FOCUS: WHAT ARE GLOBAL BOND YIELDS TELLING INVESTORS?

Government bonds have rallied sharply in response to the initial threat and the subsequent dramatic support provided by the Fed and other Central Banks. For the first time, the 10-year Treasury yield fell below 0.5% and the 30-year yield dropped under 1%. However, bonds are exceptionally expensive portfolio insurance unless there is **material deflation shock** ahead − a view we do not expect to materialise.

Oil prices have crashed, equities plunged, and currencies and bonds saw wild moves as panic appeared to grip financial markets as the world headed for a full-blown price war in crude.

Contrary to popular thinking, deflation is not about a general decline in prices as such but about a decline in the money supply. This is based on the same principle that inflation is not about a general increase in prices but rather about increases in money supply.

Since the price of a ‘good’ is the amount of money paid per unit of the ‘good’, obviously, all other things being equal, the prices of goods in general will go up over time with increases in money supply and fall with decreases in money supply. To establish whether we are in deflation we need to find out what the money supply is doing.

Normally the main driving force in the expansion of the money supply is the Central Bank's loose monetary policy. By means of monetary pumping, the Central Bank injects money into the banking system. This money in turn is amplified by commercial banks’ lending through fractional-reserve banking. Currently, however, there seems to be a breakdown between the Fed's pumping and commercial banks' lending activity.

A sharp fall in commodity prices also raises the spectre of deflation. Crude has plummeted more than 30%, sliding the most since the Gulf War in 1991. The broader Bloomberg Commodity Index hit its lowest since 1986. However, the main drivers of declining commodity prices overall included historically the discovery of large, relatively low-cost deposits − which is no longer the case. Supply, now, is also increasingly inelastic; it is more difficult for supply to react timeously and fast enough to meet potential increase in demand as the EM middle-class explodes. On top of this there is evidence that points to the long-run marginal costs of many resources increasing in the future.

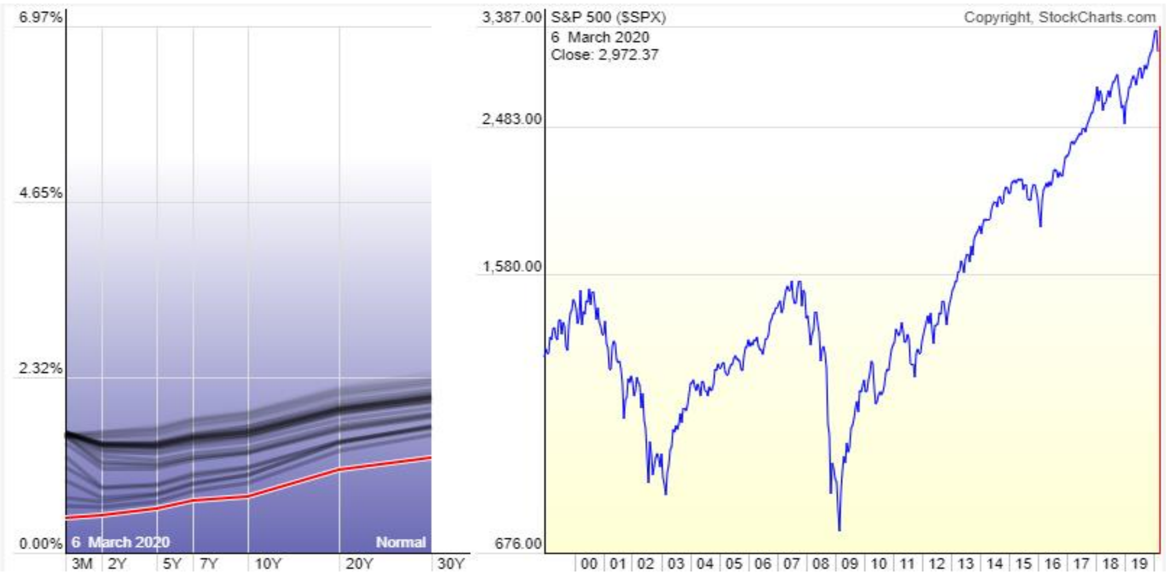
So, we would argue that what matters for deflation is the state of the money supply. If the money supply rate of growth remains a positive figure, there can be no deflation.

If we look at the recent history of US Money Supply growth, it has averaged 6.1% per quarter in this century (current reading, 7%). It reached a low, during three quarters in 2009-2010 in the wake of the global financial crisis, when it averaged 2.4%. In the current cycle, it has been growing uninterrupted since the last quarter of 2018. Looking at South Africa, our own money supply growth has averaged 10.4% per quarter this century (current reading, 6.3%), with a period low of 1.93% as it was dropping over five quarters in 2009-2010.

Despite a decline in commercial banks' inflationary credit, the offsetting monetary pumping by the Fed and other Central Banks has kept the money-supply rate of growth in positive territory. There is, however, always the future possibility that the Fed could tighten its stance in response to a strengthening in the growth in momentum of the CPI (which appears way in the future given that market inflationary expectations are non-existent).

Economic fundamentals do count and, globally, Central Banks are still clearly committed to close to zero interest rate policies; if deflation is not a threat, then on a relative valuation matrix, equity on a total return basis remains the preferred asset class. However, one needs to be careful not to get overly bearish on the recent developments in China; as COVID-19 impacts the global economy, and while making headlines is unsettling, it is a short-term "geopolitical risk".

History clearly shows recession and bear markets are 99% of the time caused by Central Bank rate hikes and "geopolitical events" do not trigger a bear market. However, "geopolitical events" do cause market corrections, of +/-10% FALLS, but recovery is seen in roughly 175 days. The yield curve and jobs data further lend support to the view that the US and the global economy are not on the brink of recession. (see graphic)



Evidence is emerging that sensible measures can significantly slow the spread of the virus. The fact that the number of new cases outside of China fell from 2,410 on March 3rd to 2,160 on March 4th indicates that these measures may be working. The confined laboratory of the 'Diamond Princess' cruise liner suggests that the true fatality rate may be under 1%. Tentative evidence that the virus has mutated into a less lethal form implies that the mortality rate could fall even more.

Investors should **remain overweight in equities**. The shift towards even looser monetary policy in the US and elsewhere has increased the probability that equities will move higher; triggering a V-shaped recovery in equity markets, and perhaps even inducing a full-fledged bubble like they did in 1998 after the Fed cut rates in the wake of Long-Term Capital Management 's implosion. Global bond yields will rise modestly from current levels; given that at current yields Bonds are an exceptionally expensive form of portfolio insurance.

As the coronavirus outbreak spreads fear, it causes price irrationality in human psyche e.g. a surge in demand for hand sanitizers and face masks, sees consumers being prepared to pay $400 for a two-pack of 2-ounce bottles of Purell, which usually goes for $10 (so irrationality not only confined to equities and bonds).

Mark Huxter, 2 March 2020