DOUCET ASSET MANAGEMENT, LLC

Fixed Income Quarterly

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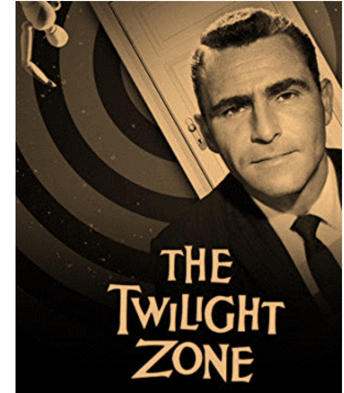
Negative Interest Rate Mania, Repo Madness and the Global Bond Twilight Zone

You are travelling through another dimension, one beyond which man has previously known. You take a journey to a place in time where you pay for the privilege of lending money and you are guaranteed a loss if you hold your bond to maturity. Now imagine a world of unlimited financial engineering, unrestrained by the confines of checks and balances or even common sense. If this sounds familiar, you may have just crossed over into the Bond *Twilight Zone*.



In 1971, President Richard Nixon indirectly lit the fuse on the $13 trillion negative interest rate bond debt bomb that exists today. It began innocently enough. The Vietnam War brought stagflation to the shores of America and Nixon was forced to terminate the convertibility of the U.S. dollar (USD) into gold. The decision effectively rendered the USD a fiat currency and the 1944 Bretton Woods agreement, which had established the de facto global monetary system, dead. A chain reaction of mini crises ensued, including the wild fluctuations of free-floating currencies formerly pegged to the USD. Perhaps no country was left more vulnerable from the broken agreement than Switzerland, a country known for its high-priced watches and precision tools. The franc spiked in value. This had the effect of making already expensive products even more expensive and weakening the Swiss economy. Government officials tried multiple measures to diminish the value of the franc in the hopes of improving exports. Finally, when all else failed, they imposed a "41% annual penalty on foreign deposits." But even a negative 41% interest rate on foreign savings proved insufficient. From 1971 through 1975, the mighty franc still managed to appreciate a whopping "70% in nominal terms versus the USD" and negative interest rates went from the realm of economic theory to reality.[1]

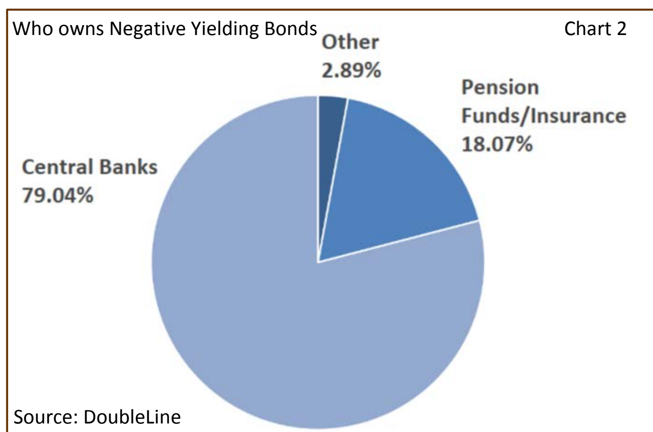
> **Bonds have a negative yield when the total amount of interest an investor receives over the life of a bond is *less* than the premium they paid for it. An investor who purchases a bond with a negative yield will lose money on their investment if they hold the bond to maturity.**

The world had all but forgotten the failed Swiss experiment until 2009 when the central bank of Sweden reintroduced the world to negative interest rates when it "lowered the rate on some deposits" it held overnight for commercial banks to -0.25%."[3] Other central banks followed suit with similar moves including the European Central Bank, Japan, Switzerland and Denmark. As this radical monetary movement increased in popularity, pensions, fixed income investors, insurance companies and others found themselves in the impossible situation of having to fund future obligations with conservative bonds yielding less than zero. Legendary investor, Howard Marks of Oaktree Capital, estimates that today "roughly two-thirds of the bonds in Europe and 25-30% of all investment grade debt in the world produce negative returns." This bizarre current chapter in economic history hit its zenith this past August when negative yielding debt soared to over $17 trillion. While most economists disagree, former Federal Reserve Chairman Alan Greenspan stated recently that negative rates "will arrive here in America soon."[2] For the time being, the lion-share of negative yielding debt, or about 88% of it, is issued either in yen or euro with the balance floated by European issuers in currencies other than the euro. As season 10 of the negative rate saga comes to a close, interest rates in the US are still positive. However, in a world of unlimited financial

engineering, unrestrained by the confines of checks and balances or even common sense, fixed income investors have crossed over into the Bond *Twilight Zone* with the promise of many more episodes to come.

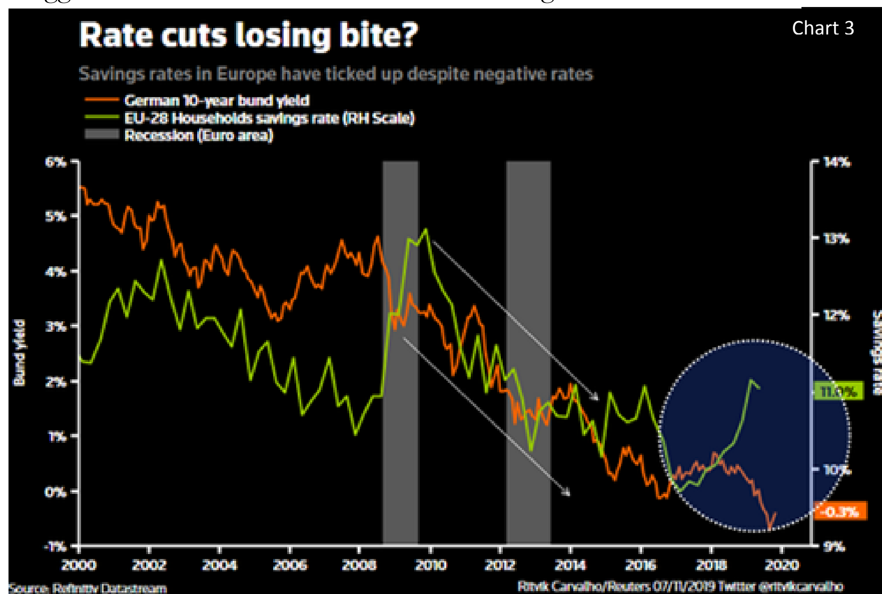
Episode 1: Who Are the Buyers?

So who in their right mind would buy a bond in which there was a 100% certainty of a negative return if held to maturity anyway? Double Line Capital stated recently that approximately 97% of negative yielding debt in the world is owned by parties who do not have a choice in the matter, namely central banks, pension funds and insurance companies. Central banks own about 80% of these bonds which they have purchased for the express purpose of creating artificial economic incentives and pushing would-be buyers out on the risk curve. But now that negative rates have been around for a while, many investors are beginning to ask if these same central banks are doing more harm than good.



Episode 2: Why, How & Does It Work?

Negative rates are what happen when practice deviates from theory. The whole purpose of these central bank machinations is to drive down yields in the hope that lower interest rates will help spur economic activity and produce inflation. But while monetary policy has helped drive savings, it has fallen short when it comes to borrowing and consumption. Ray Dalio, Chief Investment Officer of Bridgewater Associates, believes the trend will continue as this money being doled out by central banks "is being pushed on investors who invest it rather than spend it." John Donaldson, director of fixed income at Haverford Trust Company, thinks central bank policy is not being driven by empirical evidence. "If ultra-low rates and negative rates are such a panacea, why aren't Japan and Germany growing at 6% rather than teetering on recessions?" Important economic indicators like the Purchasing Managers' Index (PMI) seem to corroborate his theory. Currently, the PMI suggests the economies of those areas with negative interest rates are in contraction, not expansion. As both economic activity and interest rates have continued their descent, "savings in Europe have ticked up." This behavior is having the opposite effect than central banks intended.



Episode 3: "Not QE4"

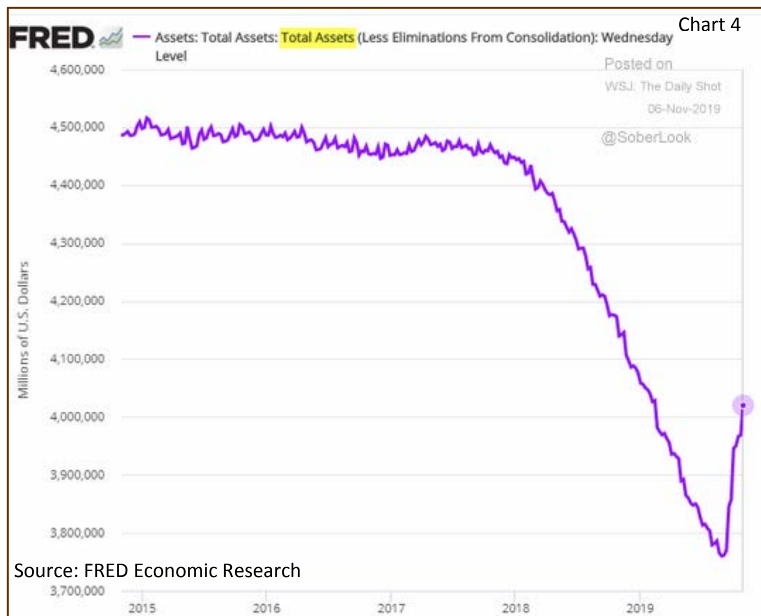
The U.S. is currently experiencing a vibrant economy relative to much of the rest of the world. Unemployment stands at a 50-year low and most leading economic indicators are still positive. But if the U.S. is this beacon of strength in the world, why is the Fed currently doing more to stimulate the ~~market~~ economy than it ever did at any time during the Great Recession?

At the height of its various bond buying programs, the Fed committed to purchasing $85 billion per month in the form of longer-term Treasuries and mortgage-backed bonds. In the past two months, the Fed balance sheet has increased by an average of $135 billion per month or 58% more in monthly purchases than the Fed ever executed in its

largest buying month in the aftermath of the Lehman Crisis! These purchases are part of a quiet, yet massive, three-pronged plan instituted by the Fed:

A repurchase agreement, also known as a repo, is a form of short-term borrowing, mainly in government securities. The dealer sells the underlying security to investors and buys them back shortly afterwards, usually the following day, at a slightly higher price.

- Fed has now reduced overnight lending rates by a total of 75 basis points since their June meeting.
- On September 17th, the repo market froze and overnight rates hit 10%, up from 2% the day before. (Zero Hedge, 9/17/19). The Fed stepped in to provide funds to its member banks in an attempt to calm the repo market and has now provided over $200 billion in aid in only 8 weeks.



Source: FRED Economic Research

- Late Friday afternoon on October 11th, with little explanation or fanfare, the Fed announced its plans to purchase $280 billion worth of Treasury Bills (T-bills) with initial monthly purchases of $60 billion which began October 15th. But the Fed vehemently proclaimed these purchases did NOT constitute the 4th round of Quantitative Easing or QE4 because they are buying T-bills which are '*temporary*' investments versus '*permanent*' investments like long Treasuries or mortgage-backed securities.

Episode 4: Finale

Since the end of the third quarter, the U.S. financial market landscape has changed dramatically as a result of the Fed's three-pronged plan. The S&P 500 is hitting fresh new highs almost daily, the inverted yield curve that we spoke of in our July edition of the Doucet Asset Management newsletter entitled "*Tarriff-ied*" has righted itself, and the volatility or fear index is hovering near all-time lows. The yield curve has now gone from an inversion of 50 basis points at the end of Q319 to a positively-sloped yield curve of 32 basis points or an 82 basis point swing in just 60 days! The good news is this tends to foreshadow a healthier economy in the future. The bad news is the Fed had to cut rates three times by 25 basis points apiece, contribute over $200 billion so far to indirectly rescue the repo market, and promise to buy $280 billion worth of T-bills over the next several months. Each one of these items taken individually historically has had the effect of artificially bringing down the yields on the short end of the yield curve. Together, the results are clear. But the enormity of size and breathe of the program begs the question, what does the Fed see that the markets clearly do not see?

Wouldn't it be ironic if the Fed was the *first* to recognize a specific problem and not among the last? Logic dictates the Fed would not throw around an extra ½ trillion dollars' worth of stimulus unless there are larger underlying issues at play here. We believe the repo market issues and the desire on the part of lending institutions to hoard cash spooked the Fed into once again taking historic monetary action. While there is presently a 'risk off' feel to the markets, the Fed's actions should be seen as a warning siren, not a victory bell.

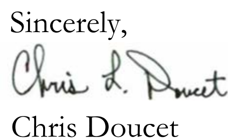
While long-term interest rates are up and bond prices down so far in the 4th quarter, domestic fixed-income markets did the opposite in the third quarter where strong returns were generated driven by the continued decreases in short-term interest rates. Bond prices in the third quarter were higher across the entire spectrum. Spreads have narrowed dramatically since the beginning of the year making bargain hunting for fixed income investments virtually impossible. In the absence of compelling values in the third quarter coupled with flat to slowing corporate earnings, we opportunistically reduced both our modified duration to 1.3, which represents only 22% of the benchmark, and our average workout date to 2.28 years, which is about 29% of the Index. This should aid performance in the fourth quarter is current trends continue. However, despite our conservative stance in the third quarter and our muni-centric portfolios, we were able to outperform the taxable Barclays US Aggregate Bond Index in the quarter and by 58 basis points year-to-date.

Doucet Asset Management Fixed Income Composite Characteristics					
	Portfolio	**Benchmark**	**+/-**	**% of Benchmark**	**Target**
Workout Date (Years)	2.28	7.79	*-5.51*	29%	65%
Modified Duration	1.30	6.03	*-4.73*	22%	65%
Coupon Rate	4.89	3.20	*1.69*	153%	>100%
Yield to Worst	4.46	2.27	*2.19*	196%	>125%
Yield to Maturity	5.61	2.28	*3.33*	246%	>150%
Current Yield	5.67	3.01	*2.66*	188%	>150%
Convexity	0.09	0.82	*-0.73*	11%	50%
OAS	170.83	52.02	*118.81*	328%	>200%
Rating	A	AA			
Note: Stated Benchmark is Barclays Agg					
Source: All characteristics calculated using Bloomberg Portfolio & Risk Analytics					

The ultra-low interest rate environment that exists today is only beginning to show some of the negative side-effects of keeping rates too low for too long. Among them are continued increases in government debt and deficits, prolonged speculative behavior on the part of investors, underfunding of pension plans, and the exacerbation of the wealth gap. But until there is a mass rejection on the part of the market of central bank currency printing and interest rate manipulation, we will continue to experience the multiple impacts of the Bond *Twilight Zone*.

Doucet Asset Management FI Strategy Composite Performance						
	YTD	2018	2017	2016	2015	Since Inception
Doucet Fixed Income Composite	9.10%	1.82%	3.89%	10.64%	0.73%	5.37%
Barclays US Aggregate Bond	8.52%	0.01%	3.54%	2.65%	0.55%	2.28%
+/- Benchmark	0.58%	1.81%	0.35%	7.99%	0.18%	3.09%
*Performance calculated by Morningstar Office, periods over 1 year are annualized						

Sincerely,



Chris Doucet

Footnotes:

[1] Stephen Mihm, "The Swiss History of Negative Rates is Ugly", Bloomberg Opinion, August 22, 2019

[2] Source: Forbes, September, 23, 2019

[3] Neve Gotshalk, Moneywise,09.18.2019

Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
- Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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