Bonds Burning, Equities Fiddling

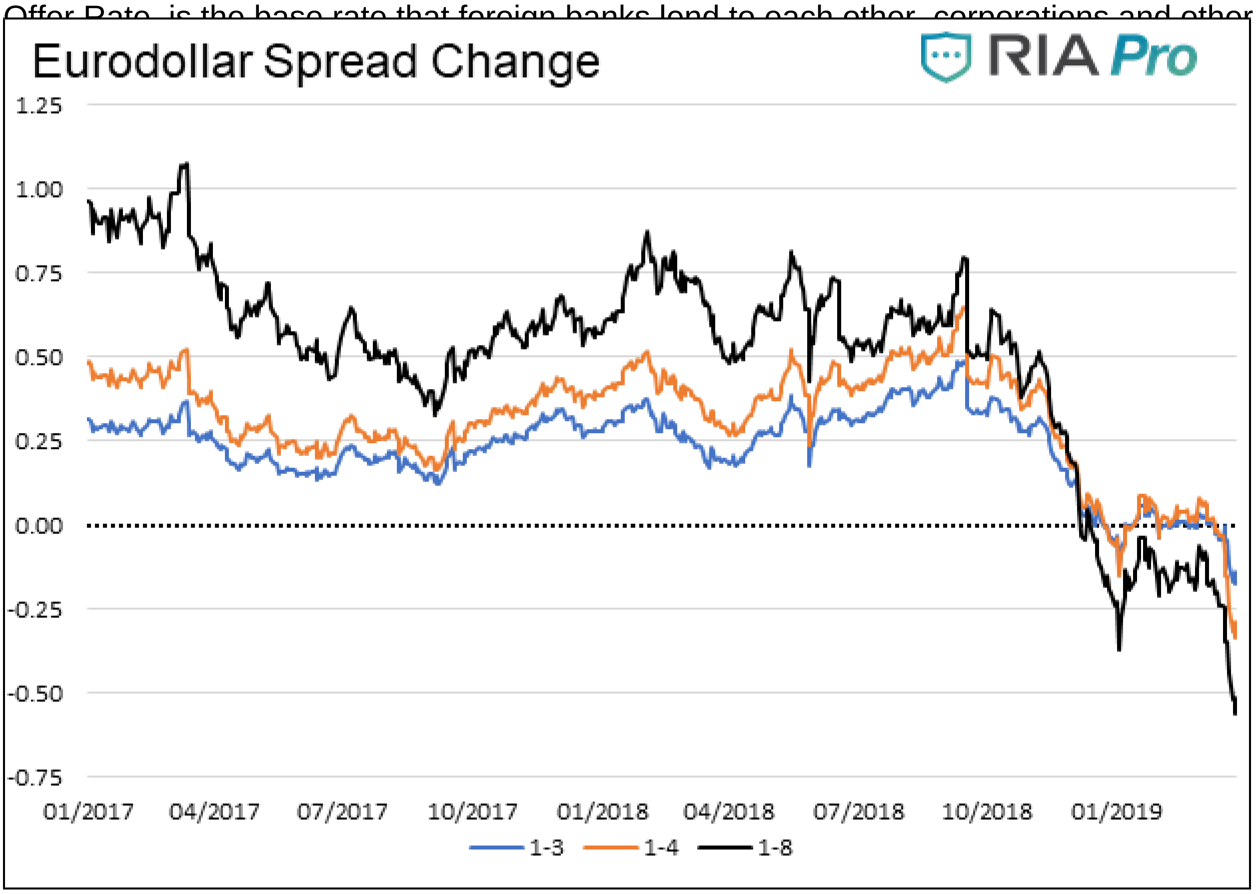
It is said that while a massive fire consumed Rome in 64 A.D., Rome?s ruler, Nero, played his violin night and day. Since then the quote, ?*Rome burned while Nero fiddled*,? has become a phrasing used when a palpable problem is ignored. Currently, the bond market and the Federal Reserve are on fire, screaming at the top of their lungs that something is wrong. All the while, the stock market fiddles as if everything is normal. In this article, we explore the steep decline in bond yields to understand what is frightening bond traders.

The Fire

The following graphs and tables will help you appreciate the message emanating from the bond markets.

Eurodollars

The first graph below charts Eurodollar contract spreads which provide us with market expectations changes for the Fed Funds rate in the future. Each Eurodollar contract represents a forward three month LIBOR rate for a specific three month period in the future. LIBOR, or the London Interbank Offer Rate, is the base rate that foreign banks lend to each other, corporations and other entities.
e from
e
nges in

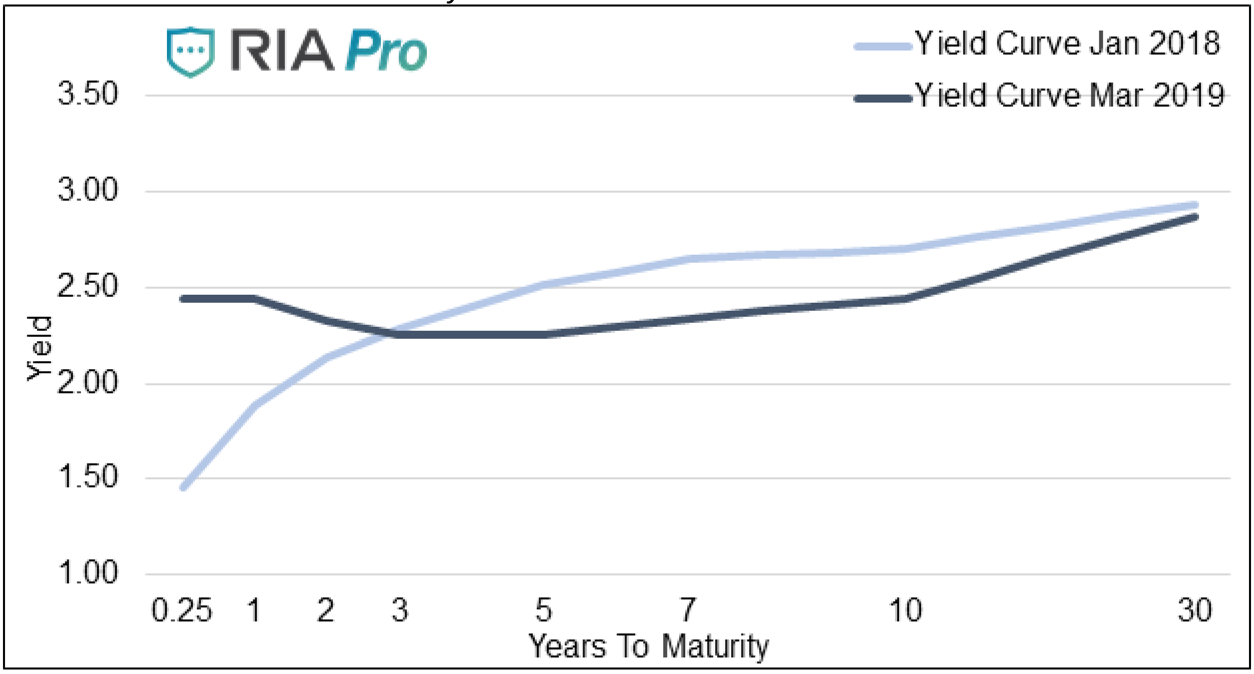


Data

Courtesy Bloomberg Currently, as shown with the blue line above, the difference between the third contract starting in mid-December is 18 basis points (0.18%) less than the first contract starting in mid-June. The difference tells us that the Eurodollar market currently expects three month LIBOR to decline 18 bps (0.18%) between June and December of 2019. Since October of 2018, the three curves, spanning three different time frames (6, 9 and 21 months), have gone from a consensus expectation of approximately 0.50% of rate *increases* over the next two years to 0.18-0.56% of rate *decreases* over the same period. The 0.75% to 1.00% shift is remarkable over such a short period. Global traders, banks, and corporations that account for much of Eurodollar/LIBOR activity, influenced by fluid Fed outlook changes, have made sharp adjustments to their economic forecasts.

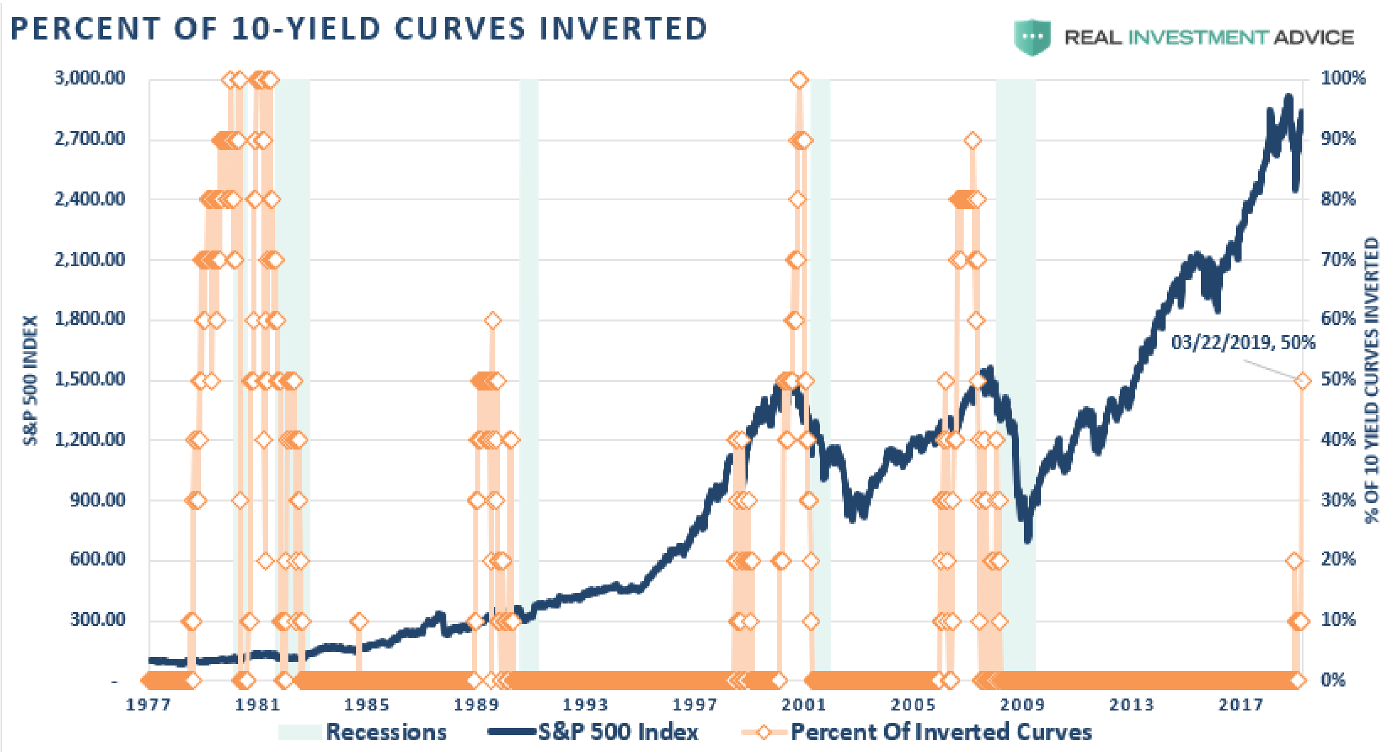
Yields and Yield Curves

The next chart shows the shift of the U.S. Treasury yield curve since January of 2018. The table below it provides further perspective for yield changes and curve gyrations.&#2013266080; RIA Pro subscribers can better appreciate the shifting yield curve by reviewing the *Latest Commentary* from March 26, 2019. In that update, we provided an animated yield curve showing monthly yield curve movements since January 2018.



Yields	Current	As of 3/1/2019	As of 1/1/2019	YTD Change
3 Month	2.43	2.43	2.35	0.08
1 Year	2.40	2.54	2.60	(0.20)
2 Year	2.23	2.51	2.49	(0.26)
5 Year	2.20	2.51	2.51	(0.31)
10 Year	2.39	2.72	2.68	(0.29)
30 Year	2.81	3.08	3.01	(0.20)
Yield Curves				
3m/2yr	(0.20)	0.08	0.13	(0.33)
3m/10yr	(0.04)	0.28	0.33	(0.37)
1yr/5yr	(0.20)	(0.02)	(0.08)	(0.12)
1yr/10yr	(0.01)	0.18	0.09	(0.10)
2yr/10yr	0.16	0.20	0.20	(0.04)
2yr/30yr	0.58	0.57	0.53	0.05
5yr/10yr	0.19	0.20	0.17	0.02

Data Courtesy Bloomberg The graph below is based on an assessment of ten yield curves of varying time frames. As shown and labeled by the orange bar on the right side, half of them are currently inverted. Note that every time since the 1970?s that at least 50% of the curves were inverted a recession was soon to follow.



Data Courtesy Bloomberg

Negative Yielding Bonds

It is not just the Eurodollar and U.S. Treasury markets that think something is amiss.&#2013266080; The final graph provides a global perspective on rates. Specifically, it plots the amount of negative yielding bonds worldwide. Again, the changes to economic outlooks and central bank policy that have occurred since last fall are not just related to the U.S. but are global.

Graph Courtesy Bloomberg There is nothing normal with a negative yield, and we take notice when such a large number of bonds are trading below zero.

Summary

Bond markets around the world are worried that economic growth and inflation are slowing drastically. In the U.S., expectations have shifted from a Fed that would gradually raise rates through 2019 and 2020 and continue to reduce their balance sheet, to a Fed that is likely to cut rates over the next six to nine months and has announced the end of balance sheet reductions. As illustrated in the table below, changes in Fed policy are a durable recession signal as the end of rate hike cycles are frequently followed by a downturn in the economy. If the Fed follows the market?s lead and puts an end to the hiking cycle that began in 2015, then we might very well be looking at a recession shortly.

First Hike	Last Hike	Result
October 1950	May 1953	**Recession**
October 1955	August 1957	**Recession**
September 1958	September 1959	**Recession**
December 1965	September 1966	Soft Landing
November 1967	June 1969	**Recession**
April 1972	September 1973	**Recession**
May 1977	March 1980	**Recession**
August 1980	December 1980	**Recession**
March 1983	August 1984	Soft Landing
January 1987	May 1989	**Recession**
February 1994	February 1995	Soft Landing
June 1999	May 2000	**Recession**
June 2004	June 2006	**Recession**
December 2015	???	???

Gluskin Sheff + Associates Inc.

Table Courtesy

David Rosenberg at Gluskin Sheff Fueling the bond markets are statements from past and present Fed Governors that are not only dovish but discuss a resumption of QE and negative interest rates. Former Fed Chairman, Janet Yellen, recently said the Fed needs *more* tools to battle a financial crisis. This is the same Janet Yellen that, in June of 2017, stated that she did not believe we would have a financial crisis in our lifetimes. The Fed is sounding the alarms. The bond market is burning. The equity market is fiddling. It is highly unlikely they are both right.