Race to the Bottom

From bond yields to currencies; fiscal stimulus to the rescue

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We wrote in our last report that the breakdown in the Sino-U.S. trade talk in May triggered a global stampede into sovereign bonds that took the U.S. 10-year Treasury yield down from 2.5% to 2%. Before the ink on the report had dried, President Trump set off another sovereign bond stampede by tweeting on August 1st that he would impose 10% tariffs on the last $300 billion of Chinese exports to the U.S. on September 1st. Although he later delayed the tariffs on roughly $150 billion of consumer goods to December 15th to avoid disrupting Christmas shopping, the damage to the market psyche was already done. It did not help that economic data out of China and Germany continued to weaken, and the months-long protests in Hong Kong turned violent. Equities wound up losing ground for the month. However, it was the bond bubble that stood out: 10-year U.S. Treasury yield dropped from 2% to 1.5%, and the 30-year yield collapsed to all-time lows. By late August, the 2-year/10-year U.S. Treasury yield curve inverted for the first time in 12 years.

In the commodity space, crude oil and base metal prices declined over the softening global growth outlook, but gold as a haven surged 7.5%. On the currency front, the U.S. dollar gained on most except the yen. Emerging markets were the big losers. The yuan broke through the psychologically important 7 level and hit 11-year lows as a response to Trump's higher tariffs. Argentina peso tanked 26% as the country was about to default again. The Brazilian real lost 8% while the world watched helplessly the burning of the Amazon rainforest. Amazingly, Brazilian President Bolsonaro refused to accept $20 million of international aid unless he receives an apology from French President Macron. The former was criticized by the latter for his handling of the forest fire and for dissing the French first lady on social media -- who else can be so thin-skinned and petty? In spite of the forest fire, the hottest June and July on record, and the extreme melting of Greenland's ice sheet, the Trump Administration planned to ease methane emission regulations for the oil and gas industry. Methane is 84 times more potent than carbon dioxide in causing global warming. Perhaps Denmark can come to the rescue by agreeing to sell Greenland to our dealmaker-in-chief in exchange for tougher regulation on methane emissions.

EQUITY MARKETS INDICES[1]	7/31/19 Price	8/30/19 Price	MTD Change	YTD Change
MSCI All Country World	524	511	-2.6%	12.1%
S&P 500	2980	2926	-1.8%	16.7%
MSCI EAFE	1897	1843	-2.9%	7.1%
Russell 2000	1575	1495	-5.1%	10.8%
NASDAQ	8175	7963	-2.6%	20.0%
TOPIX	1565	1512	-3.4%	1.2%
KOSPI	2025	1968	-2.8%	-3.6%
Emerging Markets	1037	984	-5.1%	1.9%
Fixed Income				
2-Year US Treasury Note	1.87%	1.51%	-37	-98
10-Year US Treasury Note	2.02%	1.50%	-52	-119
BarCap US Agg Corp Sprd	1.08%	1.20%	12	-33
BarCap US Corp HY Sprd	3.71%	3.93%	22	-133
USD Performance				
Chinese Renminbi (CNY/$)	6.88	7.16	3.9%	4.0%
Brazil Real (Real/$)	3.81	4.15	8.7%	6.8%
British Pound ($/GBP)	1.22	1.22	0.0%	4.9%
Euro ($/EUR)	1.11	1.10	0.8%	4.4%
Japanese Yen (Yen/$)	108.78	106.28	-2.3%	-3.1%
Korean Won (KRW/$)	1183.05	1211.30	2.4%	9.0%
US Dollar Index (DXY)	98.52	98.92	0.4%	2.9%
Commodities				
Gold	1414	1520	7.5%	18.5%
Oil	58.6	55.1	-5.9%	21.3%
Natural Gas, Henry Hub	2.23	2.29	2.3%	-22.3%
Copper (cents/lb)	267	253	-5.0%	-3.7%
CRB Index	179	170	-4.6%	0.3%
Baltic Dry Index	1868	2378	27.3%	87.1%

Source: Bloomberg.

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THE GREAT GOLD HEIST

It was the worst of times for America's economy as three years of depression had shrunk the nominal GDP by more than 40%, and the unemployment rate had surged to 25%. However, on the morning of Saturday, March 4th, 1933, there was hope in the air as Americans waited by the radio for Franklin D. Roosevelt's inaugural speech.

The new president opened his address by asserting the belief that "the only thing we have to fear is fear itself." He blamed greedy bankers and businessmen for America's economic malaise and declared that his greatest primary task was to put people to work. He concluded by asking Congress for broad Executive power to wage a war against the emergency – "as great as the power that would be given to me if we were in fact invaded by a foreign foe" (how prophetic). On the following day, FDR assembled a special session of Congress to declare a four-day bank holiday to stop bank runs. He then had Congress pass the Emergency Banking Act on March 9th, which created the federal deposit insurance and offered unlimited amounts of currency to banks. These moves restored confidence in America's banking system and emboldened people to redeposit their money at local banks.

A month later, FDR surprised many with his Executive Order 6102, which forbade "the hoarding of gold coin, gold bullion, and gold certificates." All people, including foreigners in the U.S., were required to turn in their gold to the Federal Reserve by May 1st, 1933 in exchange for $20.67 per troy ounce (equivalent to $400 today), or face a penalty of up to $10,000 ($193,000 today) and/or up to 10 years in prison. By taking gold from private hands, it enabled the Federal Reserve to increase the money supply as the currency in circulation was backed by the amount of gold held at the Fed. Furthermore, Roosevelt had another plan in the making.

In 1931, the U.K. had a budget crisis that led to a run on its currency, which forced the country to go off the gold standard in September of that year. It led to a wave of currency devaluation across Europe, Asia, and the Americas. The weaker pound made British exports more competitive and its economy started to recover in 1932. This development convinced FDR that the U.S. had to devalue the greenback to make its exports more attractive. On January 30th, 1934, the Gold Reserve Act was passed, and the U.S. dollar was devalued from $20.67 to $35 per troy ounce of gold. The 69% rise in gold price gave the U.S. government a $2.8 billion (equivalent to $53 billion in 2019) windfall profit on its gold holding, but those poor saps who were forced to turn in their gold for paper money eight months earlier were deprived of that phenomenal gain.

In August 1971, President Nixon took the U.S. Dollar off the gold standard, and on the last day of 1974, President Ford finally decriminalized gold ownership. By way of comparison, alcohol prohibition in the U.S., which was ended by President Roosevelt in December 1933, had lasted 14 years; his war on gold ownership persisted for more than 40 years. Private ownership of gold was apparently viewed as a greater sin or a larger threat than binge drinking.

BEGGAR THY NEIGHBOR

When Nixon ended the dollar's gold peg in 1971, it kicked off the era of fiat currency and floating exchange rates. During the 1970s, most countries tried to prop up their currency values in order to combat inflation. Over time, however, some started to keep their currencies undervalued in order to pursue an export-led development model. In the wake of the Great Financial Crisis, more countries pursued the weak currency policy, just like the early 1930s, as they all tried to rekindle economic growth via export. Brazilian finance minister Guido Mantega made headlines in 2010 by openly complaining of an "international currency war" started by advanced countries. Many at the time were singling out the U.S. and China as the main currency manipulators – the former for the Fed's quantitative easing programs to "print money" and the latter for its soft-peg to the depreciating U.S. dollar. The devaluation-via-money-printing strategy was later adopted by Japan in 2013 and the European Central Bank (ECB) in 2015. The U.S. Dollar started to appreciate against most currencies in mid-2014 as the Fed was poised to wind down the QE program. By late 2016, the optimism over Trump's pro-growth agenda and the expected Fed interest rate hiking cycle drove the U.S. Dollar Index to the highest levels in 14 years.

In recent months, instead of accepting the strong U.S. dollar as a consequence of his policies -- pro-cyclical fiscal expansion that boosted U.S. economic growth and protectionist measures that weakened global trade -- President Trump has repeatedly called for a weaker dollar while accusing other countries of currency manipulation. He has also made Fed Chair Powell his favorite piñata by repeatedly bashing him for not cutting rates fast enough to underwrite the trade war and weaken the greenback. On August 23rd, Trump set a new low in Fed bashing by tweeting "who is our bigger enemy, Jay Powell or Chairman Xi?"

While Chairman Powell has handled Trump's crass pressure campaign with aplomb, his ex-colleague, former New York Fed President Bill Dudley, added fuel to the fire by penning an op-ed that urged Powell to refuse supporting Trump's "manufactured disaster-in-the-making" and opined that "the election itself falls within the Fed's purview."

Dudley's ill-conceived op-ed has unfortunately created more fodder for President Trump and his acolytes to undermine the Fed's independence. They are playing a dangerous game that could ultimately erode confidence in the U.S. dollar's global reserve currency status. It's no wonder that the price of gold has climbed to six-year highs; precious metals can serve as a safe harbor in the face of rising political and economic uncertainty, fiscal profligacy, and diminished central bank independence.

RATES TO THE BOTTOM

Instead of directing his ire at Chairman Powell, President Trump should use his bully pulpit to tweet against the ECB's misguided negative interest rate policy, which has artificially weakened the euro and created massive distortions in global financial markets. It may have also contributed to the yield curve inversion which the President's opponents and the supposedly "fake news" media have eagerly played up as a sign of impending recession going into the 2020 general election.

Olli Rehn, the Governor of the Bank of Finland and a member of the ECB's rate-setting committee, recently told the Wall Street Journal that the ECB is ready to roll out "significant and impactful policy packages in September" that should overshoot market expectations. With investors currently expecting a 0.1% cut to bring the benchmark rate to negative 0.5% and a new QE program of €50 billion of monthly bond purchases, Governor Rehn may be hinting at a benchmark rate of negative 60 bps.

It does not take a stable genius to realize that the concept of negative interest rate – having lenders pay debtors to borrow money – does not make economic sense. Those who have not borrowed much with the benchmark rate at minus 0.4% are probably not going to binge on debt just because the benchmark rate gets dropped to minus 0.6%. Meanwhile, European banks' profitability has been impaired, and some are contemplating passing on the cost to retail depositors. UBS Group AG plans to lower the threshold for charging its Swiss clients an annual fee of 0.6% on deposits from €1 million to €500,000. Credit Suisse Group AG said it will impose a 0.4% fee on client's cash of more than €1 million. Some German banks have started charging "custody fees" on private customers with deposits above €500,000. The Federal Association of German Banks are pushing back at German politicians' move to explore ways to ban banks from levying the so-called "penalty interest" on retail accounts with less than €100,000 of deposits.

Pension funds are also squeezed by negative interest rates as their assets generate less income while liabilities become greater due to lower discount rates. With the size of negative yielding bonds having exceeded $16 trillion, investors are forced to buy riskier assets to reach for yield. In short, bonds with unprecedentedly low yields have turned into trading vehicles for price appreciation while stocks are bought for yield. The caveat is that stocks offer no assurance on the return of capital.

SLEEPLESS IN HONG KONG

It has been six months since Hong Kong residents started demonstrations against a proposed bill that would let local authorities extradite people to China. The situation has escalated since mid-June and turned violent of late. While Hong Kong's Chief Executive Carrie Lam has suspended the extradition bill, protesters are now demanding her resignation, formal withdrawal of the extradition bill, direct elections, leniency for those arrested, and independent inquiry on police conduct. These protests have damaged Hong Kong's economy and garnered international attention.

The next four weeks will be critical for Hong Kong as China gets ready to celebrate the 70th anniversary of the founding of the People's Republic of China on October 1st. It remains to be seen if Beijing would tolerate the ongoing protests and sporadic riots past October 1st or choose to forcefully end them before China's National Day. The former approach, a strategy of attrition, may be preferred by Hong Kong's residents and the financial market. The latter would cause much volatility in the financial market with potentially unintended consequences. It could call into question Hong Kong's status as an international financial center and regional headquarters for multinationals. Several U.S. senators have threatened to introduce a bill to remove Hong Kong's special trading status in the event of an armed crackdown. On the other hand, many Chinese believe the protests to be instigated, coordinated and financed by Western agents. President Trump has offered to mediate the situation, but that only deepened China's suspicion about America's ulterior motive. For now, risk remains elevated due to a dearth of trust among all sides and the lack of a clear path to resolution.

FISCAL STIMULUS TO THE RESCUE

While the world economy seems trapped in a downward spiral as reflected in the collapsing sovereign bond yields, the yield curve inversion, and escalating trade tension, there is a silver lining behind the economic malaise.

With the German economy potentially in the midst of technical recession, German politicians have finally shown some willingness to back off its balanced-budget policy. Germany's Finance Minister Olaf Scholz hinted that the government could come up with €50 billion in stimulus should the economy fall into recession. Economy Minister Peter Altmaier has proposed to cut Germany's corporate tax burden from the current range of 30%-33% to 25%. On the other side of the globe, the South Korean government unveiled its most expansionary budget since the Great Financial Crisis by setting the 2020 spending 8% higher than this year's expenditure. India has also announced various stimulus programs in order to reverse its sagging growth. As extreme monetary policies lose their potency on the real economy, now is the time for fiscal stimulus to pick up the baton to keep economic expansion going.

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