The Slow Agony of an Old Bull

Seven Signs that the 36-Year Old Bond Bull is Over

Bottom Line:

- The bond bear market is already here: short and medium-term treasuries have lost value in the past 5 years
- Buybacks have fallen to a five-year low, and big repurchasers have underperformed
- Oil prices are at a 30-month high, and the futures curve is in backwardation
- The long and the short ends of the yield curve are moving together again
- The Chinese surplus has shrunk from 10% of GDP to almost zero in the past ten years
- The U.S. deficit is growing again, an unprecedented phenomenon in times of expansion and peace
- Small bubbles are popping out: Auckland houses, Ethereum crypto coins, and collectible cars

"Phantom limb pain", a frequent syndrome among amputated patients, refers to a painful sensation in a limb that no longer exists. Similarly, pundits still argue (correctly) that U.S. long yields have not broken out of a 36 year-long descending channel, but many sectors of global capital markets are already reeling from the pain of a secular upturn in yields.

Consider the following observations:

- Short-term treasuries have underperformed inflation by 3.6% over the past five years, and medium-term treasuries have gone nowhere
- Buybacks have fallen to a five-year low, and big repurchasers have underperformed this year
- Oil prices are at a 30-month high, and the futures curve is in backwardation
- The long and the short ends of the yield curve are moving together again
- The Chinese savings glut has shrunk from 10% of GDP to less than 1% in 10 years. As I explained last week in "Four German Singularities", German surpluses should also shrink in the coming decade
- The U.S. budget deficit is growing again, despite a booming economy and no major military conflict
- Some (small) bubbles are starting to pop. Declines in the prices of Auckland houses, Ethereum crypto coins and collectible cars may be the canary in the coal mine of the "everything bubble"

Pablo Picasso, Dying Bull, 1934

On October 4th, I started what I expect to be a series of reports on higher rates with "a Demographic Case for Higher Rates". I was certainly pleased to see higher yields this past month, but bond prices will certainly fluctuate in a grinding topping process.

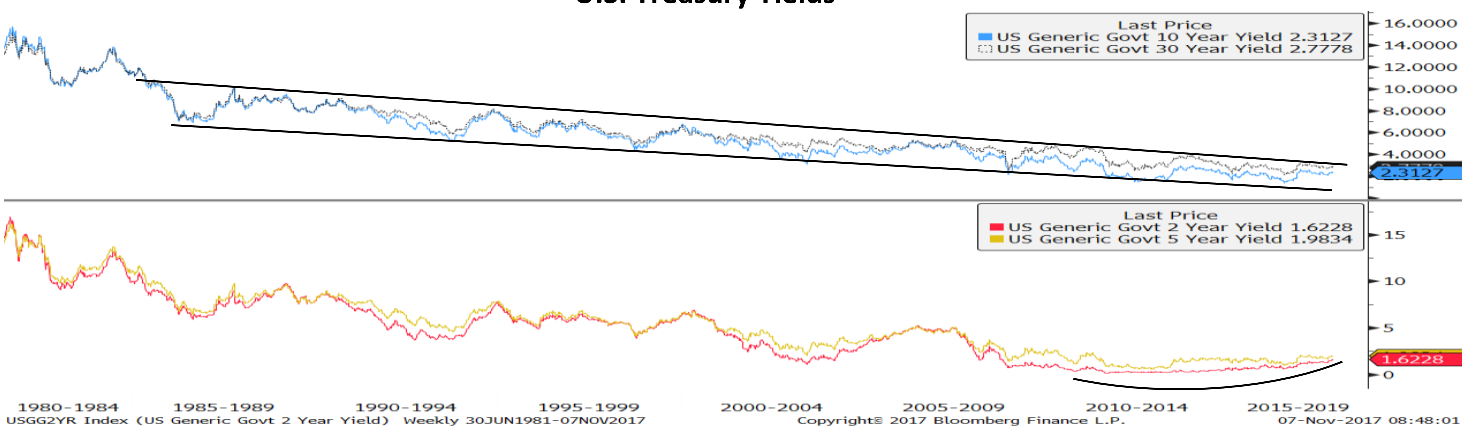
Yet, changes in secular trends reverberate across many markets, asset classes, and investment behaviors. This report should convince readers that bonds' secular bull market is over, regardless of the daily fluctuations of the 10-year yield.

The Bear Is Already There

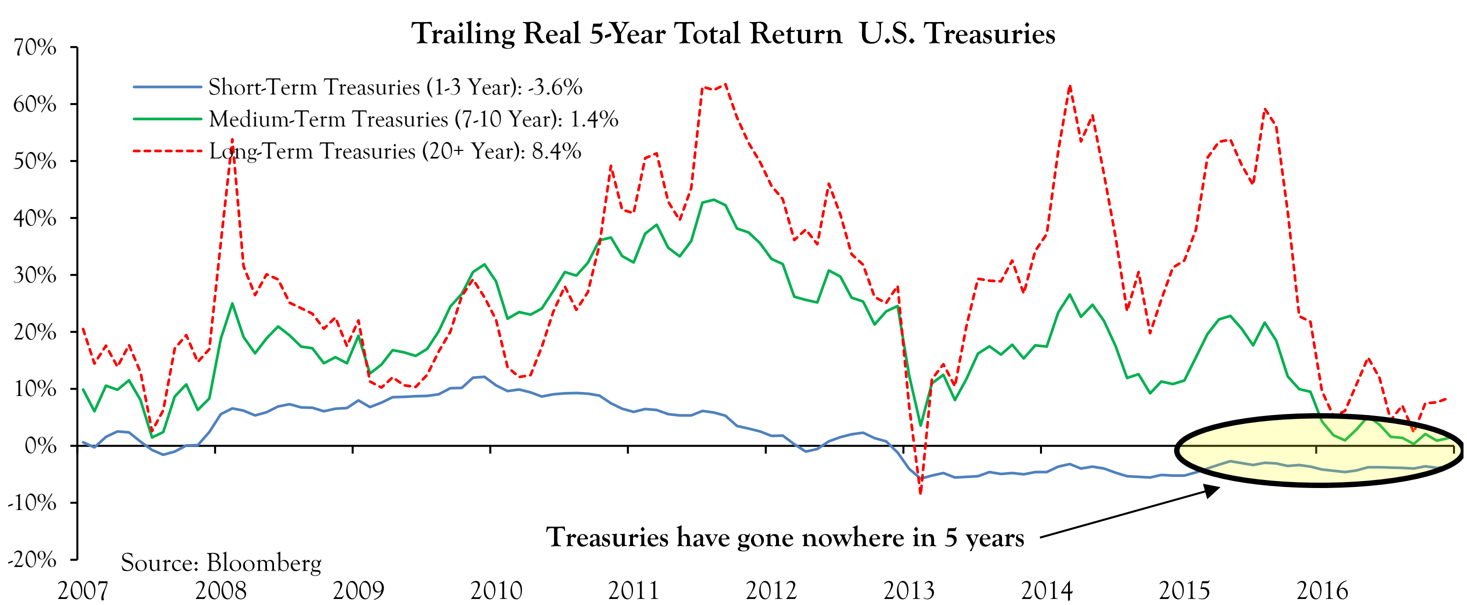
As often with charts, beauty is in the eye of the beholder. “Lower for longer” proponents are right to point that long yields have not broken from a 30-year long descending channel, and that long-term treasuries have been a great buy every time yield hit the upper band of the channel.

Bond bears prefer to point that 2-year yields are near a 10-year high, and that 5-year yields are close to break their 2011 highs. From a technical perspective, 10-year yields are in the middle of a tug of war between an already-rising short end and a still-flat long end.

U.S. Treasury Yields



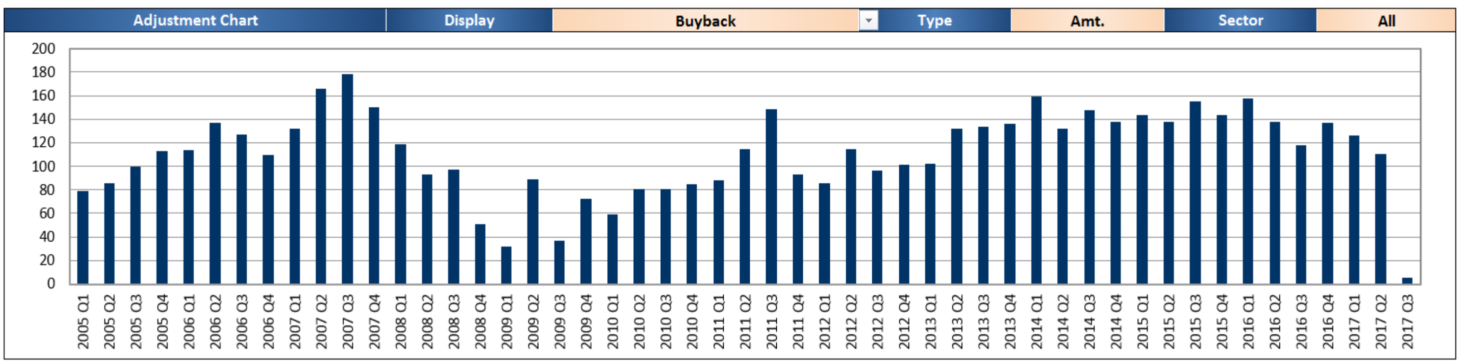
Personally, I prefer to look at real total return charts because they show whether an asset is making investors richer or poorer. Over the past five years, short term treasuries have underperformed inflation by 3.6%, and medium-term treasuries have gone nowhere. The only way bond investors made money was by extending duration. In this last phase of the bull market, investors have seemingly confused stocks and bonds: speculators have bought fixed income assets for capital gains, while long-term investors have turned to the stock market for safe income.



The Buybacks Craze is Fading

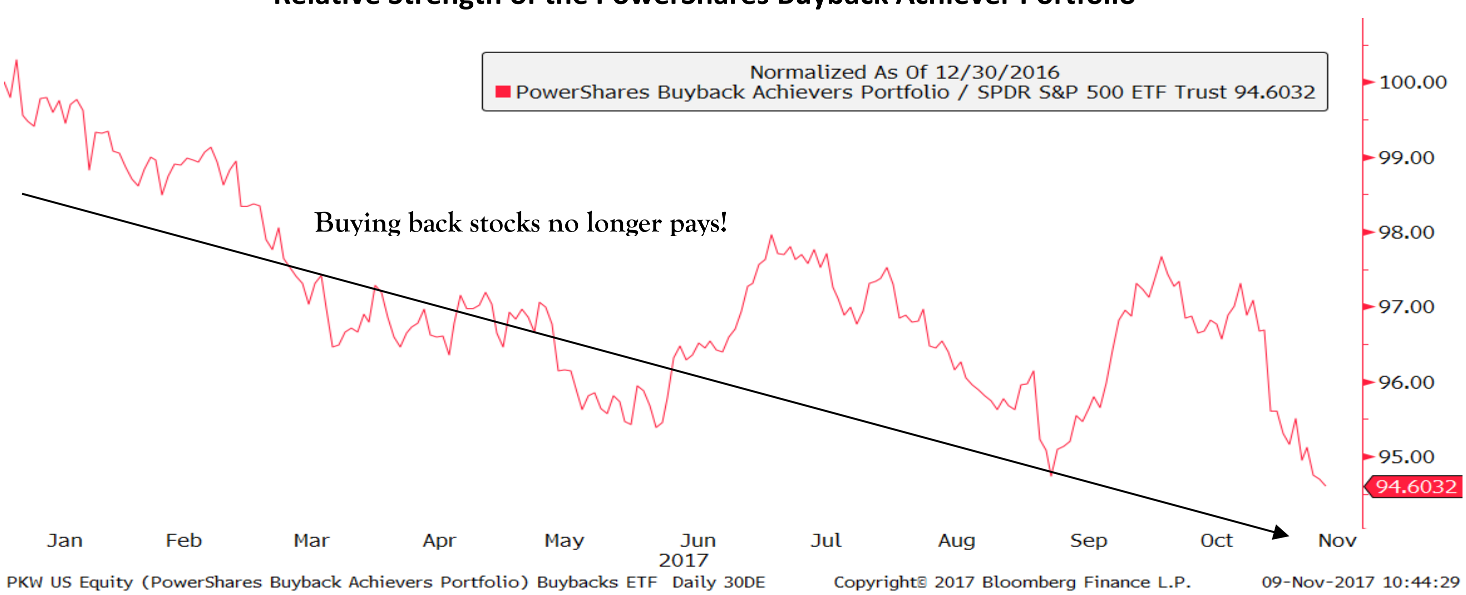
Soaring buybacks were a pleasant externality of the great bond bull market. Since the cost of debt was constantly falling, executives could magically increase shareholder value (as well as that of their own options) by taking on debt to repurchase stocks. S&P 500 index companies spent $1.7 trillion on buybacks ($142 billion a quarter) between 2014 and 2016. However, buybacks have fallen steadily this year, and are on track to reach a 5-year low of $125 billion a quarter.

Returning vast amounts of cash to shareholders made sense during the “New Normal” of low growth and low inflation. But persistently high business sentiment since the election of Trump has convinced corporate chieftains that cash can be put to better use than retiring stocks: mega deals are back on newspapers’ front pages, and the Fed’s Future Capex Index is at a 30-year high.



Stock market investors seem to agree with corporate CFOs. The largest buyback ETF, which tracks companies that have been buying at least 5% of their shares in the past twelve months, has underperformed the S&P 500 Index by 6% this year.

Relative Strength of the PowerShares Buyback Achiever Portfolio

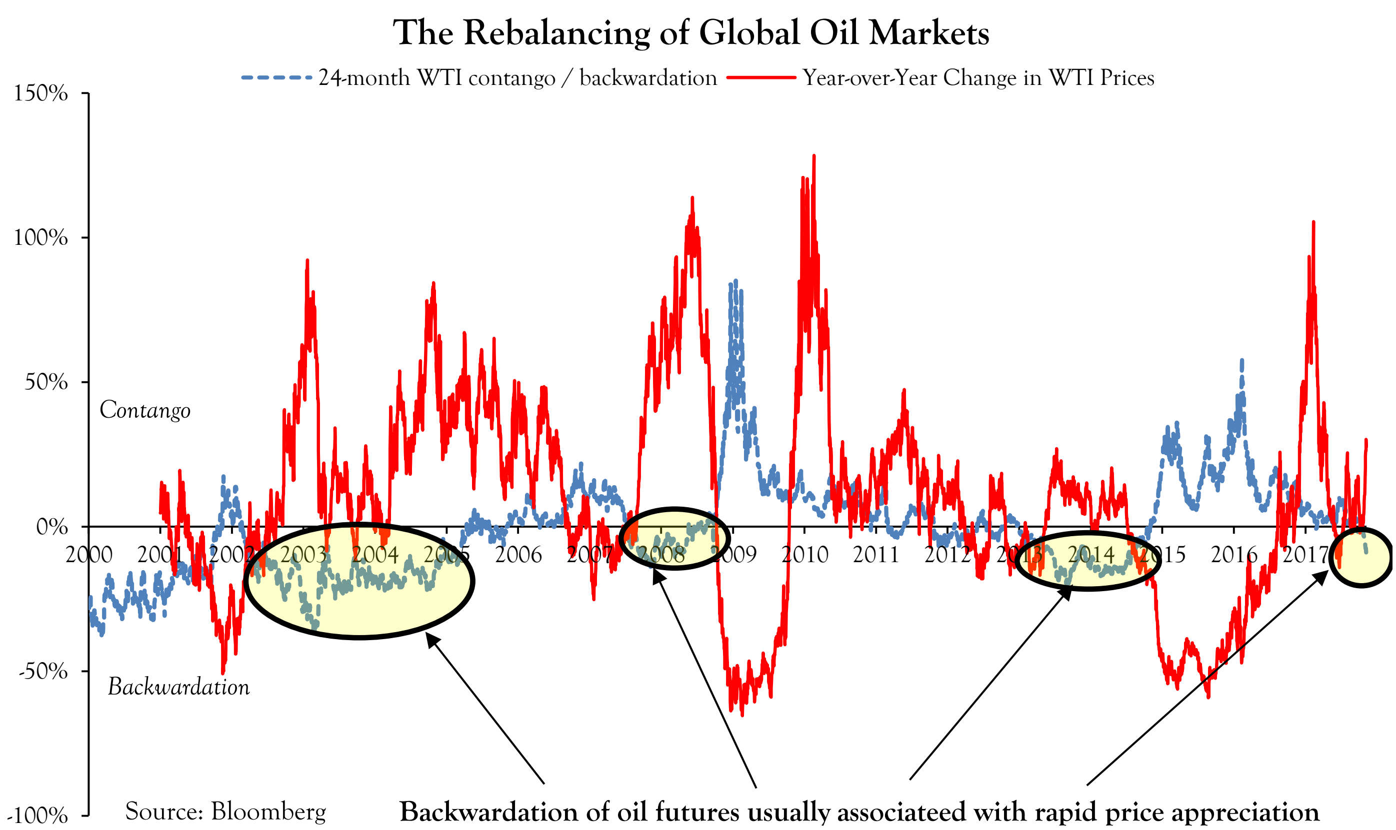


The Great Rebalancing of Oil Markets

Lower energy prices and a grinding commodity bear market have been another feature of the "New Normal". Weak global demand, technological advances, and a debt-financed investment boom in U.S. shale basins resulted in a massive supply overhang in the past four years.

As a result, oil futures were in a state of deep contango. Dealers took large discounts to get excess inventory off their hands as quickly as possible. This has changed since mid-October: WTI crude for delivery in 24 months is about 6% cheaper than the spot price.

The autumn rally in oil prices is especially significant because central bankers expected a dis-inflationary effect from the fall of commodity prices in the spring. In [Draghi's words] last month "on the basis of current futures prices for oil, annual rates of headline inflation are likely to temporarily decline towards the turn of the year, mainly reflecting base effects in energy prices." Last I checked, Brent oil was a 30-month high and about 40% higher than it was last year, so the "base effects" will be inflationary, not deflationary.



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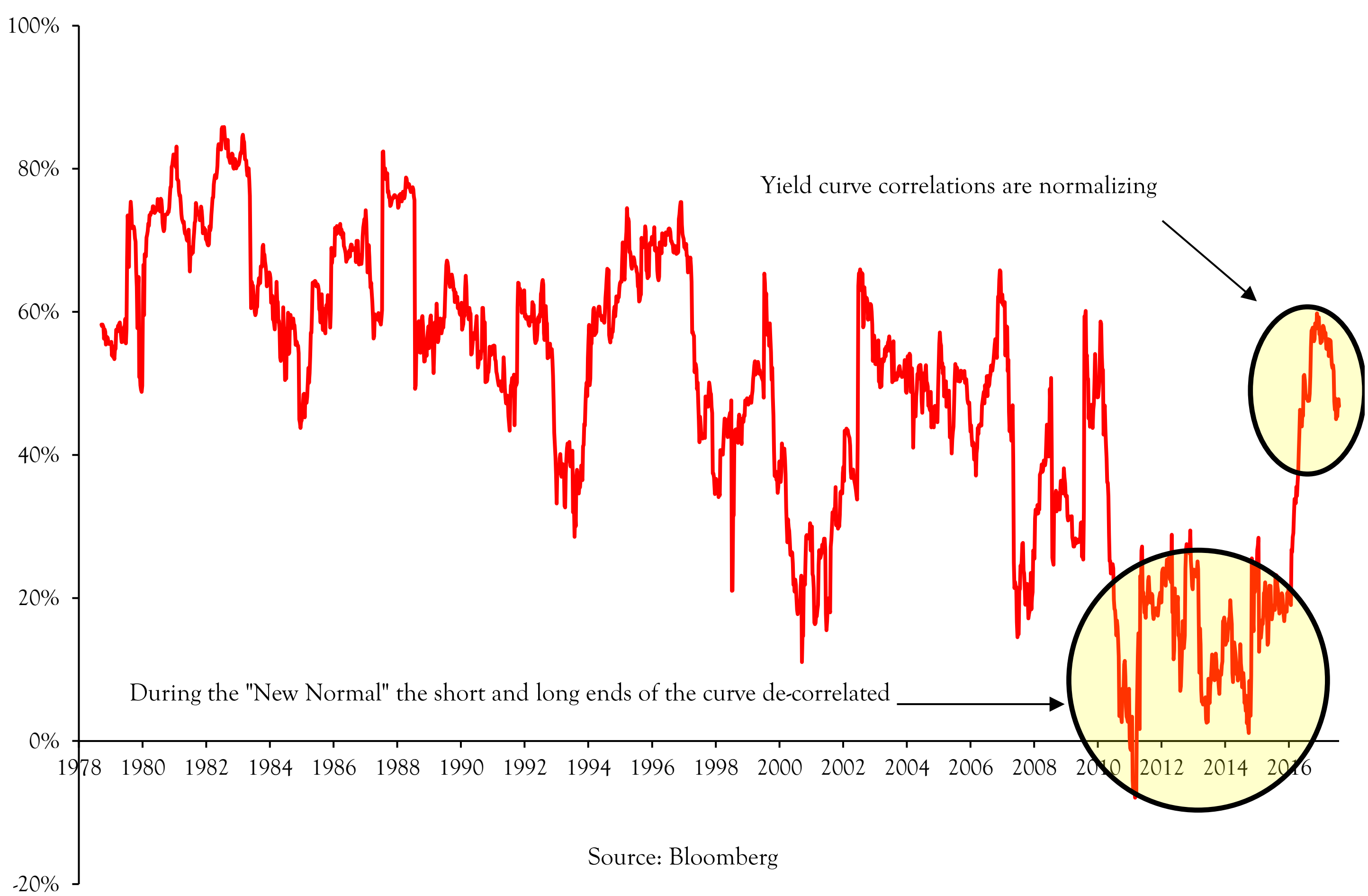
A Normalizing Yield Curve

A fourth singularity of the "New Normal" era was a breakdown in yield curve correlations. Usually, both ends of the curve move together because long rates are ultimately a sequence of short rates. Yet, the correlation between 6-month and 30-year yields fell to close to zero between 2011 and 2016. This reflected investors' blind faith in the "[New Gospel of the New Normal]": monetary policy did not matter because the world was turning into a giant Japan. Over the long-term, rates would converge towards ever-lower levels of economic growth and inflation. If short-term rates increased, long-term rates would move the other way as investors thought the economy was too weak to handle a 25-basis point hike.

This correlation, or rather lack thereof, has started to normalize since the Trump election. The correlation between changes in the 30-year yield and the 6-month yield is now a more normal 50%, which means that short-term rate hikes should shift the yield curve in a mostly parallel fashion. For reference, the futures market expects two more rate hikes by the end of 2018, while the median FOMC's dot plots has penned four more hikes.

Correlation Between the 1-Year Change in 30-Year Yields and 6-Month Yields



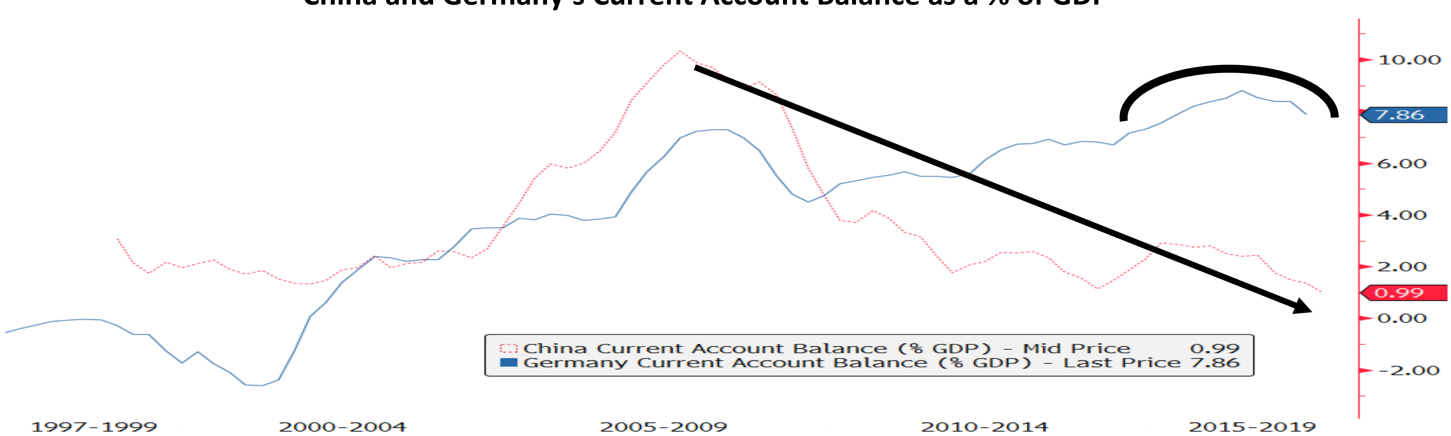
A Reduction of the Chinese and German Surpluses

As I argued in "[a Demographic Case for Higher Rates]", the savings glut of the 2010s was mostly the result of the mercantilist policies of China and Germany. These two countries have accumulated savings of $6 trillion since 2001. Rather than being invested productively, these savings have clogged global capital markets. Chinese surpluses were parked in long-term U.S. treasuries, keeping long rates from rising even when the real estate bubble was growing. In the case of Germany, trade surpluses showed up as claims on other Eurosystem banks in a ballooning €800 billion target 2 balance – much to the dismay of German economists, who do not seem to see the link between claims on eurozone banks (BAD!) and German surpluses (GOOD!).

Hence, a normalization of the behavior of China and German is a necessary condition for the normalization of fixed income yields. The process is already underway in China. In 10 years, China's surplus has fallen from 10% to GDP to less than 1% last quarter. Going forward, China could soon have a deficit because of the massive investments required by the *Belt and Road Initiative*. Better trade links with Central Asia, and Europe would redirect China's trade towards its Eurasian partners, many of which enjoy a surplus with the Middle Kingdom[1]. If the *Belt and Road Initiative* is to China what the Marshall Plan was to the U.S., China's surplus would quickly turn into a deficit. Note that this would not necessarily be a problem for China as the internationalization of the RMB would grant China the exorbitant privilege of having foreign central banks finance its structural deficits.

Germany is much less advanced than China in the process of surplus normalization: its trade surplus was still whopping 7.8% of GDP last quarter. Contrary to China, Germany has no geopolitical ambitions and is happy to accumulate surpluses – for now. Yet, as I explained last week in "Four German Singularities", the wave of boomer's retirements will deplete excess savings in the next five years. Labor shortages amidst an already-tight labor market could feed inflation and erode the country's competitiveness. The real estate bubbles in Munich, Frankfurt, and Hamburg are fueling demand for credit. Last but not least, Germany's significant foreign-born population (12 million or 15%) may not share the Germanic ethos of thrift and prudence.

China and Germany's Current Account Balance as a % of GDP



[1] China runs large trade deficits with many large *belt and road* countries: as of 2016, China had a trade deficit of $26 bn with Switzerland, $6.5 bn with Iran, $5 bn with Turkmenistan, and $2.5 bn with Mongolia.

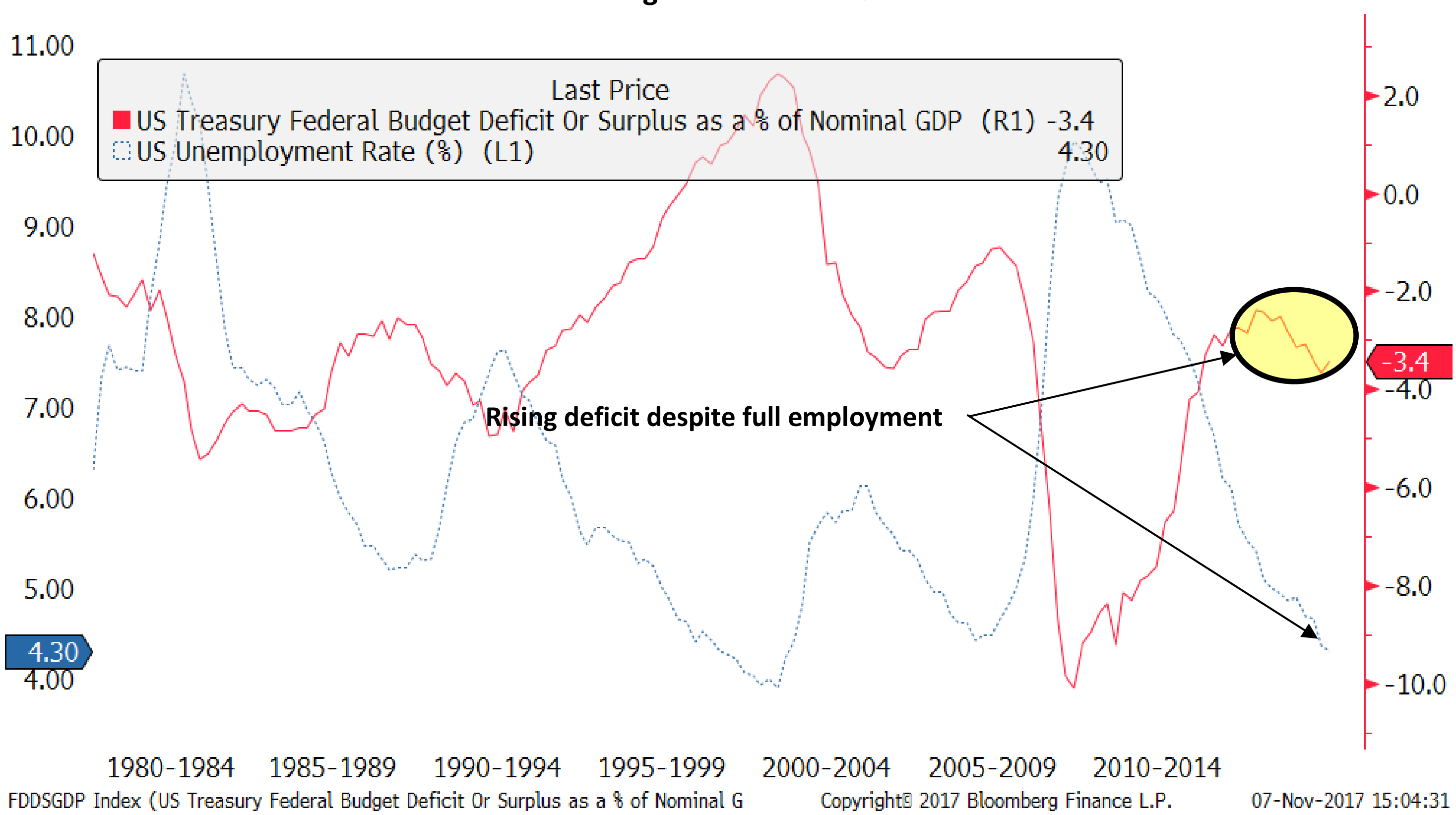
Rising Deficits in Times of Peace and Expansion

Another troubling sign comes from the U.S. budget deficit, which has increased from 2.2% of GDP to 3.4% of GDP last month. As I explained in Four Interest Rate Myths, I disagree with the austerity Cassandras who constantly crow about excessive levels of public debt. Global QE has monetized about $10 trillion of debt globally: I believe that governments in developed countries have room to re-leverage.

What I find stunning about the re-leveraging of the U.S. government is that it is happening at a time of peace and economic boom. U.S. deficits usually soar with wars (on Vietnam, on poverty, on stars, on Iraq, on drugs, on global terrorism etc) and recessions. But this time, the U.S. has effectively withdrawn from Iraq and Afghanistan, and President Trump's major initiatives have been blocked by Congress. The only logical explanation for the rise of the budget deficit is that about 10,000 of boomers retire every day, a number that is bound to rise in coming years.

If U.S. deficits are already on a structurally rising trend at constant policy, one can only imagine what will happen when (or if) Congress votes "the biggest tax cut in the history of the country".

U.S. Federal Budget Balance as a % of GDP

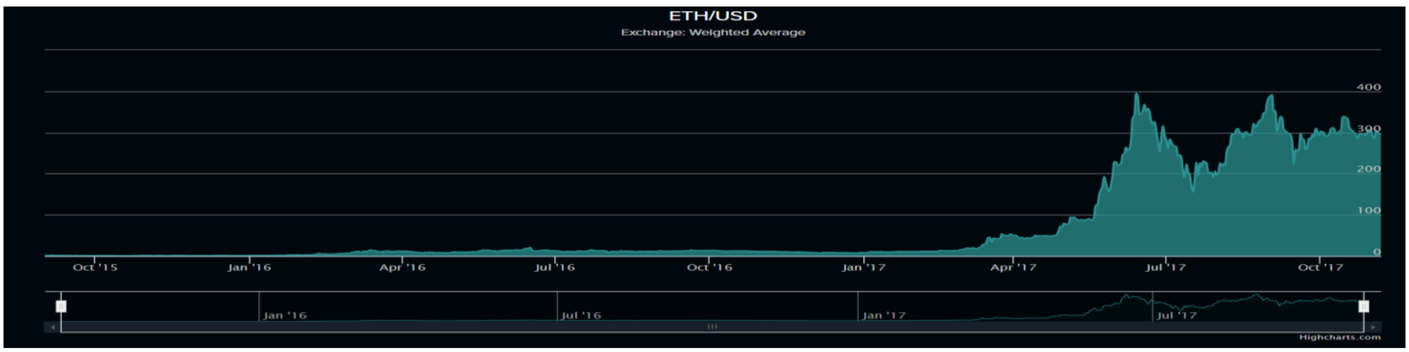


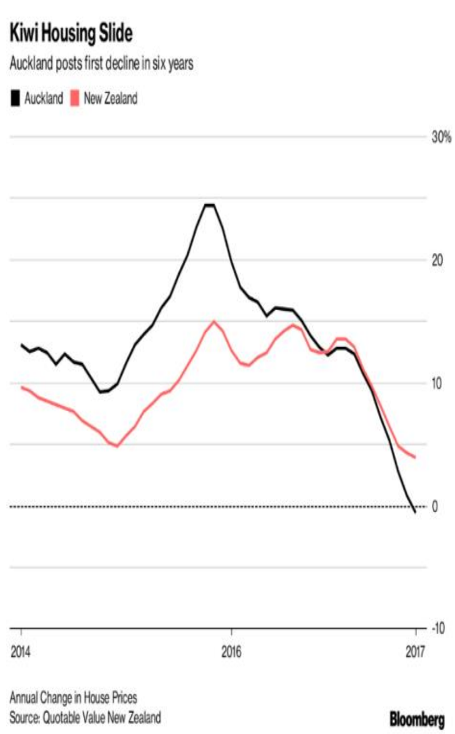
(Some) Bubbles Are Starting to Pop

This last section is probably the weakest when it comes to supporting evidence – for now. 10 years of ZIRP/NIRP/QE/QQE/LTRO/TLTRO [insert favorite acronym here] have transferred trillions of wealth to people who did not need to spend it. As a result, massive bubbles have been inflated, from traditional stocks and bonds to Vancouver condominiums, cryptocurrencies and vintage cars.

By and large, these bubbles are still growing. Bitcoin is still close to its all-time high of $7,260 and a 9,178-square-foot (853 square meter) single-family house in Hong Kong exclusive neighborhood, the Peak, just sold for $149 million (that translates in a cool price of $174,678 per square foot).

Yet, cracks are appearing in bubble land. The price of Ethereum, the world's second largest cryptocurrency by market value, has dropped by 20% since June. While I am on the topic of cryptocurrencies, I should mention that CoinMarketCap.com reports that 1,277 alternative currencies are currently in existence, and that there is about $96 billion in non-bitcoin cryptocurrency market cap.





On the real estate front, Bloomberg recently declared the end of New Zealand's housing boom. While a cooling of the Kiwi real estate market carries no systemic risk for the global economy, it may be a signal for more bubbles to pop. First, the bull market in Kiwi houses is one of the oldest on record: like the secular bond market in bonds, it started in 1981. Second, New Zealand is perhaps the smallest and most open economy in the long list of housing bubbles (Canada, Australia, Sweden, etc) and thus could be the proverbial canary in the coal mine.

Falling prices for collectible cars are another fun factoid for global macro cocktails parties. According to Hagerty.com, prices of collectible cars fell 15% in the past twelve months.

At this point, these stories are mostly anecdotal, but I would expect them to become more common. 36 years of falling bond yields have fed an "everything bubble" in seemingly unrelated assets. As this tide recedes, the prices of Dutch master paintings, collectible cars, crypto-currencies, fine wines, Marvel action figures, and Vancouver condos should start to diverge.