Infomail

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The Big Shift Begins….

The US Bond Market's Biggest Buyers Are Selling Like Never Before

In the last issue of our newsletter "Money Never Sleeps" (Bonds Aweigh!) we discussed why we thought the bond market was in a bubble and nearing a turning point. Little did we know the US election would have the implications it has had.

Donald J Trump's election has wiped out over $1 Trillion in the bond market.

Read that line again. By the time you read this, it will have been but three weeks. The global bond market has only seen a rout this bad twice in the last 20 years. On Nov 10th alone (two days after the election), the global bond market index dropped by $450 billion USD, while global stock markets gained about $1.3 trillion in the same period. Has the big shift begun?

Earlier this year, US 10-year Treasury bonds yielded 1.30%. Prior to the election, they were 1.80%, today they stand at 2.35%.

And this is not just a US phenomenon. European bonds have also had a big sell-off, with the yield on Italian 30-year bonds reading the highest level since July 2015, and German 10-year bonds hit their highest level since February. Holders like China and Japan have culled their stakes in US Treasuries for three consecutive quarters, the most sustained pullback on record.

The concern it raises is on several levels.

For individual investors, the recent consensus seemed to be that interest rates would never rise, and inflation would never raise its head again. Coming out of the Great Recession of 2008-09, the subsequent deleveraging created a deflationary environment. But its been almost a decade now, that cycle may have run its course.

Many investors have piled into long-term bonds and bond/fixed income funds reaching for higher yields. High yield bonds were only created in the mid 1980s, so they have never really experienced a sustained rising rate environment.

Interest rates could definitely move higher much faster today than in the past, simply because central banks have artificially held rates down and so many parts of the world are actually in a negative-interest rate policy (NIRP) and simply because news and information flows much quicker these days.

In my opinion, higher inflation is a much bigger risk to the bond market than rising rates. The two usually move up together, true, but I would suspect the central banks of the world will be behind the curve once inflation gets rolling.

On another level, corporations have enjoyed cheap credit for quite a long time. It's too early to tell what the impact would be on businesses (especially smaller and startups) on a higher cost of capital.

Third, what effect would higher global interest rates have on hot real estate markets like Toronto, Vancouver, San Francisco, etc.

Fourth item. Leveraged government balance sheets which are stretched like Southern Europe, Emerging Markets, US States like Illinois and California, and even our own Province of Ontario. What happens to their budget forecasts should interest rates rise even 1%?

There has been a shift in ideology, and it was happening even before the US election. Earlier this year, as I have already mentioned, consensus seemed to be low interest rates for some time, no signs of inflation, and deflationary forces at work. In but a few months, that scale has tipped to the other side, and you've seen moves in copper prices, lumber, and huge stock moves in commodity names like Teck, and even cyclicals like US Steel (up about 70% just since the US election).

Donald Trump's election has created a mandate to forcefully create policies which are designed to stimulate traditional domestic manufacturing, a more pro-business environment, and perhaps more protectionism. Aggressive simulative fiscal polices (like tax cuts) are coming as well….all these bode for <u>higher</u> inflation and rising bond yields. There seems to be a good chance the

US economy is going to shift from what has been in place for some time, and which has led to consensus type thinking.

Make no mistake, I suspect the Donald Trump presidency is a high risk/high reward type scenario, and it might take some time to see the results. He no doubt believes in leveraging what you have….he's created a global empire brand and made himself a billionaire in doing it.

I would guess he "invests" in infrastructure, but actually gets things built, not just talks about it. Government will be downsized and waste and corruption reduced. That's a good thing. The big question is what will be the social outcomes of this, and what kind of society will America become, and my guess is that too, will take some time before the end results can be tabulated.

With respect to the financial markets, so far the "Trump Rally" has been a good one, and suspect the market over the next few years will perform well under a pro-business administration.

But it may have gone too far, too fast, might last a few more weeks until year end or the Fed meeting in mid-December, but I still suspect a challenging Q1 2017 once Mr. Trump is inaugurated, and campaigning turns into actually governing the largest economy on Earth.

Stay tuned,

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