Financial Repression: *The fuel of the bull market might as well be its enemy*

Our clients have enjoyed a bull run across risky assets since the Great Financial Crisis (GFC) of 2008. Most of them have been enjoying a strong balance sheet since before the GFC, as they typically hold quality assets and low levels of liabilities. Ultra-expansive monetary policies and quantitative easing (QE) from the main central banks following the GFC led to a multi-year rally across asset classes which benefitted our clients. Our portfolio positioning, which has favored U.S. assets versus the Rest of the World (ROW), has also contributed to performance.

That said, in this Thinking Man, we wanted to make sure our clients are aware of the imbalances and distortions that expansive monetary policies have produced, and the unusual financial conditions that ensued as a consequence, on both the issuers (governments and corporates) and savers. Moreover, we think investors and market participants have now become "addicted" to overly-active central banks. This has made markets dependent on the Fed's stimulus every time there is a small economic concern or recession fear. This has happened before, however not to the current extent, which is large in our opinion. While we do not know how this party will end, we see risks to the downside.

Growing Government Debt and the "Japanification" Risk

Most central banks around the globe are pursuing easy monetary policies and stimulus packages that, in our view, are distorting the debt market. Negative yields in the least risky assets, such as German bunds (also known as bonds), have driven yield-seeking investors into other European, but less safe, sovereign bonds. Consequently, a bond rally across Europe has pushed yields lower, making risky debt securities look like a safe haven. For example, countries like the Czech Republic or the PIGS[1], once regarded as risky credits, now have euro-denominated debt trading at negative yields.

The chart below shows the maturities of sovereign bonds of developed economies. The quantity of sovereign bonds issued by the world's main developed economies now trading at negative yields is larger than the quantity of positive yielding sovereign bonds in those same developed economies. According to Bloomberg data, the total negative yielding debt represented in that chart is $13 trillion. Furthermore, there are approximately $25 trillion in bonds with negative real yields (yield below inflation).

[1] PIGS is an acronym for certain historically economically weak Eurozone nations during the European debt crisis that started in 2008-2009. The acronym refers to Portugal, Italy, Greece, and Spain and was expanded to include Ireland in 2008.

The Thinking Man's Approach

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Ignacio Pakciarz | CEO
Helen Gerstenfeld | Analyst
Eduardo Sensel | Analyst

- Our clients have benefitted from an accommodative Fed due to the rally it generated across risky assets. Nevertheless, we want to show the imbalances and distortions that expansive monetary policies have produced.
- In the government bond universe, yields have been pushed to negative levels globally. There has also been an over-extension in the search for duration and a tendency towards deflation ("Japanification").
- In the corporate world misallocations of capital have been a result of a loose monetary policy (zombification and increased funding gaps), and we encourage investors to recognize these distortions.
- We believe that when a recessionary threat reappears there might not be any monetary ammunition left.

For more on how we are positioning our portfolios, please contact your investment advisor or

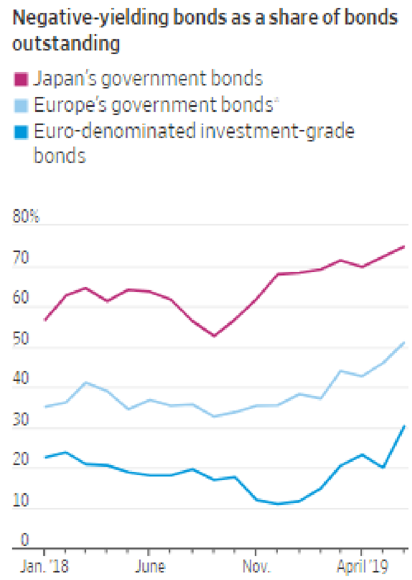
ideas@bigsurpartners.com

*Figures as of June 20

Source: Refinitiv

To put these numbers in context, total government debt exceeded \$65 trillion in 2018[2] globally, which means that real negative yielding bonds now represent around 38% of total global government debt. Since the beginning of 2018, the number of negative-yielding bonds has increased significantly. The graph to the right shows the uptick in negative-yielding bonds as share of total bonds outstanding.

Investors are scrambling not only for yield but also for duration. We have seen that investors in centennial bonds from Mexico, Argentina, and Brazil - which performed poorly last year - are now holding on to one of the best performing asset classes. For example, Mexico's 100-year bond has outpaced returns on almost all other sovereign notes – delivering a return of over 20% year-to-date (YTD). Italy, long considered Europe's fiscal problem child, attracted demand of around €17.5 billion (\$19.6 billion USD) in early July for its 50-year bond.



Notes: Japan's data exclude bills. Europe's government-debt data exclude bills and strips, but include inflation linked bonds, and are for the 14 largest eurozone economies, excluding Luxembourg and Denmark, Sweden, Switzerland and the U.K. (converted to euros).
Source: Tradeweb

[2] Bloomberg. "Global Debt of \$244 Trillion Nears Record Despite Faster Growth". https://www.bloomberg.com/news/articles/2019-01-15/global-debt-of-244-trillion-nears-record-despite-faster-growth

The causes for drop in bond yields are various and hard to measure. They include a slowing global economy mainly driven by a deceleration in Chinese growth, dropping expectations of future inflation, an escalating trade war, muted inflation, and the global economy being "hampered by aging demographics and weak productivity."[3]

In the U.S., the Fed has responded to these factors by indicating that it would likely cut the Federal Funds rate at its July meeting. Given that the market is already pricing in new rate cuts, the Fed needs to deliver in order to avoid a tightening of financial conditions and a potential economic slowdown. It is debatable, though, that the Federal Reserve should be easing monetary conditions when the general economy seems to be performing well, as suggested by the robust labor, consumer, and housing markets. Given GDP growth of 2.3% in 1H 2019 and unemployment rate near a half-century low of 3.7% in the U.S., it seems strange that rates are being cut. We believe that the market has "bullied" the Fed into cutting rates in order to continue feeding the economic expansion.

In our view, there is an analogy to be made between the U.S. and Japan and the reliance on central bank stimulus. According to Jan Loeys, senior strategist at J.P. Morgan, this situation "raises the prospect that the U.S. could join the zero bond yield world of Japan and Europe in the next few years."[4] The U.S. seems to be heading towards a "Japanification" of its interest rates, which can end up in a vicious cycle of low real economic growth and deflationary pressures. For example, Strategas shows how personal savings rates started to climb in the U.S as a result of financial repression. This could be signaling a deflationary spiral, in which consumption drops and savings increase as future inflation expectations continue to fall and consumers defer their spending. As rates keep going lower, the central bank will eventually run out of monetary tools to keep on feeding the economy, and the deflationary cycle will be hard to break.

Despite savings and household income increasing, monetary intervention has worsened inequality. An accommodative central bank has helped wealthy people get wealthier because their assets have become inflated. On the other hand, real wage growth has been modest over the past ten years, so QE has had a detrimental impact on people with no assets and large liabilities. Monetary expansion did not "raise all boats."

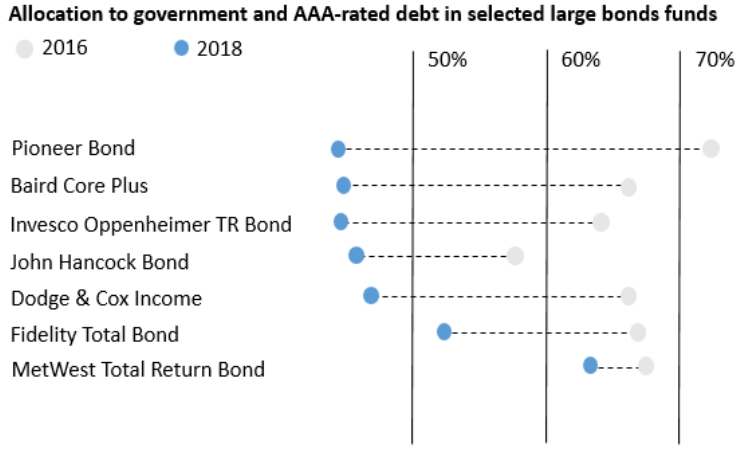
The Surge of Corporate Debt and Misallocation of Capital

On the corporate side, monetary intervention of central banks has increased corporate debt levels. Investors looking for higher yields have pushed yields lower in Investment Grade (IG) and High Yield (HY) corporate bonds. As the graph shows, 2019 saw another rise in negative-yielding euro-denominated corporate bonds. In the HY space (BBB- and lower rated bonds), where yields were once in the 7%, 8%, or even in the double digit range, yields are now low and even negative. Bloomberg notes that the number of euro-denominated junk bonds trading with negative yield is now 14 compared to 0 at the beginning of the year. Is the old HY debt now possibly IG debt? We do not think so, but investors are behaving in this manner. The corporate world seems to be over-leveraged, and not all of it is necessarily "good" debt.

[3] Wall Street Journal. Bond-Yield Plunge Confounds the World's Economy. https://www.wsj.com/articles/world-economy-comes-to-grips-with-bond-yield-plunge-11561311410

[4] Financial Times. "Betting man Kyle Bass wagers Fed policy will turn Japanese." https://www.ft.com/content/fa8cfc36-a7d0-11e9-984c-fac8325aaa04

Bond Funds are also invested in less AAA-rated securities and government bonds, and moving towards riskier debt (showing the "push for yield" or the "push towards risk") seen in the graph to the right. We believe that the number of "negative" junk bonds issuers will likely increase as a result of this trend. None of this is because the underlying credit is financially stable, but because some investors, like endowments and pension funds, are searching for the returns they have struggled to find in other sub-asset classes.



Data: Bloomberg (Fund Filings and Investor Reports)

Cheap financing has also resulted in the percentage of non-earning companies increasing. Strategas notes that the percentage of Russell 2000 non-earners is currently 36%, while the long-term average is 25.8%. According to Bank of America Merrill Lynch, 16% of companies in the U.S. are "zombified."[5] Artificially low interest rates allow companies that are not necessarily profitable to borrow cheaply and stay afloat for longer. This brings several negative consequences, such as capital misallocation that could be used in healthy companies.

We have also seen a change in capital allocation in "healthy" companies. Instead of investing in their business, companies have preferred to engage in share buybacks. According to Bloomberg, spending on share repurchases increased more than 50% in 2018, to $819 billion and "America's 500 largest companies are poised to spend almost $1 trillion removing shares from public markets this year."[6] This is because when the risk free rate is lowered, hurdle rates also fall and buybacks suddenly become a popular investment that simultaneously increases earnings per share. Funding gaps have also increased in non-financial corporates, since debt financing is cheap. We are seeing that not only "zombie" companies are being sustained by these low interest rates, but healthy companies have crowded out long-term investments in productivity, and funding gaps have increased. With an accommodative Fed everyone becomes more accommodative. The problem is that this economic environment might have sheltered companies too much to be prepared for an economic meltdown.

BSP View

While we do not know when or how the bull run will end, we believe that an ultra-expansive monetary policy has produced imbalances and distortions that presents threats in both the government and corporate debt spaces. Continued super-loose monetary policy has also led to misallocations of capital with negative implications for long-term investments in the productive factors of the economy. We

[5] "Central Banks Are Spawning A Zombie Apocalypse" https://seekingalpha.com/article/4259993-central-banks-spawning-zombie-apocalypse

[6] Bloomberg. "The $1 Trillion Buyback Hysteria May be Overstated. Here's Why" https://www.bloomberg.com/news/articles/2019-05-29/the-1-trillion-buyback-hysteria-may-be-overstated-here-s-why

encourage investors to recognize these distortions and not to overlook the fundamentals of issuers in the search for higher yields.

In the government bond universe, we have seen how bonds issued by countries that were considered risky currently offer yields similar to those of much safer issuers. There has also been an over-extension in the search for duration in several sovereign bonds.

This pattern is also seen in the corporate bond universe, where investors are increasingly turning to high yield debt in the search of yield not offered by investment grade bonds. The demand for HY bonds has been so high that some issues now have negative yields. In other words, loose central bank monetary policy has allowed low quality companies to have access to cheap debt. At the same time, monetary policy has allowed high quality companies to have larger funding gaps, finance stock buybacks with extremely cheap debt, usually at the expense of long-term capital spending.

An accommodative Fed has fueled the bull run and made wealthy people even wealthier. However, as investors pour into riskier assets for return, caution is warranted in our view.

In summary, our clients have benefitted from the rally in risky assets that an accommodative Fed has allowed. However, we believe there are limitations to what the Fed can do to protect investors from a market or economic downturn, that could be triggered by a specific event, such as mounting trade tensions or unexpected U.S. Presidential election results. We recommend clients be aware of the asset and market distortions generated by continued ultra-loose monetary policy and remain diversified as a way to protect their portfolios on the downside.

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