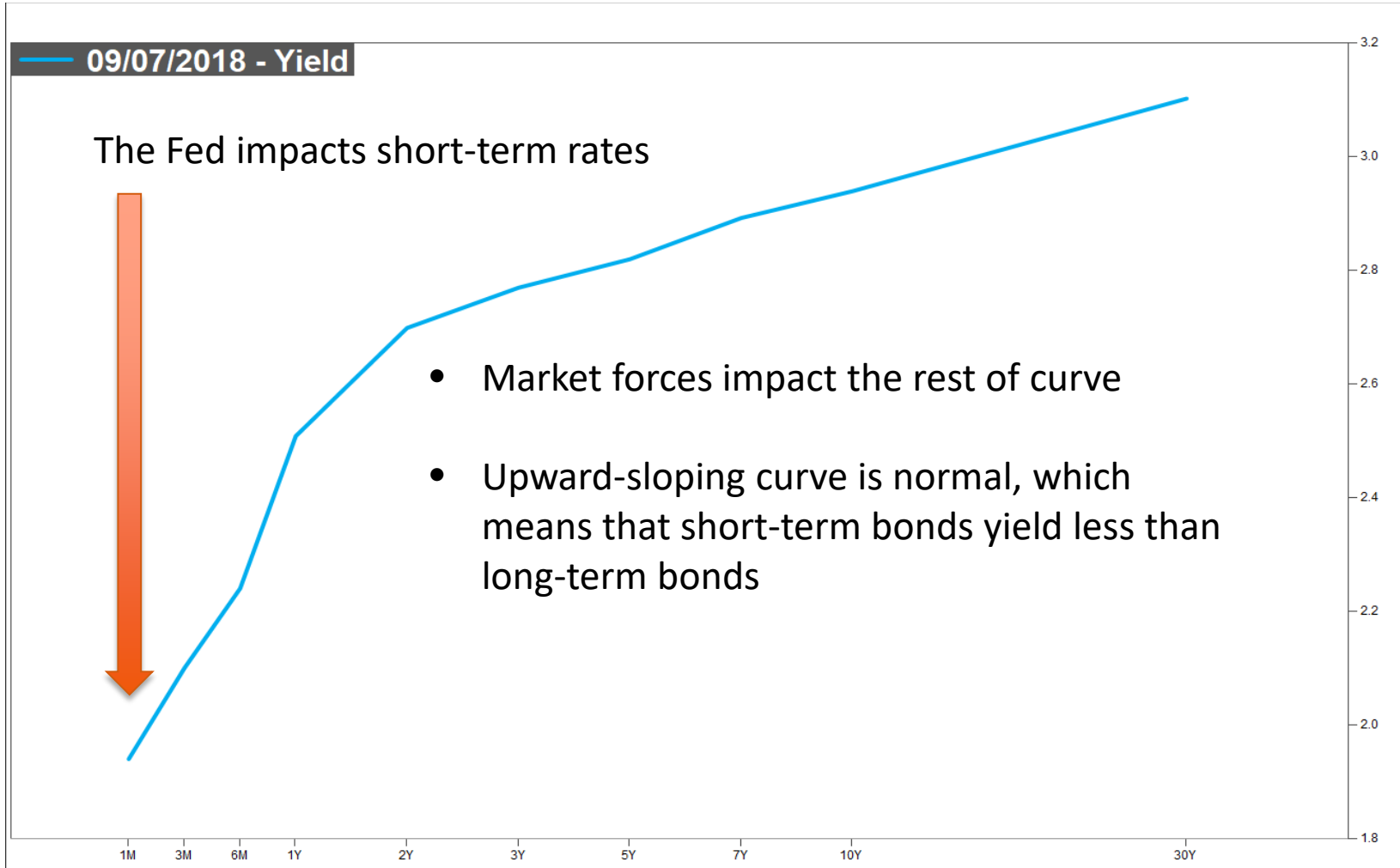
2018 Major Asset Class Returns



Source: Dimensional Fund Advisors



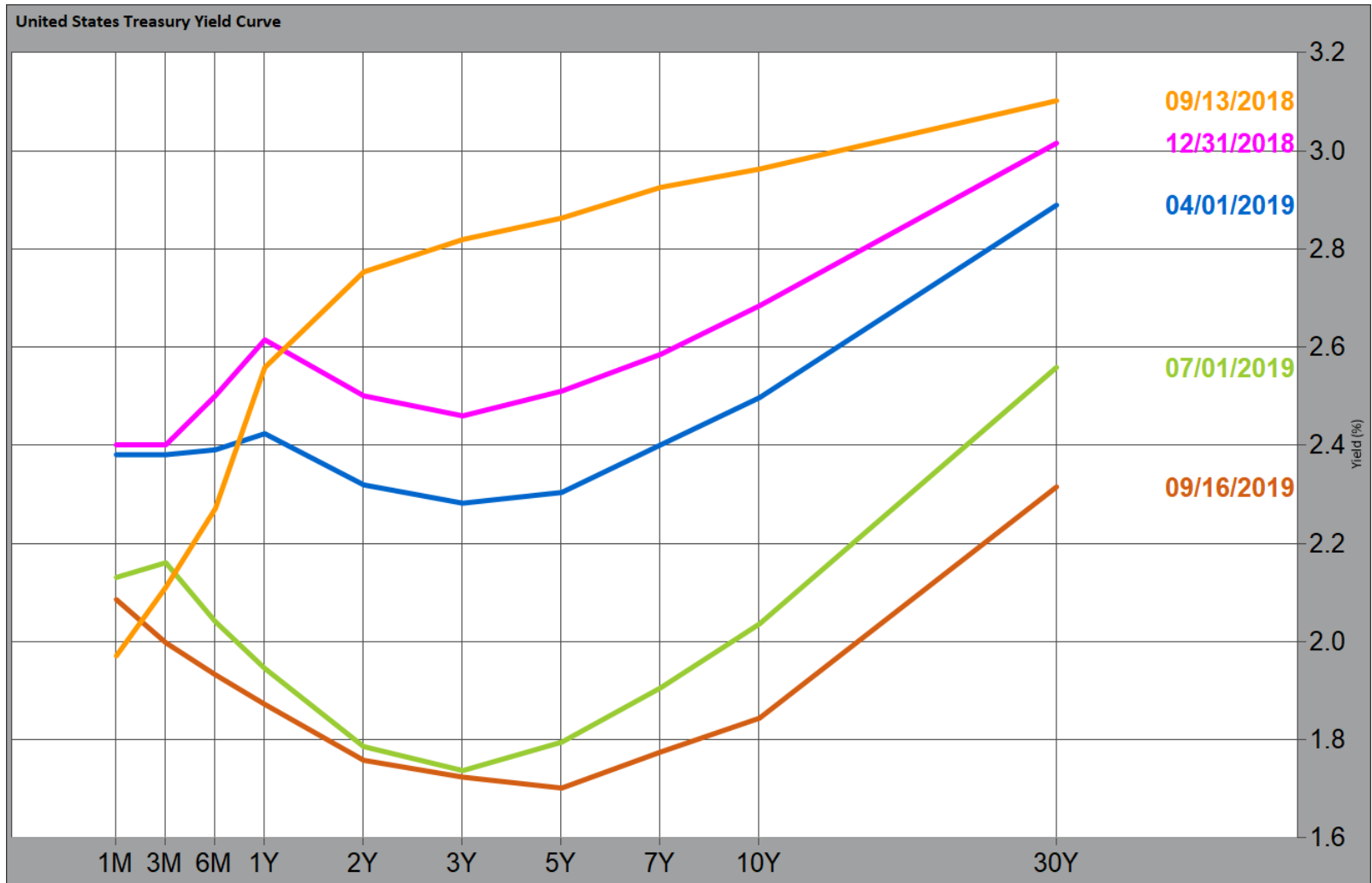
Yield Curve Basics



Source: FactSet



Inversion Stokes Fear of Recession



Source: FactSet



US Economic Indicators: A Simple Model

Leading

->

Coincident

->

Lagging

GDP and its components

Housing

- Starts
- Permits
- Mortgage rates



Housing

- Sales



Business (mfg)

- **Manufacturing PMI**
- PPI



Business

- Industrial Production



Business (non-mfg)

- **Services PMI**



Consumer

Consumer

- **Sentiment/expectations**
- Retail spending
- Initial claims for unemployment

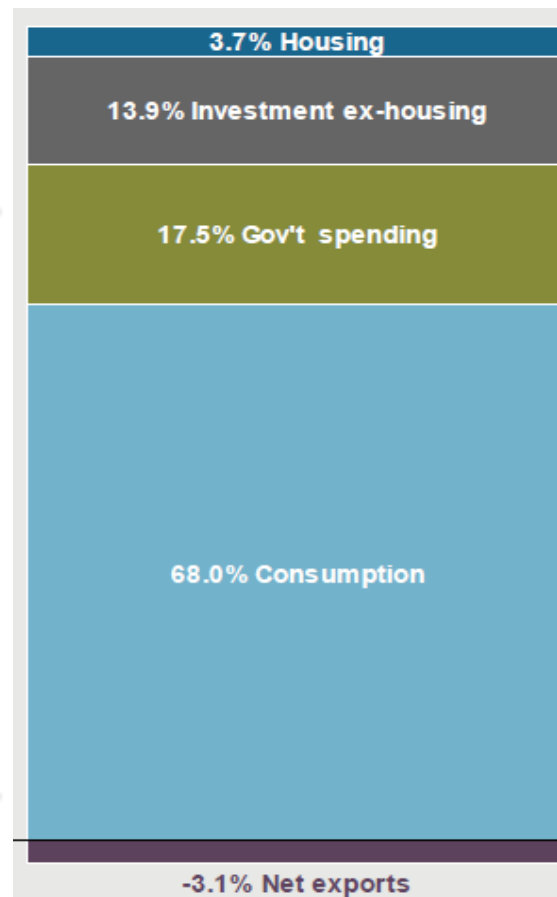


- **Jobs (payroll, earnings)**
- **Confidence**
- Balance sheet



Overall

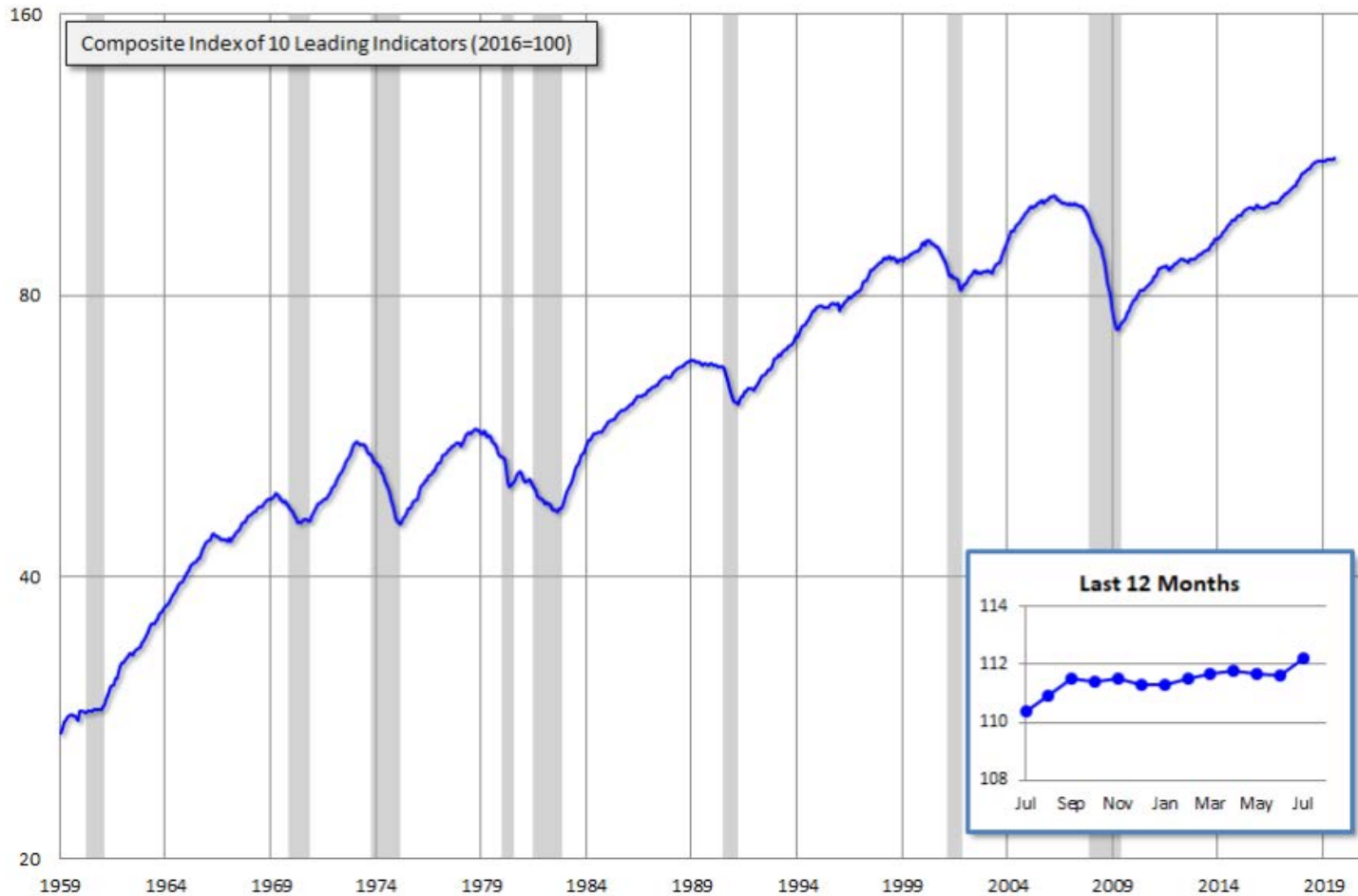
- Citi Economic Surprise
- **Index of Leading Economic Indicators (LEI)**
- Yield Curve



Source: J.P. Morgan Asset Management



July Leading Economic Index (LEI) was Positive



Source: Advisorperspectives.com



Consumer Data: Good for Now

- August nonfarm payrolls came in at 130K, weaker than the 160K consensus. The trend of job creation has been slowing all of 2019. Unemployment rate sits at 3.68%.
- August average hourly earnings rose 0.39%, the biggest increase in months, keeping the YOY change at 3.23%.
- Consumer sentiment fell to a 7-month low in August, potentially endangering consumer spending. The survey showed that consumers “strongly reacted” to the proposed tariff increases and consumers also reported that they need to be more cautious about spending in anticipation of a potential recession.
- Consumer confidence fell in August, although less than forecast. Consumers’ assessment of current conditions climbed to the highest level in 19 years, helped by the strongest perception since September 2000 that jobs are currently plentiful. However, consumers’ expectations about the future declined somewhat.



Manufacturing Weakness Materializing

- The ISM index fell for the first time in 3 years below 50 (indicating contraction) on low orders, production, and hiring.

Factory Slowdown

Manufacturing gauge contracts for the first time since 2016



Source: Institute for Supply Management

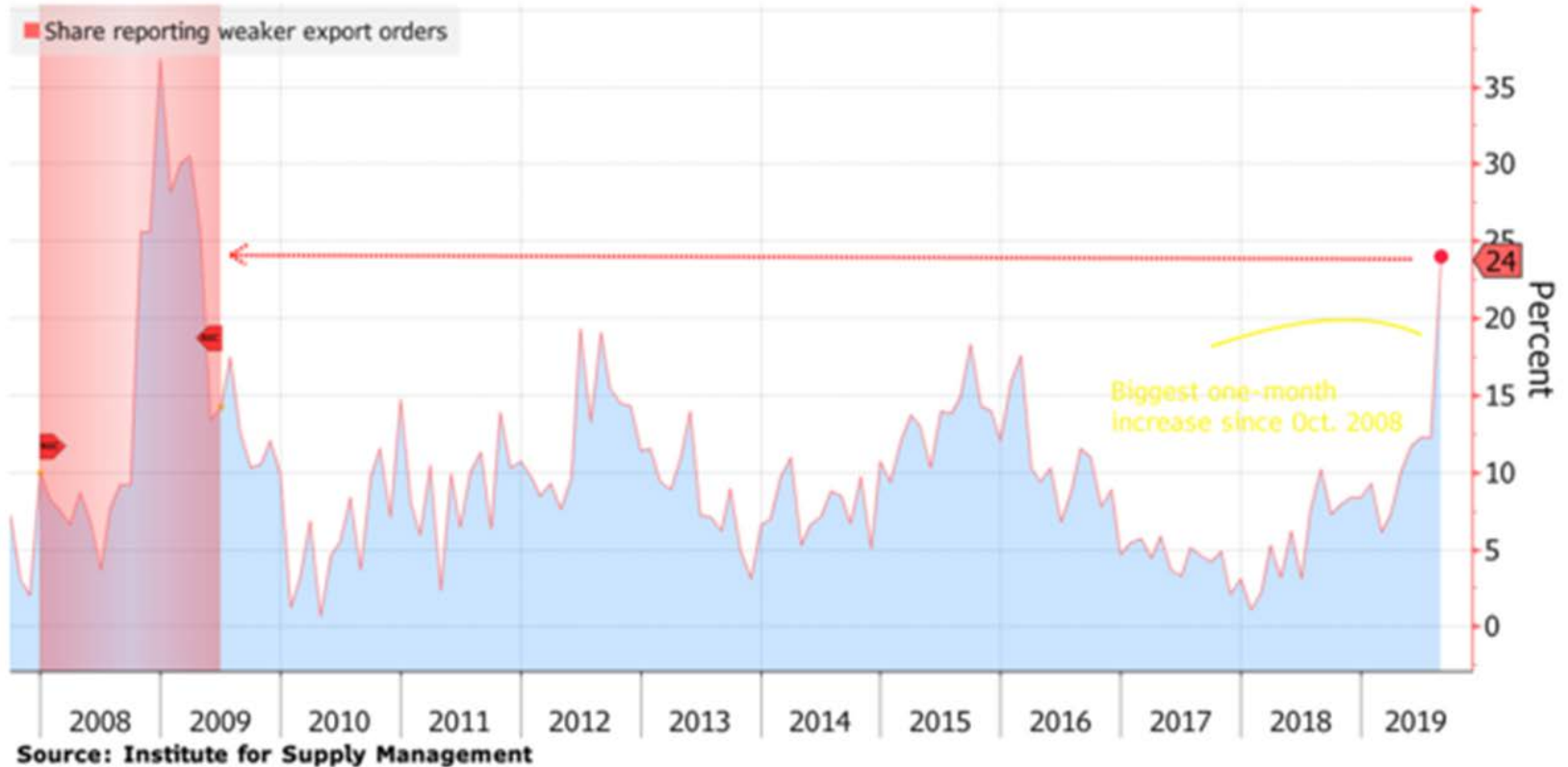
Source: Bloomberg



Very Weak Overseas Demand

Demand Drying Up

Largest share of U.S. factories in a decade report falling export orders



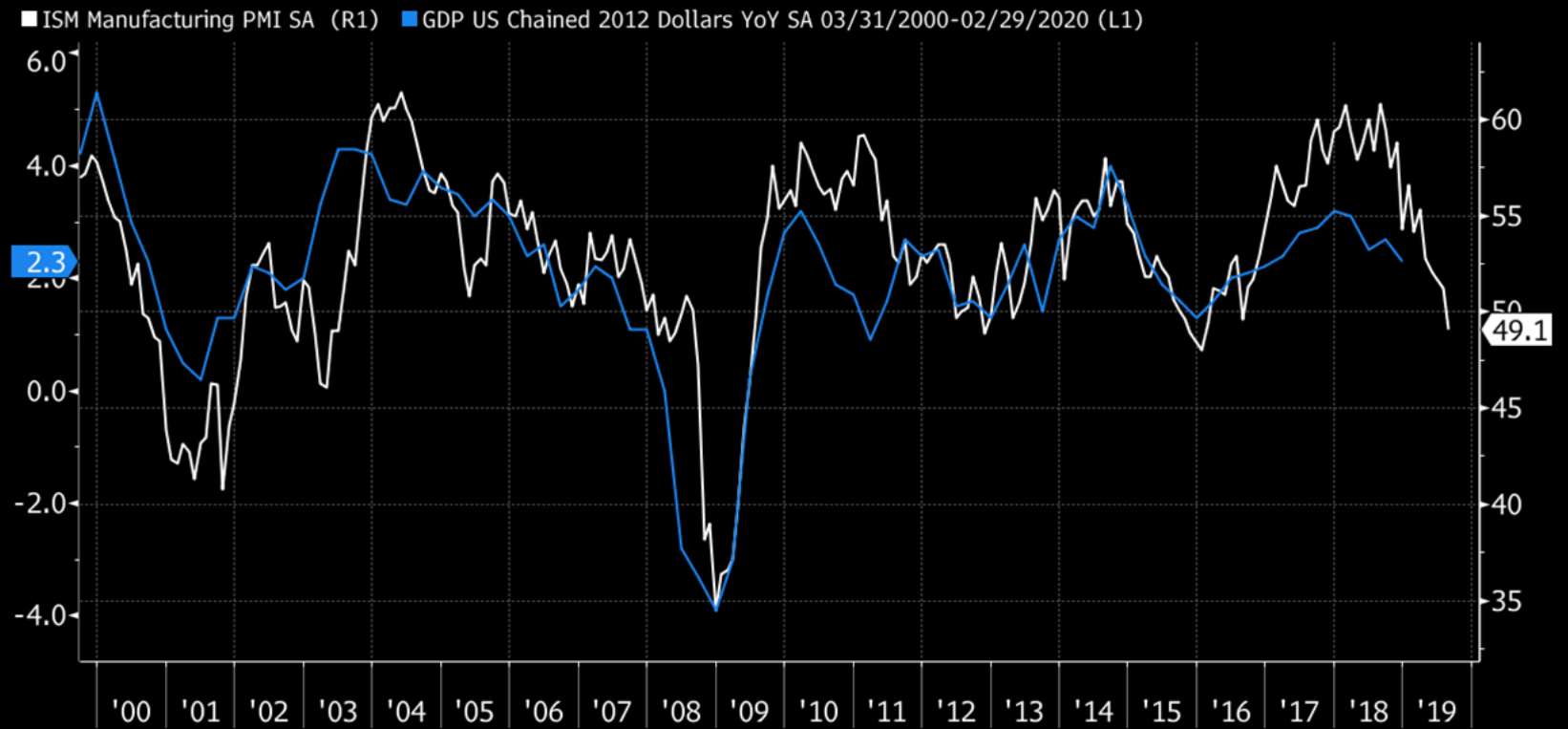
Source: Bloomberg



Manufacturing as a GDP Indicator

An Alarmingly Reliable Leading Indicator

GDP growth tends to follow the ISM manufacturing index - with a 6-month lag



Source: Bloomberg



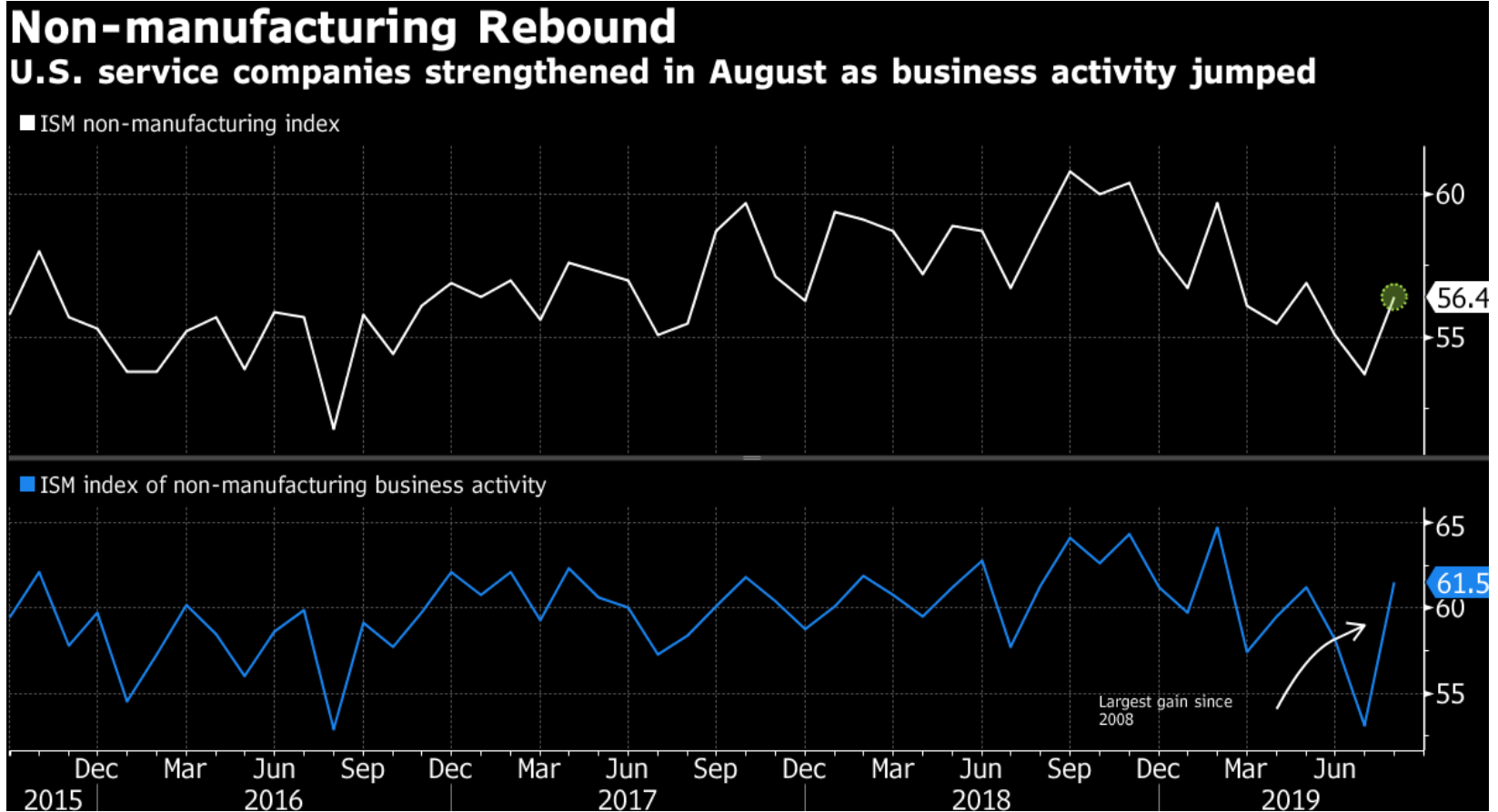
Global Decline in Manufacturing



Source: Bloomberg



Service Industries Strong For Now

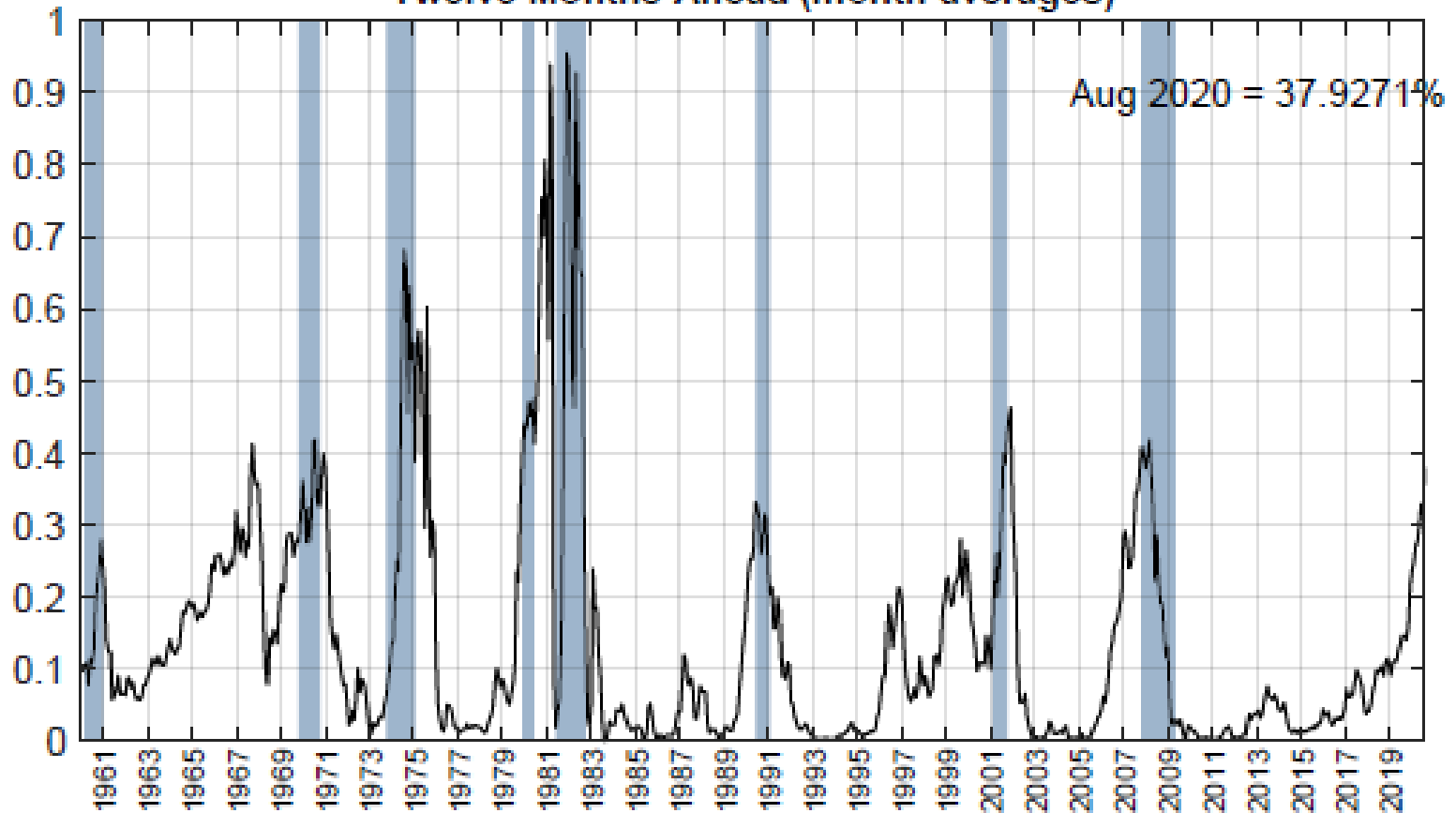


Source: Bloomberg



Recession Probability Has Risen

Probability of US Recession Predicted by Treasury Spread*
Twelve Months Ahead (month averages)



Source: New York Fed



Impact on the Bond Market

\$17T of negative-yielding global bonds currently

Interest Rates in the <i>Developed</i> World														
As of 8/14/2019														
Country	Policy Rate	6-Month	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	30-Year
Switzerland	-0.75	-1.16	-1.12	-1.12	-1.13	-1.12	-1.12	-1.10	-1.08	-1.08	-1.13	-1.03	-0.80	-0.52
Germany	-0.40	-0.75	-0.79	-0.88	-0.94	-0.92	-0.87	-0.87	-0.83	-0.78	-0.71	-0.65	-0.51	-0.18
Netherlands	-0.40	-0.81	-0.86	-0.89	-0.87	-0.87	-0.81	-0.74	-0.70	-0.63	-0.58	-0.52	-0.40	-0.16
Sweden	-0.25	-0.50	-0.65	-0.71	-0.68	-0.61	-0.53	-0.44	-0.33	-0.17				
Denmark	-0.65	-0.75	-0.88	-0.90	-0.88	-0.83	-0.74	-0.60						
Finland	-0.40	-0.76	-0.81	-0.81	-0.78	-0.75	-0.65	-0.61	-0.51	-0.47	-0.38	-0.20	0.06	
Japan	-0.10	-0.22	-0.23	-0.28	-0.28	-0.30	-0.31	-0.33	-0.34	-0.33	-0.28	-0.23	-0.05	0.19
Austria	-0.40	-0.71	-0.79	-0.79	-0.77	-0.71	-0.66	-0.57	-0.55	-0.49	-0.39	-0.13	0.19	
France	-0.40	-0.71	-0.78	-0.82	-0.81	-0.74	-0.67	-0.60	-0.52	-0.45	-0.37	-0.06	0.47	
Belgium	-0.40	-0.80	-0.72	-0.78	-0.80	-0.74	-0.66	-0.61	-0.54	-0.46	-0.39	-0.32	-0.04	0.53
Ireland	-0.40	-0.64	-0.63	-0.61	-0.55	-0.42	-0.34	-0.20	-0.09	0.22	0.74			
Spain	-0.40	-0.53	-0.50	-0.52	-0.51	-0.38	-0.31	-0.19	-0.09	-0.03	0.05	0.15	0.56	1.03
Portugal	-0.40	-0.55	-0.53	-0.60	-0.45	-0.33	-0.28	-0.13	-0.07	-0.02	0.10	0.18	0.52	1.04
Italy	-0.40	-0.21	-0.06	0.12	0.52	0.69	0.96	1.00	1.23	1.29	1.31	1.58	2.07	2.59
United Kingdom	0.75	0.73	0.55	0.47	0.36	0.36	0.35	0.31	0.34	0.38	0.36	0.46	0.76	1.07
Australia	1.00	1.04	0.88	0.72	0.67	0.67	0.67	0.73	0.79	0.85	0.92	0.94	1.18	1.55
New Zealand	1.00	1.73	0.80				0.86		0.98			1.10	1.28	
Canada	1.75	1.64	1.56	1.33	1.29	1.23	1.17		1.17			1.15		1.37
United States	2.13	1.93	1.80	1.60	1.54		1.50		1.54			1.59		2.03

Concept courtesy of @CharlieBilello

<https://www.biancoresearch.com>

Source: Bianco Research



Impact on the Bond Market (cont.)

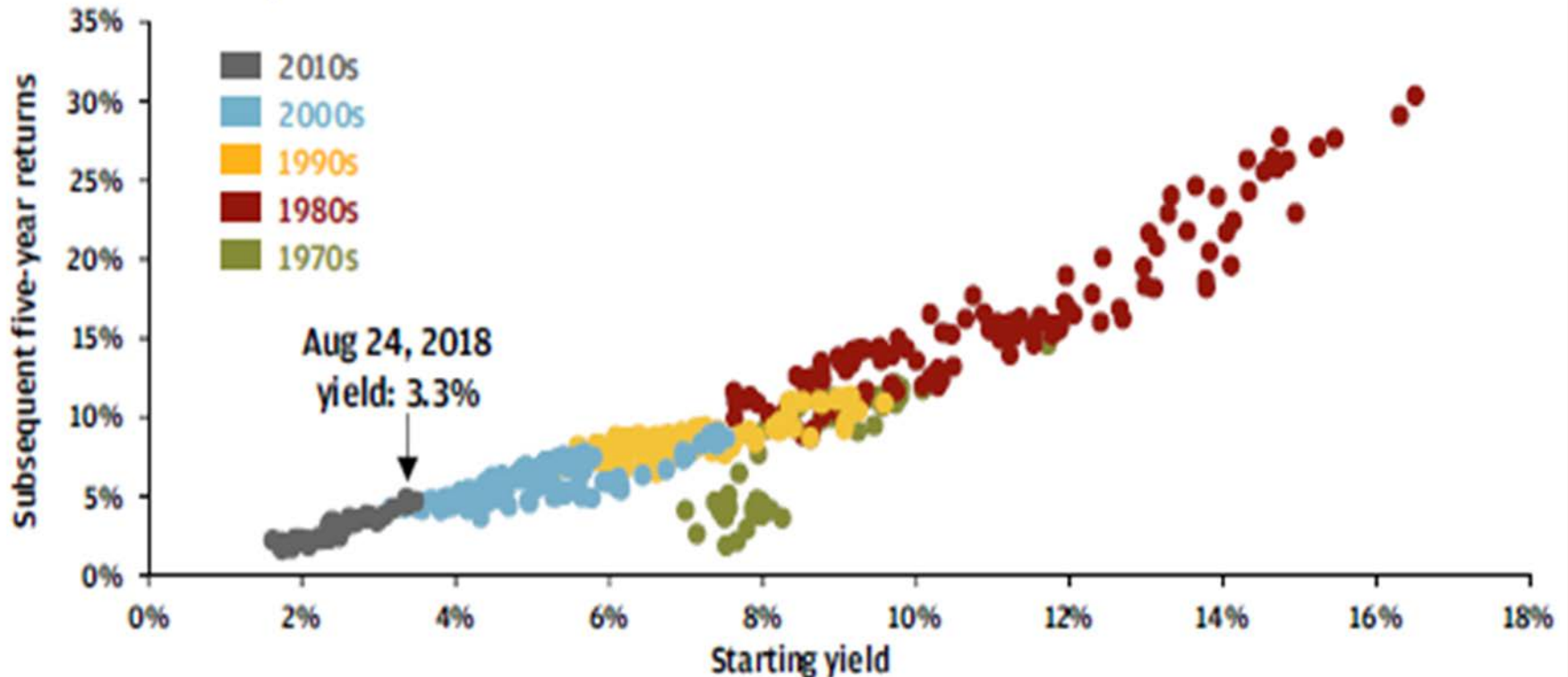
- Treasuries as a global safe haven
 - Record lows in US rates
- Inversion of US Treasury Yield Curve
 - Bond market volatility
 - More Fed rate cuts expected
 - Global central banks easing



Bond Portfolio Implications

1. Cash will yield less than it is today.
2. Ratchet down return expectations from bonds in the future.

EXHIBIT 4: RELATIONSHIP BETWEEN STARTING BOND YIELDS AND SUBSEQUENT FIVE-YEAR RETURNS FOR THE U.S. AGGREGATE % return versus % yield

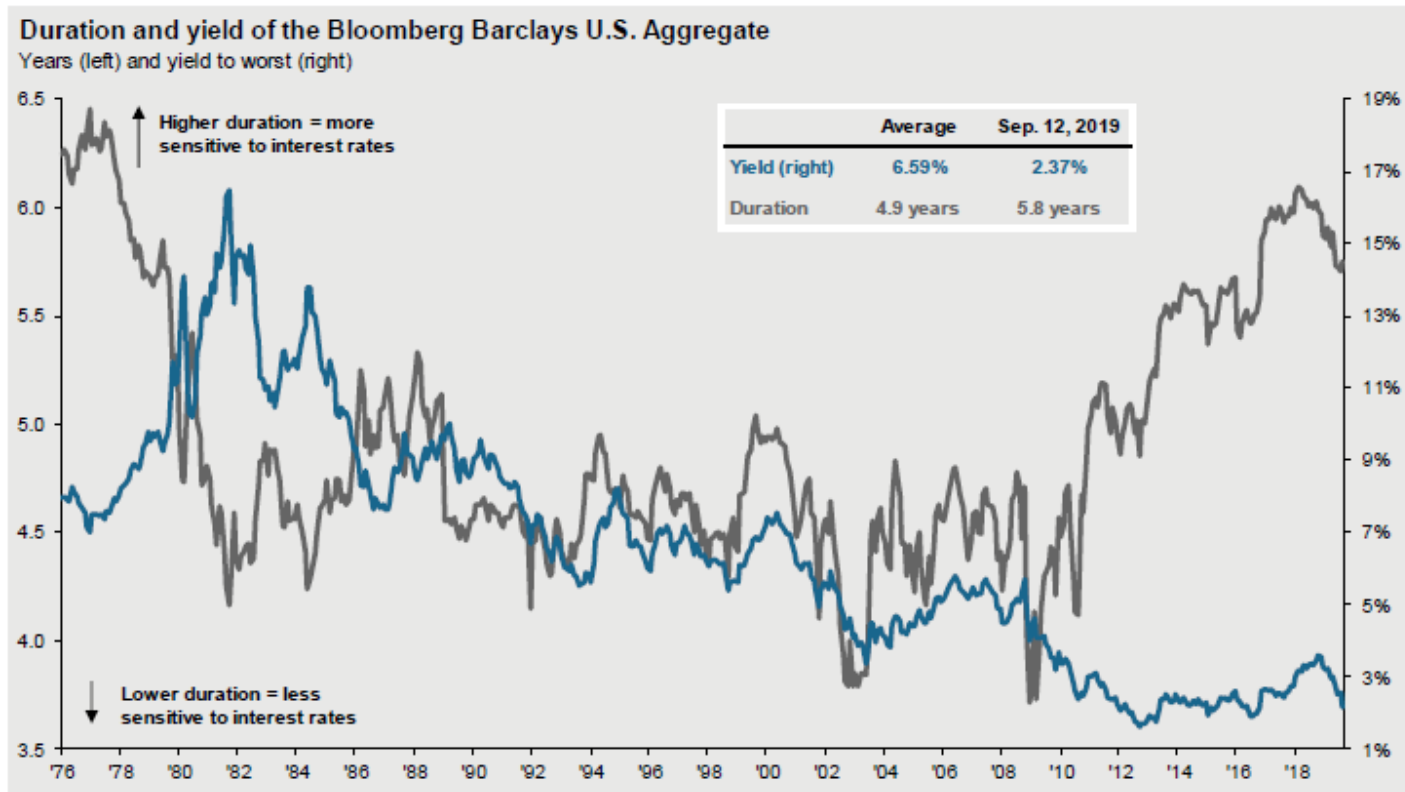


Source: J.P. Morgan Asset Management



Bond Portfolio Implications (cont.)

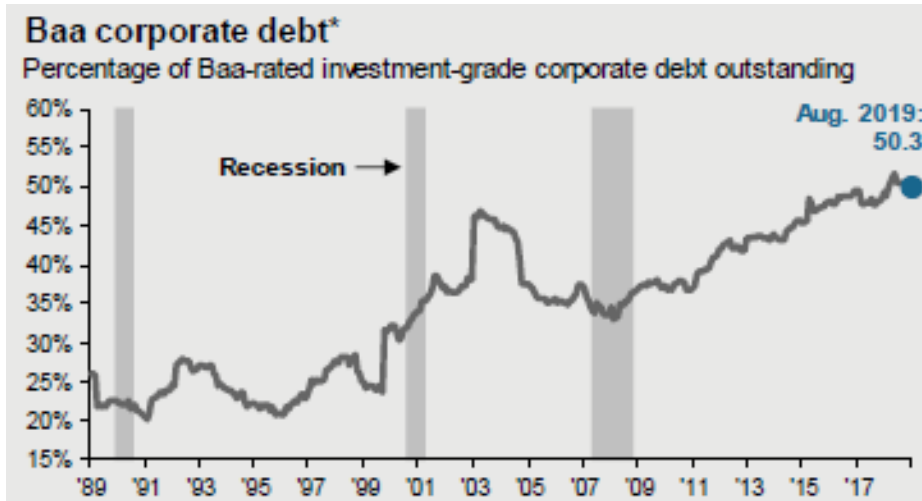
3. Recognize the risks in passive fixed income instruments. The Barcap Agg Index has a historically low yield today and greater interest rate sensitivity.



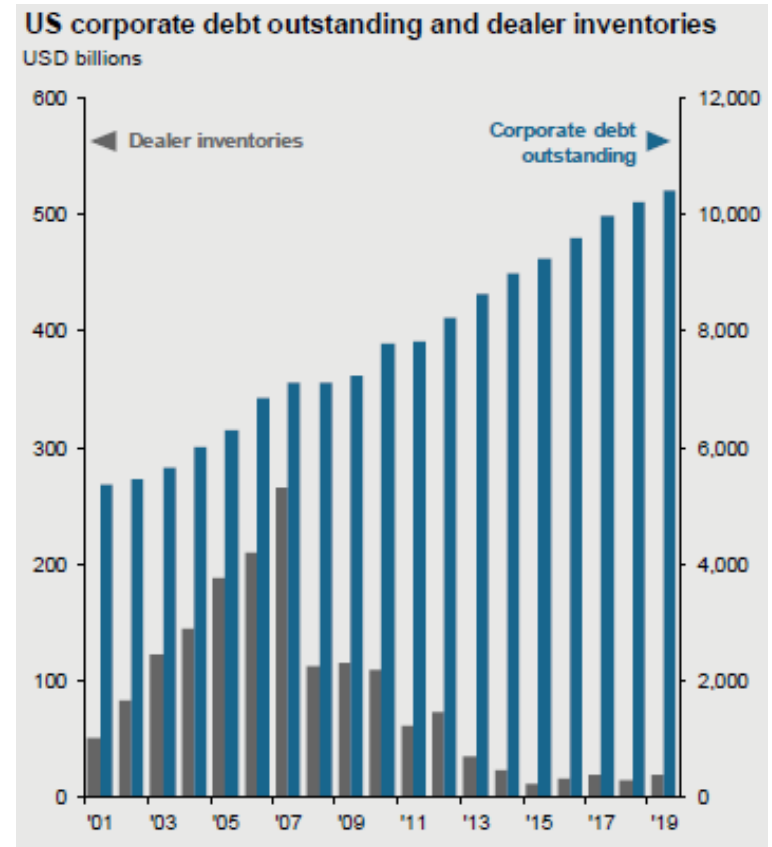
Source: J.P. Morgan Asset Management



Bond Portfolio Implications (cont.)



4. In the US, there is more corporate debt today, much of it one level away from a junk rating. Recessions can exacerbate weak corporate balance sheets and trigger defaults. Be mindful of the risks (narrow spreads, downgrades, liquidity, etc.) in corporate debt.

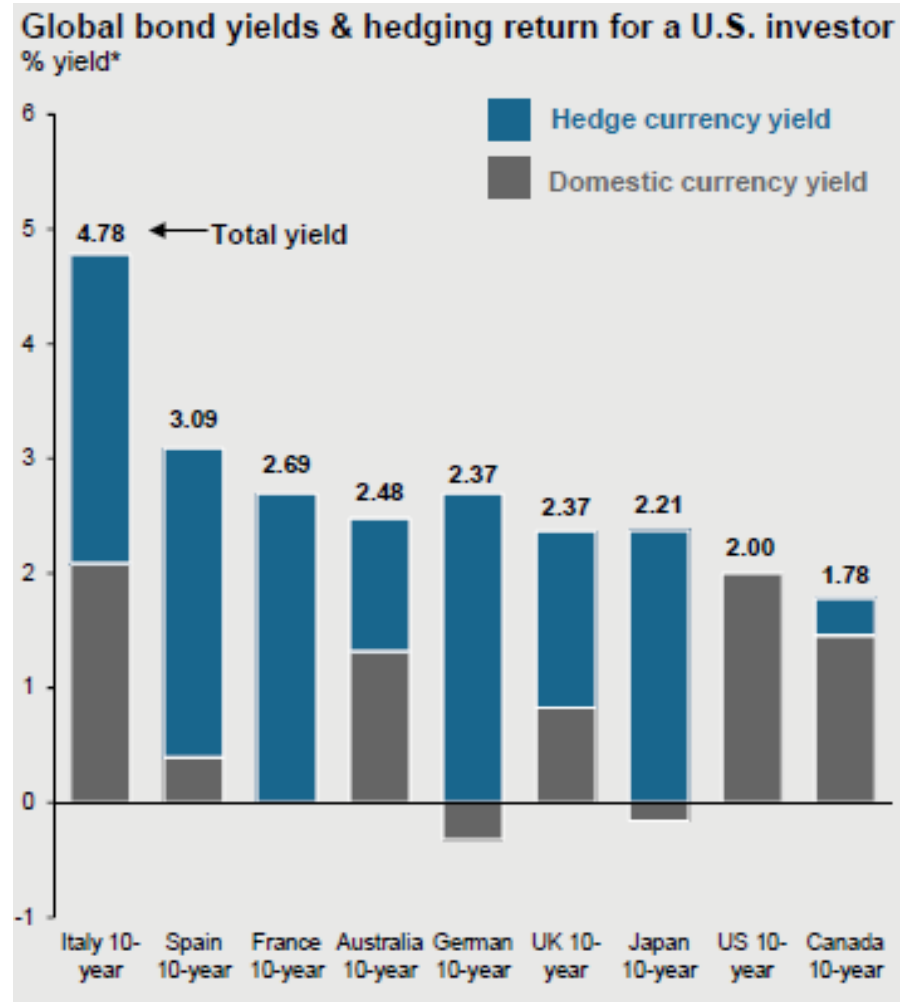


Source: J.P. Morgan Asset Management



Bond Portfolio Implications (cont.)

5. Tread carefully in global bonds.
6. It is difficult to pursue income yield, capital preservation, and equity diversification in a single solution. Be clear about your aim in fixed income investing and expect to make trade-offs across these aims.



Source: J.P. Morgan Asset Management



www.riverviewtrust.com

360-693-7442

900 Washington Street, Suite 900
Vancouver, WA 98660

