WEEKLY ANALYSIS

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End of global QE and support for rate markets

Normalisation of US monetary policy is intensifying. Some correlation on rate markets once again. Commodities and employment are propping up inflation.

Key points

- 2017 will mark the end of global quantitative easing
- Normalisation of monetary policy is confirmed with the Fed's 3rd rate rise
- Next steps: the ECB, BoJ, and PBOC will reduce liquidity injections
- Inflation, propped up by commodities and employment, should not be under-estimated in 2017
- United States: the fall in the jobless rate to 4.5% will spark a rise in domestic inflation
- Eurozone: the ECB will not hold back interest rate rises in the long term
- United Kingdom: insufficient yield
- Japan: still uninspiring
- Emerging markets: current rates are providing some protection against the risk of capital losses

2017 will mark the end of global quantitative easing

For a few years now, central banks have been injecting trillions in liquidities into the financial system, firstly to counter the systemic risks sparked when the financial crisis hit, then to contain its negative consequences, and finally to foster a lasting recovery of economic activity. The aim of revitalising inflation came later, to work as a counterbalance to the negative, deflationary forces acting on economic growth.

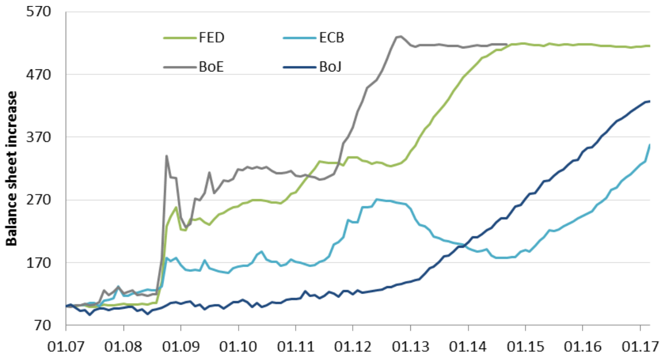
The Fed was key in developing this approach, which was initially branded as unconventional policy (quantitative easing). Today, its effects, at least for the US economy, can be considered broadly positive in light of the growth achieved and the situation on the labour market.

In **Europe,** this policy of huge liquidity injections came later, and came up against damaging after-effects, which might in part explain the region's delayed economic growth, although the recovery has now been making itself felt for a few quarters.

In **Japan,** the situation is rather different, as the BoJ's balance sheet is clearly showing that liquidity injections were made very late in the day, and that their effect on the Japanese economic trend is relatively modest for now.

In **China,** growth of the PBOC's balance sheet has not been insignificant, and liquidity injections have enabled the Chinese economy to weather a phase of collapse in international demand by developing infrastructure and consumption.

Central Banks' Balance Sheets



Sources: Bloomberg, BBGI Group SA

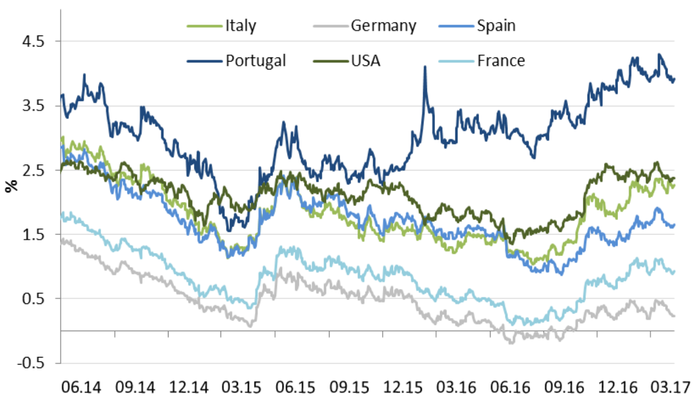
For a few quarters now, the global economic cycle has been gaining in strength thanks to the US acting as an economic catalyst. The good performance of the US economy provided the grounds needed to end quantitative easing in the United States in 2015, although the wheels of normalisation of global monetary policy have only slowly been put into motion since then. The current global economic recovery is on the point of sounding the death knell for expansionary monetary policy in the other large developed economies. We should certainly see similar sequences of very gradual withdrawal of central banks. They will probably follow the same steps, first of all stopping liquidity injections (ending asset purchase programmes), and only then moving towards modest increases in their key rates. For bond markets, the end of quantitative easing will remove a key element of demand and support, which is keeping long rates low.

Normalisation of US monetary policy is confirmed with the Fed's 3rd rise in key rates

As we start the 2nd quarter, we believe that the Fed is determined to take another step in normalising its interest rates soon. As such, it is clearly demonstrating that it evaluates the US economic situation in a more positive light in 2017. In January 2015, the Federal Reserve put an end to the expansion of its balance sheet and announced that it would normalise its policy. Between September 2008 and January 2015, the Fed's balance sheet had swollen by US $900 billion to US $4.5 trillion. As such, nearly US $3.5 trillion were injected into the economy.

Over the last two years, since the end of QE was announced, the size of its balance sheet has only marginally shrunk (around US $50 billion). Interest rate normalisation started in December 2015, but we had to wait a year before seeing a second rise in key rates. In 2008, the high target for Fed Funds was set at 0.25%, before seeing a first rise to 0.5% in December 2015, and then a second to 0.75% in December 2016. This was then hiked to 1% at the latest FOMC meeting on 15th March.

Government Ten-Year Yields (%)



Sources: Bloomberg, BBGI Group SA

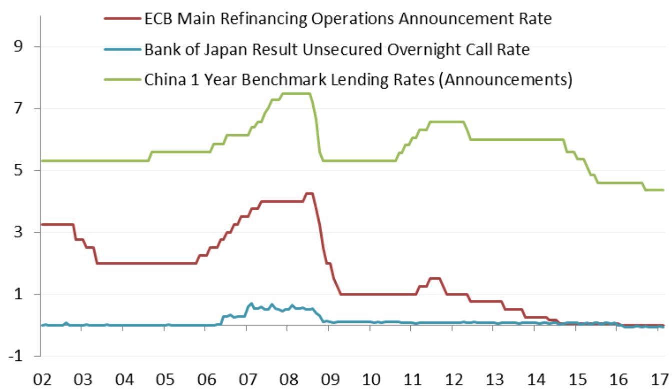
Although the US Federal Reserve consented to a fresh rise in key rates, this was first and foremost because it considers that the US economic situation requires action. However, it is also because its evaluation of economic and political conditions internationally is much more positive and includes fewer risks of negative surprises. By hiking its key interest rates in March, the Fed was indirectly sending a message of optimism regarding the international economic situation. In other words, it considered that it is increasingly likely that the economic situations, particularly in Europe, Japan and China, will also show clearer signs of recovery, providing grounds for a change in monetary policy in these countries in the near future.

Next steps… the ECB, BoJ and PBOC

In Europe, the ECB chief seems increasingly convinced that economic conditions in the Eurozone have improved. The ECB increased its GDP growth forecasts to +1.8% in 2017 and +1.6% in 2018. The recovery in Europe is still considered to be tentative, but is in fact close to forecasts for the United States.

The Central Bank increased its inflation forecasts from +1.3% to +1.7%, despite inflationary pressures excluding food and energy remaining modest. Monetary policy should remain expansionary for a time still, but having stated that "there is no urgent need to take new measures", it is underscoring a change in attitude, showing greater confidence in the effectiveness of measures taken and the ability of the European economy to cut itself free of ECB support to post good performances.

ECB, BoJ and PBOC Key Rates



Sources: Bloomberg, BBGI Group SA

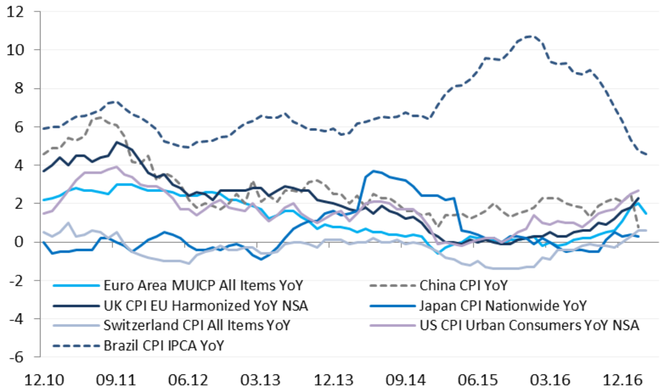
The ECB will leave its key rates unchanged at zero for MROs, and at -0.40% for its DFR, likely until it announces the end of its €80 billion asset purchase programme, which should continue until the end of 2017. As such, growth in the ECB's balance sheet should fall over the next few months. We are expecting a similar situation in Japan and China at the end of the year, when growth prospects and inflationary forecasts are confirmed. We therefore believe that total liquidity injections from the four main central banks will all but dry up in the second half of 2017. This represents the first stage of unconventional policy normalisation (end of QE). The second stage of expansionary monetary policy normalisation will take the shape of a gradual rise in key interest rate levels. However, this adjustment phase should take time, particularly for Europe and Japan.

Inflation should not be under-estimated in 2017

Global indices are now moving in the same direction as those excluding food and energy. Markets have become accustomed to very low inflation figures over the last few years, but we believe that this will change markedly in 2017. The rise in inflation is partly due to base effects which will intensify and then stabilise. In the United States in particular, forecast inflation is now higher than the Central Bank's target.

Inflation excluding food and energy is already close to the Fed's 2% target. In 2017, it is entirely likely that endogenous factors (salaries) and exogenous factors (commodities) could combine to push prices above the Central Bank's generally stated targets. Inflationary forecasts have rather considerably increased in developed countries, and dropped a little in emerging markets.

Consumer Price Indices (USA, UK, Europe, Switzerland, Japan, China, Brazil)



Sources: Bloomberg, BBGI Group SA

These developments will have a significant impact on rate markets. A clear trend reversal on inflation, particularly if it falls within a context of a gradual improvement in economic conditions, will affect investors' assessment of opportunities and risks.

Rapid readjustments of forecasts could spark considerable rate shocks on bond markets over the next few quarters. We believe that inflation could be one of the new key factors in determining changes in rate markets over the coming months.

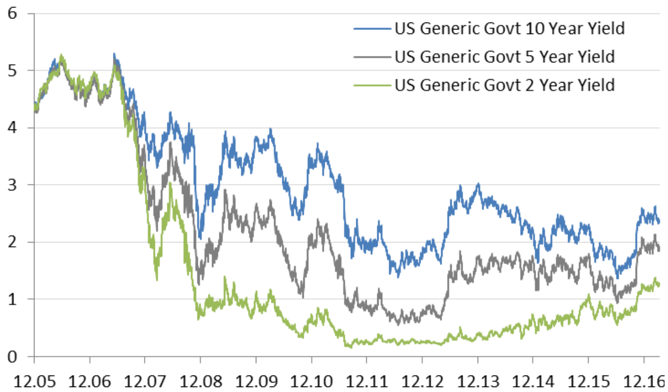
United States: the fall in the jobless rate to 4.5% will spark a rise in inflation

In the United States, monetary policy is now undergoing active normalisation. The signs of improvement in the economy are increasingly clear, and the latest unemployment rate figures of 4.5% bear testament to this strength, despite some less favourable statistics, which had been affected by difficult meteorological conditions over the period. A rise in crude oil prices is often the first factor used to justify a bounce back in prices. However, the vim and vigour of the employment market will definitely create some tensions, which will translate into an increase in salaries.

The Fed is impatiently awaiting this rise in order to demonstrate that its policy is effective, and will undoubtedly be a little lax in fighting any potential rise in price indices. The increase (+28%) in the average hourly wage is the greatest since 2009. Pressures should start to be more strongly felt, with wage rises likely to intensify. US long-term rates have continued to rise since Donald Trump was elected, hitting +2.6% for ten-year Treasury bonds in March.

Today, we believe that this level- close to our 3% target for 2017- is more or less consistent with the current economic situation. The rise could continue if growth forecasts of +3% to +4% prove accurate. For the time being, however, the expected rise in inflation and leading inflation provides no grounds for any such movement.

US Government 2, 5 and 10 Year Rates (%)



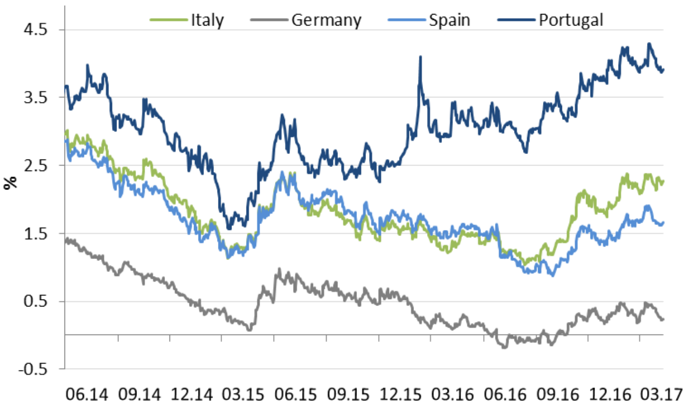
Sources: Bloomberg, BBGI Group SA

At current levels, bond yields in US dollars are able to attract American and international investors seeking alternative yield, as the yield differential is often favourable. This might also slow the rise in yield, despite a globally favourable context for bonds.

Eurozone: the ECB will not hold back any rise

After a first rise in ten-year yields up until January 2017, we are now seeing a temporary stabilisation of interest rates at just above zero, as expected. This current consolidation should be relatively short-lived, before the upward trend asserts itself. ECB action and a lack of acceleration in growth are still enough to prevent a rise in long-term rates. However, when this rise does happen, we should see a broadening of the rotation away from Eurozone bonds and towards equities in portfolios. This can already be seen in the large volumes invested in European ETFs in equities.

10 Year Rates – European Gvt (%)



Sources: Bloomberg, BBGI Group SA

In absolute terms, rates are close to zero or negative. They are therefore even more vulnerable to profit taking and all methods of reallocating risk. We should not forget that German Bund yields had leapt from 0.15% to 1% between May and June 2015, when inflation had headed back above zero. We therefore recommend paying particularly close attention to risks of a rise in long rates, which could grow with improvement in economic prospects and the bullish trend on inflation.

United Kingdom: insufficient yield

Inflation made a clear come-back in the United Kingdom, largely due to the fall in the pound sterling, which sparked a rise in imported inflation. Price indices are increasing, sometimes at an impressive pace, although the overall price rise (CPI) is still only +1.8% year on year, and +1.6% for the index excluding food and energy. In this context, ten year rates have bounced back considerably from the lows seen in mid-August (0.5%), recovering to pre-referendum levels (1%).

Japan: still uninspiring

The change in the situation regarding inflation is still too recent and too tentative to have any real impact on interest rates. Although the upward trend in government long rates since July 2016 is undeniable, the breadth of this movement, nonetheless, remains rather restricted.

Emerging markets: current rates are providing some protection against the risk of capital losses

In the end, emerging debt did not undergo mass capital withdrawal, as one might have feared. On the contrary, capital flows have been positive for the past few months, particularly for sovereign bonds from emerging markets.

The risk of emerging markets being affected by protectionist measures under consideration by the new US administration, which was raised after Donald Trump was elected, was eventually ruled out thanks to more favourable prospects in light of the improvement in the global economic cycle. Emerging markets may still represent an interesting opportunity for diversification in the current context, but they have become a little riskier. They will not be immune to any change in perception on developed markets.

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