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My Preferred Charts: Bond Rally in August. Challenging the Recession Narrative

This summer, the yield curves have experienced a significant downward movement (corresponding to an increase in bond prices). As shown in the attached chart, the yields on bonds in the United States and Germany have adjusted downward by nearly 20% over the summer (I've rebased them to 100 to clearly illustrate the intensity of the movement). This behavior has generated very favorable results for bondholders, as well as for our discretionary management mandates, both conservative and moderate, for which we have already achieved the expected performance for the entire year.

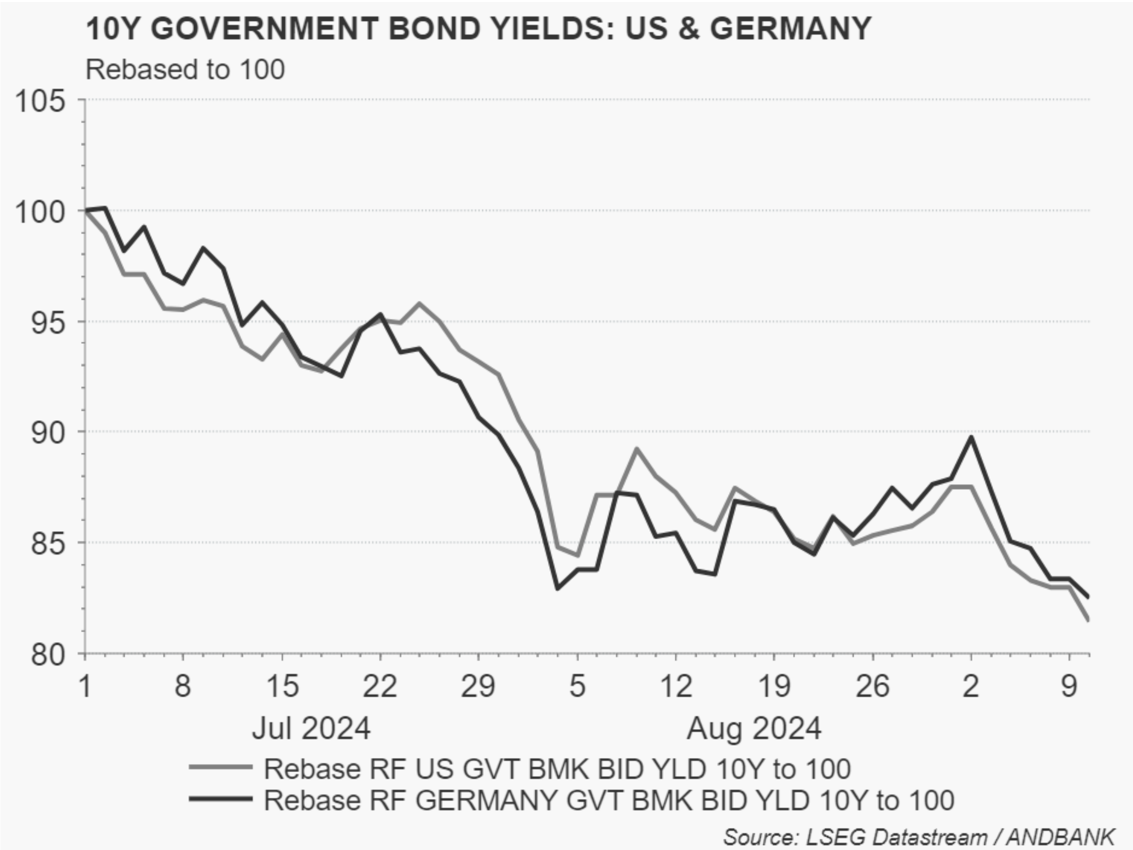
Any prudent manager must question the nature of asset movements to properly assess their potential continuity. In this regard, the consensus—though in my opinion, somewhat naive—attributes this bond rally to fears of an imminent recession. A traditional explanation, but not necessarily a correct one.

From our perspective, we do not see a recession as a likely scenario in the near future, which compels us to seek the real causes of this movement in other areas. In this analysis, I have made an interesting finding. Upon reviewing Japan's balance of payments—a practice I perform monthly— I discovered that Japanese domestic investors made record purchases of foreign debt in August (and part of July), driven by the strength of the yen. Japanese households and mutual funds allocated $51.3 billion in August to the purchase of foreign bonds, mainly government bonds. This is an unprecedented amount, exceeding the monthly record set in July 2016 by more than 35%. The more than 20% appreciation of the JPY over the last two months has given these investors greater purchasing power for foreign assets.

Consequently, I believe that the argument of a recession and aggressive rate cuts by the Fed and the ECB could soon lose relevance. However, this does not necessarily imply an immediate normalization of yields upward. I anticipate that the buying pressure from Japanese investors may continue. Why? I have learned that JPMorgan, UBS, and BNP have recommended eliminating currency hedging on Japanese asset positions (equities). If they are making such recommendations, it likely means these entities hold a strong long position in the yen, suggesting they do not anticipate a rapid depreciation of this currency. If I am correct, Japanese investors—both private and institutional—will continue to have substantial purchasing power, thanks to their strong currency, and will be able to purchase a higher nominal value of bonds for the same amount of local currency.

Strategy

In light of this information, and based on our recent reflections, we will allow yields to continue their downward trend a bit longer before reducing our interest rate sensitivity exposure, in anticipation that the "no recession" narrative will once again dominate the market and trigger a renewed upward movement in the yield curve.



Best regards