Neal Foundly
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Meltdown management

The recently published book, *Firefighting: The Financial Crisis and its Lessons*, is a terrific read.

It details the unravelling of the 2007 - 2009 credit crisis and was written by the three men that led the key institutions at the time, Ben Bernanke who was the governor of the US Federal Reserve, Tim Geithner, New York Federal Bank President, and Hank Paulson who was Treasury Secretary.

As the title suggests, the authors were in the white heat of the crisis, charged with trying to quell the flames as the financial system was in meltdown. It's a fascinating story of how events unfolded.

The financial regulators at the time were ill-prepared for the inferno. Their hardest challenge was not so much as coming up with solutions but getting the appropriate permissions from the government and regulators to implement them. Many of the institutions that blew up were investment banks and non-bank financial companies, and yet most of the contingency plans in place at the time were designed for plain vanilla bank failures.

As they watched the dominos begin to fall, they could see what was needed to be done but could not convince the authorities to move in time – as they say, "it's hard to fix something before it breaks".

On page 111 they directly answer a key issue on investors' minds today: "A decade later, the vital question to ask is whether the US is better prepared today. We believe the answer is: yes and no. There are better safeguards in place to avoid a panic in the first places. But the emergency authorities for government officials to respond when an intense crisis does happen are in many ways even weaker than they were in 2007."

Having finally put the fire out by 2009, the emergency powers that they were given were wrested back such that, "in general, the crisis managers of tomorrow will have less authority and less flexibility to take action to support the financial system than we had."

Sparks?

Both bond markets and equity markets are now taking the prospect of a recession in the US pretty seriously.

In our newsletter back in April we talked about the heightened state of alert in the US bond market, in particular as the government bond yield curve had "inverted", resulting in long-term bond yields falling below short term yields. This may seem like anodyne financial trivia but many leading bond investors are taking it as a cue that a recession is looming.

Within the bond market, there's been a flight to safety with high demand for government bonds, whilst some of the riskier corporate bonds have been sold off.

Not only that, but investors are expecting that central banks will respond by lowering interest rates to fend off weak economic growth. The market is now pricing in almost a 60% probability of three (or more) interest rate cuts this year by the Federal Reserve – with one already announced in June that would amount to more than four cuts in total for 2019. In a 'normal' economic cycle such a rapid pace of cuts would imply a severe economic shock; there were four in 2007 and five in 2008.

However, whilst that might reflect investors' expectations, they are often wrong. The bond market invariably over- or under-estimates the future movements in interest rates.

No interest

Bond investors have sought safety to such an extent as to drive prices up and – given the inverse relationship between yields and prices – yields down so far that many are now negative. Today, if an investor was to buy any bond issued by the German or Swiss governments, they would be guaranteed to lose money if they hold the bonds to maturity because they are all at negative yields.

It's not just secure economies like Switzerland that are experiencing this. This has become a growing phenomenon in 2019 as investors have sought safety and a total of $16 trillion of debt now has negative yields, more than a quarter of the global bond market.

This does lead to perversities in the financial system. Savers need positive interest rates to encourage them to save for future expenditure; capital markets price asset values and discount cashflows and liabilities using interest rates.

Indeed, Jyske Bank, Denmark's third largest, has started offering borrowers a 10-year mortgage at minus 0.5%. Borrowers will make a monthly repayment as usual but the amount still outstanding will be reduced each month by more than the borrower has paid (although there are the inevitable fees and charges payable on top). Equally, they have started charging clients interest for deposit accounts.

Long-term bond yields generally reflect the outlook for growth for an economy, and clearly bond investors are currently pretty gloomy about prospects if yields are so low as to be negative.

Free money

So, what can be done? Some commentators have suggested that governments should go on spending sprees to build and renew infrastructure to provide a good old-fashioned fiscal boost to growth and stimulate employment. The idea is that this would be funded by issuing long-term government bonds - after all, investors are willing to pay to own them.

The problem here is that the aggregate amount of debt built up by governments has increased significantly since the credit crisis. In the US, debt as a percentage of GDP is reaching post-war highs and is expected to rise (assuming no new economic crisis) from 79% this year to 95% in 2029. The picture is similar in other major economies with the debt-to-GDP ratio across advanced economies now standing at 76% as compared to 45% in 2001.

This leaves little in the way of ammunition to deal with another crisis. The authors of *Firefighting* acknowledge this and are clear in their message: "Right now, even a modest recession could leave Washington without much leeway to respond to a financial crisis."

That said, at Equilibrium we do not share the bond market's very negative outlook. Yes, some economic data, especially in manufacturing, has been weak and, yes, many investors have fled to safe bonds driving yields below zero, but we think this is classic behavioural over-reaction. Remember that only nine months ago the markets were worried about how far interest rates were expected to rise in order to put the brakes on growth.

Of course, there is always the danger that global investors talk – or tweet - their way into recession, but important economic drivers such as US consumer demand and employment remain robust for now and do not presage a downturn.

Indeed, there is a danger that the bond market may be whipsawed as expectations of interest rate falls evaporate and investors think again about the guaranteed losses on negative yield bonds. A large rise in yields would also be felt in the equity market, as we saw in the fourth quarter of last year. This is a key rationale behind our holdings in the alternative equity portfolio which provide returns with little correlation to both bond and equity markets.

No alarm

At the beginning of August, Donald Trump sent shockwaves through markets as he tweeted that he was to go ahead with plans to impose tariffs on $300bn of Chinese goods. As equity markets fell, we took advantage of the weakness and bought a UK FTSE 100 index fund at around 7,100. As with previous "volatility trades", we will look to sell this position if we see a gain of around 5%. Such trades allow our clients to capitalise on knee-jerk reactions in markets, especially in the current climate of geopolitical turbulence.

We heed the lessons from the leading protagonists of the last credit crisis in the *Firefighting* book. They inform our strategy for the next downturn. However, we are not at that point yet and, indeed, agree with their assessment that, "The financial system seems stronger today and, in some ways, the economy seems more stable as well. Banks are safer and are providing the credit the economy needs to grow."

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Investment Newsletter

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General economic overview

The threats and soundbites from both sides of the US/China tariff talks continue to heighten the risks to global growth. Several sectors of the global economy, especially in manufacturing, have seen price rises as a result of the initial round of tariff increases. In Asia, some companies have moved production from China to other countries such as Vietnam to sidestep the tax.

That said, consumer spending in the US, which comprises nearly 70% of the economy, remains very robust and employment figures point to a tight labour market supporting wage growth.

In Europe, weak demand from Asia combined with the changes in the automotive market are major headwinds to growth. Like Germany, the UK economy contracted in the most recent quarter due largely to slower business investment. The uncertainty around Brexit is likely to result in weak UK economic performance for at least the next few months. We think central banks may cut rates but perhaps not to the extent that is now being priced in.

Equity markets

Recent volatility has led to some markets pulling back to offer better value. Many stocks in the UK now are undervalued and it is interesting to note the rising number of takeovers, especially from overseas bidders. The US stocks still look very expensive whilst some Asian markets have fallen to buying levels. We are cautiously optimistic on the outlook but volatility is expected to persist.

Fixed interest

Given the inverse relationship, the strong rise in bond prices this year have resulted in very low yields. We expect future returns to be lower but still expect positive returns over 18 months. We like active bond funds which can move between government and corporate bonds and move up and down the maturity spectrum as market conditions change.

Commercial property

Commercial property has been hard hit by Brexit-related uncertainty. This is particularly the case in the retail sector. Given the rising risks and concerns over liquidity, we have reduced exposure to around 5% of most portfolios.

Cash

With interest rates remaining at record lows, returns on cash will remain below average for the foreseeable future.

Balanced asset allocation

For a typical balanced portfolio, we are underweight fixed interest, property and traditional equity. This is balanced by additional holdings in defined returns and alternative equity, giving an overall risk/return profile roughly in line with our long-term average position.

These represent Equilibrium's collective views. The value of your investments can fall as well as rise and is not guaranteed. Investors may not get back the amount originally invested. We usually recommend holding at least some funds in all asset classes at all times and adjusting weightings to reflect the above views. These are not personal recommendations, so please do not take action without speaking to your adviser.