

Mirror, Mirror, On the Wall, Which Bond Is the Fairest of Them All?

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European political risk dominated 2017, with the German presidential and federal elections in February and September, respectively, and the French presidential and legislative elections in May and June, respectively. It was a year with a lot of variation with 10-year yields in most major global government bond markets trading within a 30-40bp range. We believe risk for global yields is skewed to the upward side of the forwards in the medium-term. We expect the main drivers to be higher global real interest rates and an upward creep in inflation expectations.

Government bond yields finished the year higher in only Canada and Germany, and little changed elsewhere. In addition to political factors, there were several drivers of the performance of global bond markets in 2017.

- First, unlike the situation in early 2016, when worries about a slowdown persisted, **global growth** surprised to the upward side. Growth was above-trend in all the major advanced economies. The most noticeable surprise was in the **Euro Zone**.

- Second, most **commodity prices**, especially energy (excluding Natural Gas) and metals, enjoyed an overall strong year, aided further by OPEC's agreement at the end of November to extend the oil production cuts until the end of 2018, this time including previously exempt Libya and Nigeria.

- Third, despite the stronger than widely anticipated global growth and positive commodity price developments, **inflation** remained subdued relative to both consensus and Central Banks' inflation forecasts.

- Fourth, **geopolitical risks** were prominent, with several unfortunate terror attacks as well as increased tensions in the Korean peninsula.

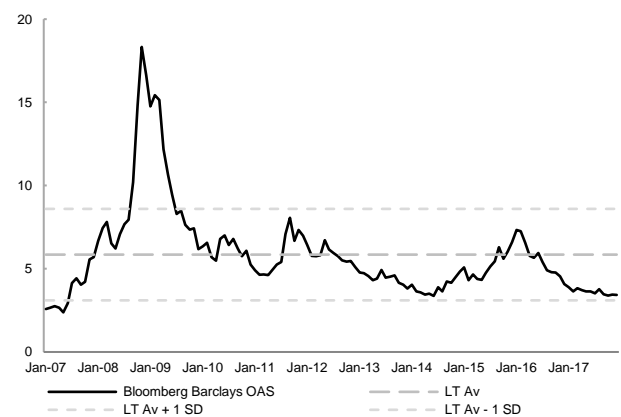
- Fifth, corporate **high yield** spreads finished the year about 70bp tighter across the US and Europe, with Pan-European spreads materialising bigger swings within the year.

Yields on benchmark 10-year government bonds fell about 10bp in all major markets in the first quarter, apart from Germany where yields finished the quarter up 10bp. Subsequently, yields declined over the second quarter, before coming under upward pressure towards mid-year. The backdrop to the earlier decline was provided by low global inflation and evidence of a soft patch in economic activity in the US.

Yields then increased towards the end of June when several major central banks gave hints of a less dovish

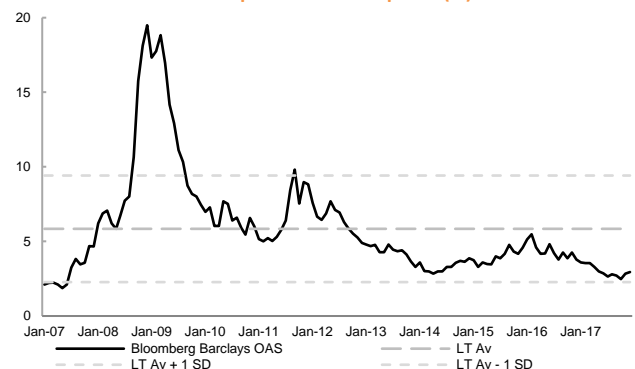
policy stance. Yield spreads in the Euro zone periphery narrowed after the French elections.

US HY Credit Spread (%)



Source: Bloomberg Analytics, own calculations

European HY Credit Spread (%)



Source: Bloomberg Analytics, own calculations

Corporate bond spreads narrowed slightly over the quarter, extending the decline since before the end of the previous year.

Over the third quarter yields were little changed in most of the major markets but finished the quarter about 35bp higher in Canada and 25bp higher in Australia. Yields started the quarter under upward pressure before mostly declining from mid-July to early September. The main

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exception to this pattern was Canada, where yields came under upward pressure prior to a rate hike in mid-July, and then increased further following a second surprise rate hike in September.

Global yields came under renewed upward pressure around mid-September in response to robust growth indicators and hints of less accommodative central bank policy. US corporate spreads declined to reach new lows for the year.

Finally, global government bonds posted mixed performance in the fourth quarter. The dominant theme was a further flattening of the US yield curve as the Fed tightened for the third time of the year. Approval of the tax reform package in the US contributed to optimism about the global economic outlook.

Outlook

We identify the following **key global macro themes** in the formulation of strategy at the outset of 2018:

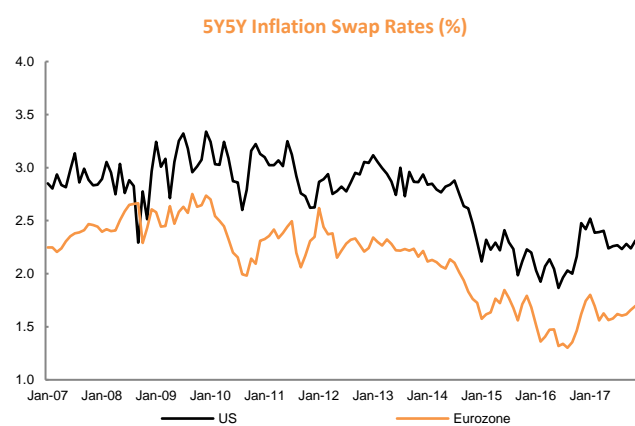
- **Robust Global Growth** – the major advanced economies are growing above-trend with emerging economies following closely behind. We identify China as the main risk to the outlook, though economic growth has stabilised close to 7.0%.
- **Elimination of Spare Capacity** – there is a growing number of both developed and emerging economies running at full employment. The Euro zone is a standout exemption, on an aggregate level.
- **Gradual Upturn in Global Inflation** – inflation is still running below most of the major central banks' targets but we anticipate a gradual increase in wages and prices in the advanced economies. A further increase in oil prices should also see headline inflation rates drift higher.
- **Monetary Policy Tightening** – the Fed is leading the way in this tightening cycle, followed by Canada and the UK. Elsewhere, in the Euro zone we expect a gradual shift toward a less accommodative policy from the ECB. In Japan, there is the potential of the removal of the yield curve control. We now see a broader group of countries likely to initiate their interest rate normalisation process expanding in Central Eastern Europe, Emerging Asia and Latin America.
- **Political Disturbance** – a number of political events are likely to impact financial markets, including the implementation of US tax reform along with other policy initiatives, the US mid-term elections, the Italian elections as well as a number of elections taking place across the globe (e.g. Sweden, Malaysia, Brazil, Mexico).

One thing also worth keeping in mind is global **cyber-attacks**, which have the potential seriously to disrupt economic activity.

Bond valuations in the major markets appear expensive, with momentum though providing more mixed signals.

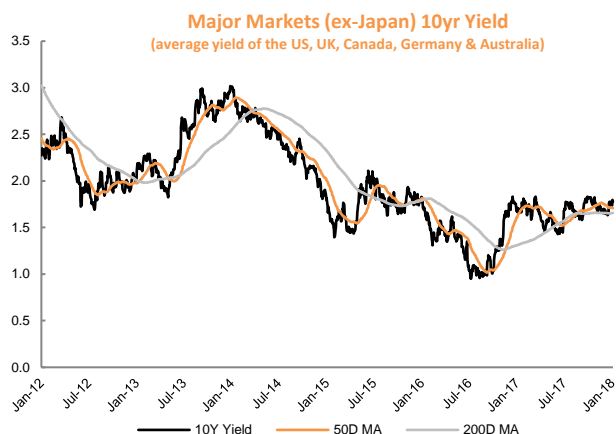
We note the following factors in forming our assessment:

- **Real Yields** – real yields in the US, Australia and Canada have increased from 2016 lows. In the UK, Japan and Germany though yields remain negative. Real yields in all major bond markets, except Japan, are close to one standard deviation below their long-term historical average. The 5-year, 5-years' forward (5y5y) real yield in US treasury inflation-protected securities (TIPS) is about 0.7% - significantly below long-term trend real GDP growth and below the end-2016 level.
- **Breakeven Inflation** – 10-year breakeven inflation rates have recovered close to the levels of mid-2014 before the slump in the price of oil, with the notable exception of Japan. The 5-year, 5-years' forward (5y5y) inflation swaps have increased since mid-summer with the US now yielding 2.3% (the Fed's own measure using the breakeven inflation rate is 2.0%), not far from the end of 2016. The Euro Zone, on the other hand, has traded decisively higher since mid-year to 1.7%, though still faring below the European Central Bank's inflation target.



- **Yield Curve Slope** – the slopes of 2s/10s curves are still below their long-term average in all of the major markets except the UK and Australia.
- **Short Rate Forwards** – the market is pricing US short-term interest rates below the forward guidance path implied by the Fed for this year onwards. Whereas overnight indexed swaps are pricing 1.9% for end-2018 and 2.1% for long-term, the Fed indicates 2.1% and 2.8%, respectively.

- **Momentum** – signals have turned mildly bearish, with the average 10-year yield (of the major bond markets, excluding Japan) above the 50-day moving average, which in turn has crossed above the 200-day moving average. The signal is also mildly bearish in the US.



Source: Bloomberg Analytics, own calculations

Current Strategy

We see above-trend growth in all major regions of the global economy. Following an extended period of upward revisions to growth forecasts, however, it will become increasingly difficult to surprise the consensus to the upward side and markets may be vulnerable to disappointments.

We believe risk for global yields is skewed to the upward side of the forwards in the medium-term. We expect the main drivers to be higher global real interest rates and an upward creep in inflation expectations. Although recent relatively benign inflation reports may continue to distract focus away from the prospect of reduction in central bank policy accommodation, we anticipate the forward path of the global short rates gradually to be re-priced higher.

Some re-building of term premiums associated with the gradual reversal of the unconventional policy easing is likely to underpin higher global yields.

The basic thrust of current strategy in FX and cross-country positioning is to highlight those countries that we believe will be in the forefront of policy tightening (with low real rates and little if any tightening already priced in) versus other countries experiencing still very subdued inflationary pressures and/or with overvalued currencies.

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