20 January 2017

Inflation will support the rise in bond rates in 2017

Trend reversal in long-term interest rates. Clear return of inflationary expectations. Higher yields in the US and emerging markets. Stay cautious regarding increases in Europe.

Key points

- The election of Donald Trump hastened the end of the global bond bull market
- The shift in global expectations has caused a generalised increase in long-term interest rates around the world
- This strong correlation among interest rate markets is likely temporary but will strengthen
- In 2017, rising inflationary expectations will drive up long-term rates
- The swift upswing of long-term rates could slow the pace of the Fed's interventions in 2017
- President Trump's programme will not have a material impact on the real economy until the second half of the year
- The monetary policies of the ECB and BOJ will be less accommodative in 2017
- The outlook for emerging bond markets is still positive

Reversal on long rates did take place

As we predicted in July, the result of the British referendum was one of the key events for rate markets in 2016, as it sparked a last push of the downward trend.

The surprise of Brexit precipitated the fall in government bond yields in most countries. At the time, we indicated that this yield drop could not last.

Yields were quick to bounce back, with renewed confidence just as economic data were giving greater visibility and positive economic prospects.

Before the US elections, 10-year interest rates had already bounced back to their pre-Brexit levels. However, it was really the surprise result of the US presidential election that truly marked the end of the bull market for bonds, sparking an abrupt, major readjustment of growth and inflation forecasts for 2017.

Over the last few weeks of 2016, long rates posted one of their greatest rises of the last few years, in a rather widespread movement, affecting practically all international bond markets.

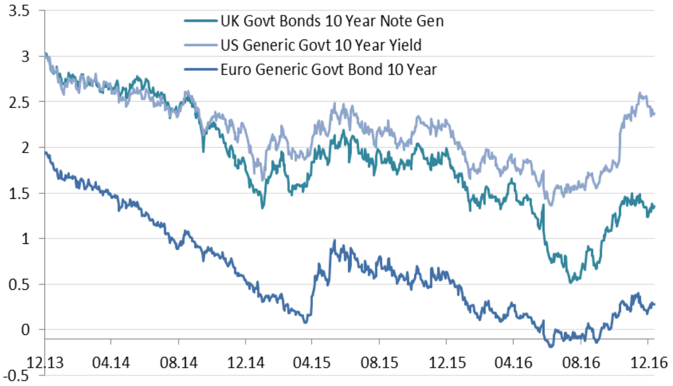
Correlation was relatively strong for a few weeks, although we were already underscoring our scepticism as to whether this could continue into the start of 2017. The downward trend on long rates has often been slowed by short recovery periods over the last few years.

There is therefore reason to wonder as to the nature of the current long rate bounce back, and how long this trend will last. In order to provide a satisfactory response to this question, we need to distinguish between economic issues, and current monetary policy.

In the United States, we will undoubtedly see truly stronger growth prospects, which will gradually lead to inflationary effects. The rise in long rates in US dollars is therefore grounded in fundamentals that are already visible, and improving. A limited, short-term correction is likely, but will be followed by a fresh rise. We believe that the trend reversal in the United States has taken firm hold.

It seems to us that this is also the case in Europe, although we are expecting a more significant temporary correction in yields due to ECB action. Overall, we will be able to say with greater certainty that the rate trend has indeed reversed by the second quarter 2017.

10-year yield - Government Bonds



Sources: Bloomberg, BBGI Group SA

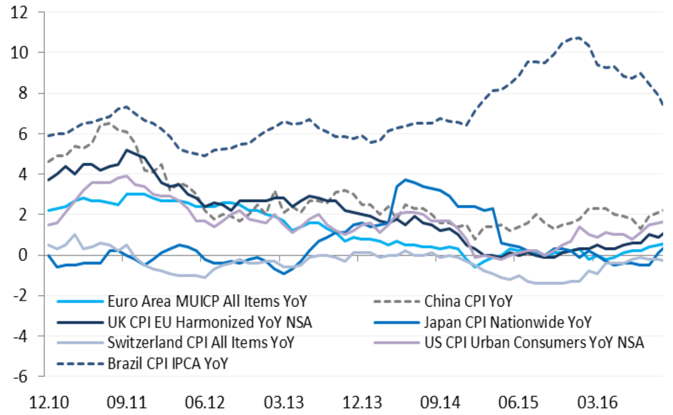
Effects of a return to inflationary forecasts

New prospects for US growth incorporate the increased probability of an inflationary recovery. We believe that investors will now gradually change the focus of their analysis and will be more concerned by rises in inflation rates when setting out the expected nominal yield on their bonds.

Inflation has also gradually been improving for a few months, and is heading back above zero in countries experiencing deflation.Markets had become accustomed to very low inflation figures over the last few years, but we believe that this will clearly change in 2017.

Rising inflation, along with the Fed normalising monetary policy, will affect investor confidence and the level of yield demanded. Bond yields should adapt to these new demands, by offering higher yields than those seen over the last few years.

Inflation - Consumer price index



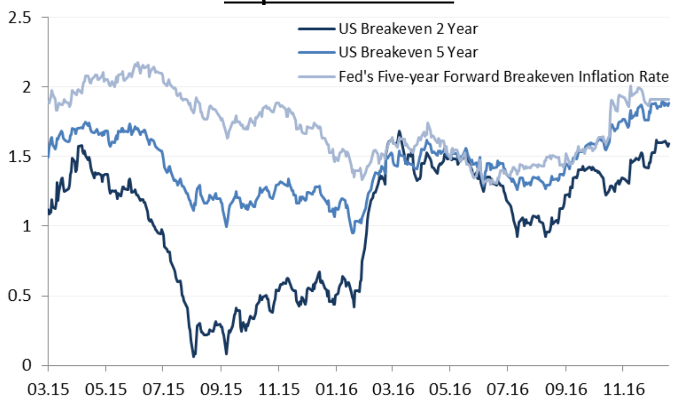
Sources: Bloomberg, BBGI Group SA

United States: renewed interest thanks to higher yields

We were expecting a new stage in monetary policy normalisation in the United States in December, which did take place. After this +0.25% rise in key rates, it is likely that the Federal Reserve will take a break until the second quarter, before taking further action. There were signs of economic improvement at the end of the year, as suggested by the annualised +3.5% rise in GDP in the 3rd quarter. These signs will undoubtedly come thicker and faster over the coming months.

The abrupt change in growth and inflation forecasts following the presidential election directly caused a sudden rise in long rates. This increase could put the brakes on the economy over the coming months.

Expected inflation



Sources: Bloomberg, BBGI Group SA

Although long rates should head even closer to the 3% threshold, the Fed probably will not run the risk of shaking up the economy, and could even slow down its interventions in 2017.

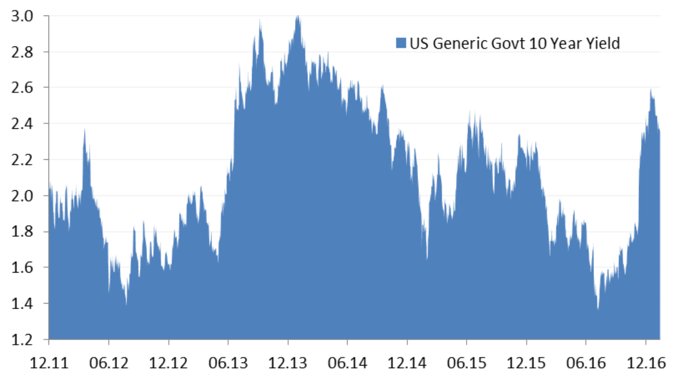
This rise in Treasury long rates was one of the quickest of this decade due to the rather radical shake-up of forecasts linked to the surprise election of Donald Trump. Although we have no doubt about the health of the US economy, which should improve further in 2017, we nonetheless do not expect to see such quick tangible effects from Republican economic policy measures. Such measures will likely only be implemented in a few quarters' time. An economic surge is therefore still not on the cards, and gradual economic improvement will likely continue in line with the performances already posted.

We might therefore wonder if the rise in long rates is already high enough to incorporate new post-election prospects.

In our last "Investment Strategy", we pointed out that the US economic context provided justification for the increase in long rates, which would be sparked by the election results and upward momentum from price indices. The expected rise in long rates did indeed take place, just as we are predicting a very stark inflation rebound at the start of 2017 Despite this, the rise in long rates should lose some momentum, causing yields to stabilise at between 2.5% and 3%.

The US bond market is now offering more tempting yield prospects linked to a modest currency rise. Bonds denominated in US dollars are claiming back their place within an internationally diversified strategy.

US Treasury Bills – 10-year yield



Sources: Bloomberg, BBGI Group SA

Eurozone: rate rise hands the ECB an opportunity

The Eurozone has recovered some confidence. Economic prospects are improving, despite the rather unconvincing Juncker plan. ECB monetary policy will be more expansionary in 2017. Inflation is finally heading back above zero, and pushing real interest rates into negative ground. This trend will gain in strength over the coming months due to the rise in crude oil prices. The capacity utilisation rate and the high level of unemployment will not, however, provide any support for the inflation recovery. Key interest rates will actually remain very low.

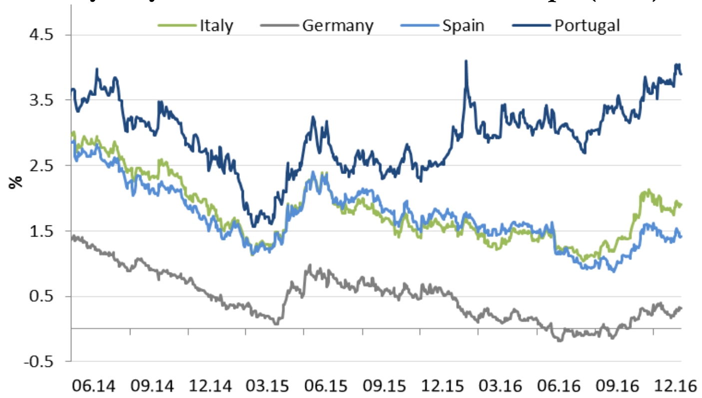
The ECB is still trying to spark inflation, but economic growth rates still seem to be insufficient for it to hit its targets. In the short-term, the rapid bounce back in long-term interest rates are offering the ECB a new opportunity to take action regarding nominal rates and to bolster its purchase programme. Interest rates should once again fall in the Eurozone, leading to negative real rates; this should prop up growth in 2017.

Prospects for European bond markets are ever so slightly positive. Long rates should once again yield ground, but without hitting the low points seen in June 2016.

Low capital gains are to be expected over the next few months, but we predict renewed correlation on rate markets after the temporary lull that will come during the next phase of long rate hikes.

We recommended paying close attention to the risks of a rise in long rates, which had increased last quarter. With the November rise, long rates have surpassed their nominal level, de facto increasing the likelihood of a temporary drop at the start of the year.

10-year yield – Government Bonds Europe (in %)

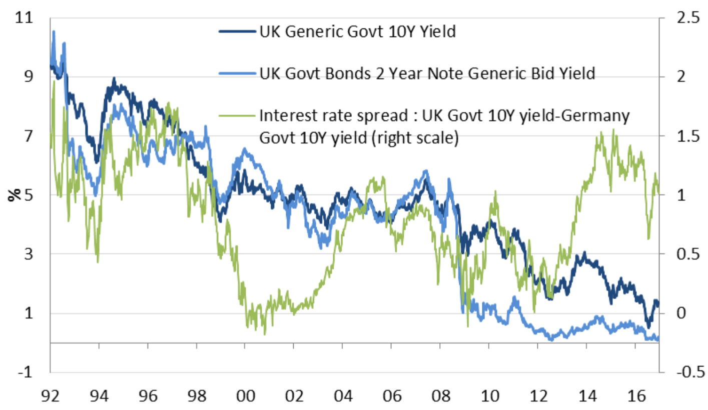


Sources: Bloomberg, BBGI Group SA

United Kingdom: pressure on the Bank of England

As we had previously stated, the fall in the pound should have revitalised inflation. Import prices have indeed risen, and the country's economic performance is somewhat higher than what might have been feared following Brexit, which may nudge the central bank into revising its policy. The BoE had announced a sweeping recovery plan, which aimed to reassure business leaders and households, who were concerned about the possible repercussions of the referendum. It then dropped its key rate from 0.5% to 0.25% in order to bolster households' and businesses' financing capacity.

UK Government Bonds (in%)



Sources: Bloomberg, BBGI Group SA

It also introduced a more competitive financing programme for banks in order to facilitate the transmission of its policy. Its asset purchase programme has been stepped up in order to enable further monetary injections.

However, the latest developments rather give the impression that there could be a rise in key interest rates in the near future, especially in light of the revisions to inflationary forecasts that have been announced.

Price indices are at times increasing at an impressive rate, although the overall price rise (CPI) is still only +0.9% year on year. In this context, ten-year rates have leapt considerably since their 0.5% low in mid-August, recovering to their pre-referendum level of 1.5%.

Japan: a market to be avoided

The situation for bond yields in Japan is already serious and important enough to be mentioned; government long rates in yen leapt from -0.3%, their rock-bottom level just after Brexit, to +0.1% at the end of the year. Without trying to hide the correlation effects seen on most international rate markets, the rise in inflation in Japan is undoubtedly finally being seen has a lasting trend reversal, buoyed up by the -17% fall in the yen at the end of the year. The BoJ cannot yet start celebrating, but its attempts to reflate the economy by dropping the yen finally have a shot at success, just as they will also benefit from the added effects of the rise in crude oil prices.

As such, the first quarter 2017 should see a rise in price indices in Japan. With no yield, no prospect of capital gains, and in a context of the yen weakening, Japanese bonds have no place in an internationally diversified strategy.

Emerging markets: take advantage of Trump's shock statements

Emerging bond markets had benefited from yields falling in developed countries and investors repositioning. Since the start of the year, we had highlighted that this segment of the bond market was still offering a rare opportunity for capital gains and decent yields. This was slightly less true following the +15% price rise seen up to October. However, fresh uncertainty linked to Donald Trump's statements regarding free trade wiped off some of this increase.

These calamitous prophecies will not be repeated, so diversification in this sector seems reasonable at current prices.

Moreover, the commodity cycle recovery will certainly strengthen the currencies of commodity-producing countries, thereby also improving their current accounts. The trend reversal on prices of crude oil and industrial metals could alter investors' perceptions of prospects for the most severely punished emerging economies and encourage a change in forecasts.

However, although emerging bonds might provide an interesting opportunity for diversification in the current context, they have also become higher risk.

Conclusion

The global long-term interest rate cycle clearly reversed during the summer of 2016, coinciding with the normalisation of US benchmark rates.

In 2017, long-term rates everywhere will likely follow a similar normalisation and growth trend driven by a gradual rise of inflationary expectations.

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