Palisade
CAPITAL MANAGEMENT

PALISADE CAPITAL MANAGEMENT, LLC
ONE BRIDGE PLAZA, SUITE 695
FORT LEE, NEW JERSEY 07024
T (201) 585-7733 • F (201) 585-7552
www.palisadecapital.com

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U.S. TREASURY BONDS IN A WORLD OF NEGATIVE YIELDING SOVEREIGN DEBT

On July 10, 2019, I appeared on CNBC and made the casual comment that the 10-year U.S. treasury bond, as compared to the debt of other countries around the world, was like a high-yield bond. At that time, the 10-year U.S. treasury bond was yielding 2.07% – as of Monday, that same bond yields approximately 1.60%. By comparison, central banks around the world are lowering interest rates at an increasing rate and the amount of sovereign debt with a *negative* yield now exceeds $16 trillion dollars (growing from $8.5 trillion at the beginning of 2019). These downward interest rate trends are a result of the growing trade war between the U.S. and China that is slowing global growth. However, despite the failure of China and the U.S. to reach a trade deal, stock prices remain elevated around the world even though the Federal Reserve and other central banks have acknowledged the global growth risks by lowering interest rates. The U.S. most recently lowered short-term rates by 0.25%, but very likely will go even lower if global growth does not improve.

I believe we are entering a new phase of rising risk to global growth for the following reasons:

- The U.S. and China are at an impasse and both sides are making political miscalculations which are complicating negotiations. The U.S. President is taking a pragmatic and clinical approach to trade negotiations, leaving the Chinese leader without a way to save face and advance China's interests. As time goes by, Chinese leaders may decide they have nothing to lose by waiting for the next U.S. presidential election thinking, perhaps, a new president will be more likely to take a more lenient position on trade. Tariffs are slowing Chinese growth, most recently to 6% as measured by GDP, which is the slowest rate of growth in 27 years.
- China's slowdown is having a major impact on Eurozone growth, causing the historic phenomenon of negative interest rates. Right now, interest rates on 10-year debt are negative in a number of countries including Belgium, Denmark, France, Germany, Ireland, The Netherlands, Sweden, and Switzerland. Germany, perhaps the economy most impacted by Chinese growth, has interest rates on the 10-year Bunds of -0.69%. Take a moment to think about that – those who lend money to the German government today are willing to receive less money back at maturity. While other countries' rates are more negative, Germany is the largest economy in the Eurozone and it relies partly on Chinese demand for goods. Recent German GDP data has been so weak that the German government took the unprecedented move of announcing a fiscal stimulus plan, which could be triggered by a recession. Germany's long memory of hyperinflation in the aftermath of World War I had prevented it from taking these types of measures in the post-war era.
- Rioting in Hong Kong could complicate China's ability to negotiate a trade deal with the U.S. (and comments from the White House are probably not helping). In a historic move, Beijing forced the CEO of Cathay Pacific, perhaps the most recognized airline in Asia, to resign because some protesters were Cathay Pacific employees. Beijing was sending a message to all companies in Hong Kong – if you want access to the Chinese market, you must play by Beijing's rules. If the protests (which continue in record levels as of this writing) get out of hand, the military could be sent in and take tensions to yet another level of uncertainty.
- A key component to the economic expansion is capital spending by corporations. Given the long-term nature of those investments, corporate spending is highly influenced by corporate CEO and leadership team confidence. In earnings comments this season, confidence is being tested as a result of a dimming outlook for a successful trade deal.

CONCLUSION

Though the stock market remains near all-time highs, volatility has returned with a vengeance. Slowing economic growth and rapidly declining global interest rates have increased fear that a recession could be at hand. Complicating matters in Europe is the United Kingdom's impending exit from the European Union (Brexit) and weakness among European banks that appear to have less capital to weather a protracted economic slowdown. It is difficult to believe that accelerating weakness in China and Europe will not affect growth in the United States.

However, lower rates make corporate earnings streams more valuable and support stock prices. From August 20, 2018 to August 19, 2019, the S&P 500® Index has risen 4.42% and the Nasdaq has risen 3.48%. During the same period of time, 10-year U.S. treasury yields dropped from 2.82% to 1.61%. The Russell 2000® Index is a negative outlier having dropped -9.94% over the same period, which likely reflects the fact the Russell 2000® Index has about a third of its constituents losing money.

These are uncertain times and we are entering the Fall season when stocks often exhibit weakness, but I remain optimistic a trade deal can be reached or, at a minimum, tensions can subside. Ultimately, it is up to the leaders of China and the U.S. to settle the issues that continue to weigh on growth. In the meantime, focusing on security selection of companies that are profitable, cash generating, and have solid balance sheets is perhaps even more important today as investors deal with these global issues.

Dan Veru, Chief Investment Officer

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