# Income & Fixed Interest Newsletter

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*A change in the trend?*

Just as the markets had convinced themselves they were in for an uneventful carry-harvesting summer, something started to change at the end of the month, with central bank communication seemingly dominating economic data with respect to their impact on market moves. Whilst the theme of disinflation continued to play out in the economic numbers, a growing concern around new central bank hawkishness dominated the moves in global bond yields. We had a negative month of performance as our long duration positions suffered with the rise in bond yields triggered by these comments.

March, June and December are generally the most significant meetings on the central bank calendar. They are typically accompanied by either a press conference where a central banker will be able to flesh out their thoughts on the future of monetary policy, or answer more specific questions from the press. These meetings also provide an opportunity for central banks to publish new forecasts of growth and inflation, although their historical accuracy of such economic forecasting has left much to be desired. June is usually especially important as it's just before the (northern hemisphere) summer when central bankers and politicians break for an extended holiday, so it is the last chance to signal intent before the liquidity lull.

This month, ECB President Mario Draghi was the major market mover who unwittingly caused a mini-VaR shock, doubling German Bund yields in less than a week. European markets led the move higher in yields, underperforming most other regions, taking the currency with them as the Euro climbed c.3% against the Dollar. The US yield curve steepened more dramatically than it did after the US election. Australian interest rates subsequently underperformed heavily as they do every time you see moves like this. Even commodities seemed to be basing and performed well into month-end, no longer dominated by China growth concerns that have troubled the market for most of this year.

## *The loquaciousness of central bankers*

The reliance on central bank communication, because we are in a world of zero or negative rates, has both its positives and its drawbacks, but we feel that generally central banks communicate way too much. Communication, as one of the touted tenets of modern monetary policy, is a much more bizarre component than forecasts, and a far more complicated part. This month whether this was via press conferences or speeches, they were plain confusing and open to a myriad of different interpretations, but to our reading there was a definite hawkish turn evident.

Draghi's speech, albeit similar to his remarks during the ECB meeting press conference earlier in the month, had changed enough of his views to be taken as hawkish, and lit the fuse. Over the month there were also a number of other central bankers (US, UK, Canada, Norway, Korea, etc.) who had taken a decidedly hawkish shift. This sparked rumours of a 'pact' between central bankers formed at a gathering in Sintra, Portugal. Their purported aim was to put forward a less accommodative plan for monetary policy. This is crucial because globally inflation numbers have disappointed recently and the markets have been moving towards expecting more, not less, monetary accommodation. So what exactly did central banks say to alter these expectations?

Looking through the minutiae of central bank verbiage, we can draw some broader trends from recent communications. Firstly, nearly every central bank either removed the prospect of further rate cuts in the future, talked about rate hikes in the future being appropriate or actually hiked rates. This undeniably is an across-the-board hawkish move by all of these central banks, and it is reflective of the better underlying growth picture in the global economy. Secondly, all central banks that produced a forecast for inflation as part of the meeting revised future inflation down (with one key exception, the Bank of England), while growth was kept more or less the same. Since most central banks are inflation targeting, in one sense or another, this was a dovish move. These two trends are not entirely inconsistent, and may in fact represent a fairly balanced message from the central bankers. The removal of any future easing bias can be justified by the current growth picture (when viewed in the context of post GFC growth), while inflation disappointments mean more uncertainty about the future and hence a need to treat the economy with caution.

Yet we know that the market is biased to be more optimistic on growth, to want higher yields, and if the economic environment is 'OK', then to interpret central bank communication to be more hawkish. We feel there is a degree of this in the interpretation over the month but it is also clear via comments from both the Fed and the ECB that they are now prepared to ignore the apparently 'temporary' period of lower inflation (which has been reflected in their forecasts).

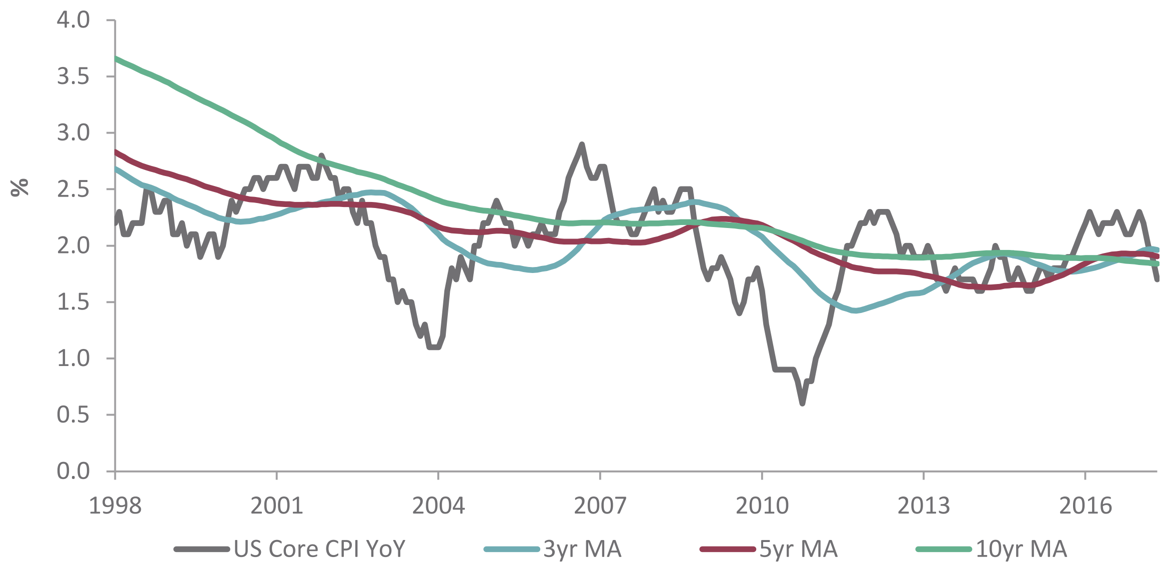
Whilst stronger growth with temporarily low inflation could be one reason why policy may need to shift tighter in central bankers' minds, a far scarier reason might be driven by concerns over financial stability. The latter reasoning supports a case for hiking as much as equity markets will allow, and if symptomatic of a systemic shift in policy outlook, will bring volatility back to the markets, driven by a likely unwind of the financial largesse we have seen over the last few years. In the former case, we question just how 'temporary' is the current low inflation situation, and whether a hawkish stance can be maintained if inflation heads down further. The story here starts with some really disappointing inflation prints in the US.

## *Inflation weakness: temporary or structural?*

On the day of the interest rate hike by the Federal Reserve in June, the CPI print was scheduled to be released that same morning, complicating what was meant to be a simple day where a hike was viewed as a certainty. The previous two inflation prints in the preceding months had disappointed. More specifically, this disappointment occurred on the core measure of inflation (where higher volatility items like fuel prices and fresh food prices are taken out of the calculations). This measure, once again, disappointed for the third month in a row, because of the effect of data plan pricing in the mobile phone carrier industry. While the Fed did end up hiking rates that day to 1.25% (not too far from Australia's overnight interest rate at 1.50%) the question was asked of Janet Yellen in the press conference, and she pointed towards temporary factors pushing down inflation and that they would effectively "look through" these more recent suppressed readings.

"Looking through" lower inflation readings makes sense in the short run, especially if the biasing effects are one-offs. The unfortunate fact is that the downtrend in inflation is all explained by one-offs, and this is why it may prove to be tougher and tougher for the Fed to ignore it at all. The 10 year rolling average of the core measures of inflation (PCE and CPI) are currently at historical lows. The 10 year figures are obviously affected by the GFC however, leaving the 5 year and 3 year measures higher, but now both of these measures have turned down as well. On the shorter term, core PCE measures of inflation are nearly at zero over the last 3 months. While the ISM has held up, the prices paid component (a fairly good lead on core inflation pressures) is still falling. The picture for inflation isn't strong at all in the US, and this is even before the most recent fall in oil is incorporated into the picture.

**Chart 1: No sign of an uptrend here**




Source: BTIM, Bloomberg

The Fed partially nodded to the lack of inflation pressures by downgrading 2017 expectations to 1.7% from 1.9% at their meeting earlier in the month. They left 2018 and further forecasts unchanged at 2%, which is coincidentally the run rate needed for the remainder of the year to hit their lowered 2017 inflation target. 2% is also a level that hasn't been hit consistently for any three-year period since the GFC. It isn't hard to see how these forecasts will once again be missed, and in record time to boot. Despite the downgrade to inflation, the Fed's communication placed it in the group of hawkish, inflation-ignoring central banks. At the margin, there has been growing concern over whether central banks have abandoned their inflation targets altogether.

From the outset, a realisation that the Fed or the ECB don't care too much about low and falling inflation is negative for bonds, given that we should on balance see more hikes and less QE, or some combination of both. Higher short rates coupled with fewer buyers of bonds should mean bonds get slammed. However, thinking about this a little more deeply reveals some inconsistencies.

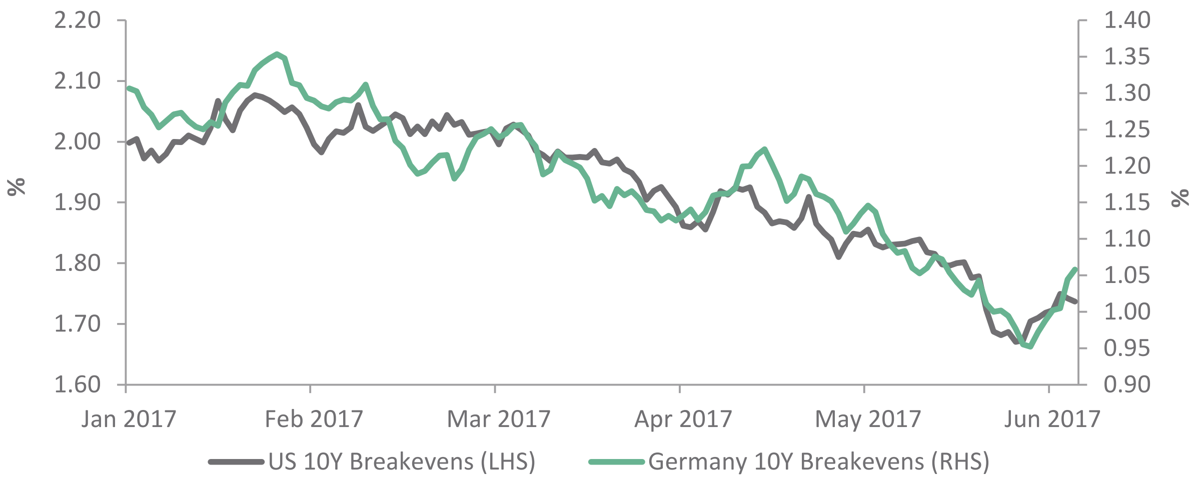
## *Real yields are the key*

If central banks were hawkish because they considered inflation to be accelerating, then higher yields would be fine. Inflation breakevens would go higher, leading nominal yields higher. But pact or no pact, most central banks have said that inflation hasn't been running as fast as they have expected. This can be seen nearly everywhere, with the exception of the (massively currency helped) UK. Central banks have failed to hit their inflation targets while monetary policy has been the loosest it's ever been, so what chance do they have if they tighten now?

The Fed has only been above their 2% target 29% of the time since the GFC, and only 13% of the time in the last 5 years. The results are slightly worse for the ECB, with the hit rates being 26% and 12%. Oil is once again set to provide a drag on inflation right at the time monetary policy will be tightened. The free kick from base effects has been and gone, and inflation is set to struggle against expectations everywhere except for Europe (where growth and inflation expectations are probably still a little too low). The bottom line is it is incredibly hard to generate any inflation in the midst of the huge technology disruption and change of working practices which are impacting globally.

Tightening monetary policy should slow inflation, which means that the inflation component of bond yields (the breakeven inflation rate) should stay low and maybe even go lower. As bond yields rose over the month, this has broadly happened. Breakeven rates of inflation in both the US and Europe have only risen slightly in the move higher, and are still lower than where they started June.

**Chart 2: medium term breakevens are still heading lower….**




Source: BTIM, Bloomberg

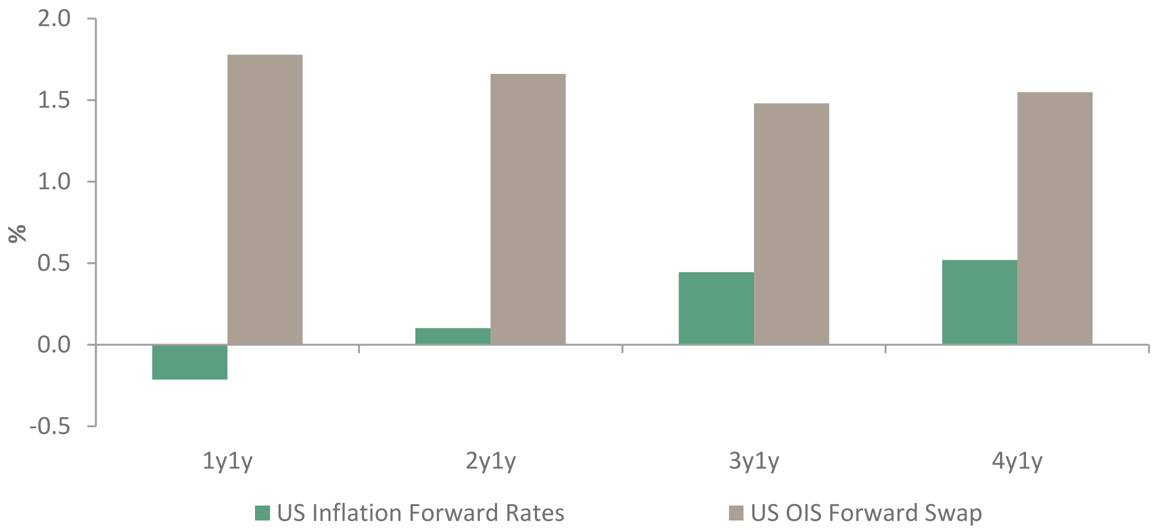
With inflation expectations only marginally higher, the rise in nominal yields has caused real yields to spike. As we can see from the chart below, 10 year real yields are back to the levels that we saw when global growth expectations were sky-high in the first quarter, before the reality of poor US data and an eventual shockingly poor Q1 GDP print hit the market. US manufacturing surveys are off substantially since then and Q2 GDP is looking like a number closer to 2% than the 3.5% everyone was expecting earlier this year.

**Chart 3: …while real yields are heading higher**


Source: BTIM, Bloomberg

Central bankers are now facing a real dilemma: unless there is a substantial recovery in inflation, higher nominal yields will mean higher real yields which will suppress growth even more, increasing the downward pressure on inflation and further flattening yield curves.

**Chart 4: big divergence in US yields**




Source: BTIM, Bloomberg

## *QT on the qt*

We have established that less monetary accommodation against a backdrop of disinflation should not lead to a sustained rise in yields, as rising real yields will force even easier monetary policy in the future. Nevertheless global bonds sold off over the month, so maybe it's to do with the type of tightening that the market expects. If a move to a less accommodative stance is driven by concerns over financial stability, and there is a desire among central bankers to remove the market distortions created through near-zero interest rates and QE, this may go some way to explaining why we can see yields go higher before economic fundamentals dictate an eventual reversal.

When considering QE there is also a disconnect between the markets and central bankers understanding of the main impact. The Fed has been very vocal that they consider the stock (i.e. the size of the balance sheet) as the primary variable, while the market (empirically) favours the flow. This is key as we've just been through a record twelve months in terms of central bank liquidity injections, which will now begin to be tapered off. Janet Yellen made the point clear that they will be reducing the amount of buying to make up for the maturities very soon. Although a date and sizing hadn't been set yet it is widely expected to start in September. She did however, and very hopefully, say that it would be like "watching paint dry" implying the pace of this normalisation would take many years. The reduction of QE from the ECB and BOJ poses a bigger risk to the global financial system. Due to a lack of eligible bonds to buy, the ECB programmes will have to contract in size not due to desire, but because of the reality of the amount of assets that are available for purchase.

As we have previously argued, there will have to be a change in ECB bond buying programmes as they slowly run out of German government bonds to buy. This is because of the the constraint of a capital key on ECB purchases of Eurozone government bonds. We believe that Germany's adherence to the capital key is highly unlikely to be dropped. The pace of purchases will need to slow again, like it already did in April. Earlier in the year, we saw the response in the curve steepening at the long end as fewer purchases were now occurring here, but the 10 year part of the curve remained relatively insulated from the repricing until June.

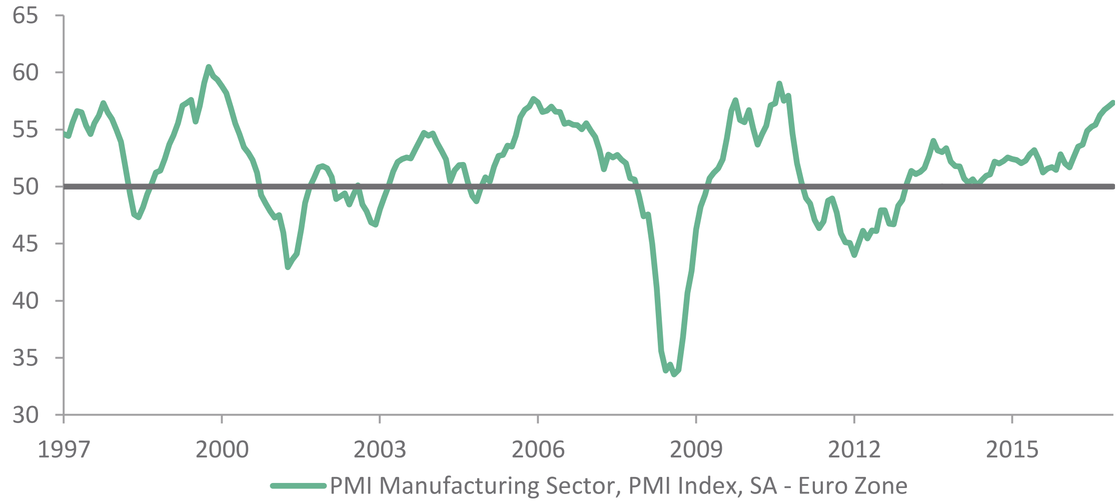
This perhaps made the 10 year part of the curve far more susceptible to a sell-off, thus helping to explain the magnitude of the moves that we have just seen. The next round of ECB tapering is likely to start in early 2018. A measured slowdown in the amount of buying would put the first chance at a rate hike in late 2019, as long as the ECB stay by their promise that no hike would occur until after a full taper (something reiterated this month at the ECB meeting).

## *European growth is strong, no really*

The rise in European bond yields led the bond sell-off this month, so it is worth re-visiting the growth story in Europe. European growth data has been good. Really, really good in fact, and strongly above potential. This is not isolated to Germany, where the benefits from exports are well known from the huge uptick in global trade, emanating mostly from strength in Asia which is something we've pointed to for a while. Economic data has printed better levels since the start of the year with no retracement unlike in the US, yet European yields hadn't really reacted until this month. Consumer confidence is at a 10 year high across the Eurozone, German machinery orders are off the charts, new car registrations are strong across the semi-core of Europe, business surveys are still climbing and actual economic growth has been solid.

This is something we've pointed to before, especially in recognition of the performance of bonds last year. It wasn't until the US election that bonds decided to react to the bounce in economic activity seen since the middle of the year, supporting the rule that trading the economic activity rather than the short-term musings of central bankers or political events is the guide to profit in the medium term.

**Chart 5: watch out above**




Source: BTIM, FactSet

The issue of value may be another factor behind the recent move in European bond yields. The main risk-free instrument in Europe, the 10 year German government bond (Bund) is expensive, both in an absolute sense and in a relative sense. Before the most recent shift higher in yields, Bunds were trading at c.0.25%, an extraordinarily low rate for 10 years of interest rate risk in anyone's language (although maybe not German or Italian). With inflation at just below c.1.25% this puts the real rate of interest on this bond at c.-1%. This level is only marginally higher than where it traded last year, yet Europe is still one of the few markets to have seen a rise in yield after the US election. And while this real yield hasn't been as negative as we've seen in some other parts of the world, it is arguably still too low when placed in the context of the current strength of European economic growth and a far lower concern over Euro break up risks compared with the start of the year, following the election of the European friendly Emmanuel Macron in France.

**Chart 6: heading back to 0%**


Source: BTIM, Bloomberg

When real yields are negative to this extent, pricing will exhibit more volatility at points than bonds that offer a better value case. You only need to go back to March 2015 (the German led puke in bond markets) to see how unstable things can become when yields get too low, too fast. This is not to preclude the case for negative real yields where bonds are considered truly safe. We strongly believe that real yields should be negative given the strong imbalance between the lack of any real productive investment and high savings and thus demand for financial assets as demographics degrade. Nevertheless, with the need for ECB tapering well telegraphed against a backdrop of stronger economic growth, yields may continue to sell off in the near term, and such corrections are usually sharp and ultimately vicious.

If stronger European growth has been the primary driver behind the yield moves globally, then we should expect to see an eventual unwind of higher yields in regions without the same upside potential to growth.  But we feel that the markets are currently being driven more by central bank speak than by economic fundamentals. If central bankers really want to rein in financial risk, then they will ignore poor inflation dynamics and continue to raise rates absent a rout in risk assets.  This means that we could see yields go higher before they ultimately start their reversal, and such moves will be accompanied by rising volatility across all asset classes. By trying to reduce financial risks, the central banks may in fact ignite them.

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## About BTIM's Income & Fixed Interest Boutique

BT Investment Management's Income & Fixed Interest team of thirteen dedicated professionals, led by Vimal Gor, manage the #1 performing Australian composite bond fund of 2014 and 2011.

For the latest Market Insights from Vimal Gor and his team visit btim.com.au/education-and-resources/



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