14 October 2016

Inflation will be a key factor for interest rates in 2017

Brexit will constitute an inflection point for long-term interest rates. Increase in prices indices in the first quarter of 2017. Rising wages in the US. Vulnerability of European markets.

Key points

- Brexit may constitute an inflection point for long-term interest rates in 2016
- Inflation could become the next determining factor for interest rates
- US ten-year rates reverted back to their pre-Brexit levels and follow a new upward trend
- Endogenous (wages) and exogenous (commodities) factors will push price indices above 2% in the United States
- The recovery in Europe is underway; growth and liquidity injections by the ECB will support a rise in price indices already observed with the correction of the euro
- In the next few quarters, significant rate shocks in the bond markets cannot be excluded

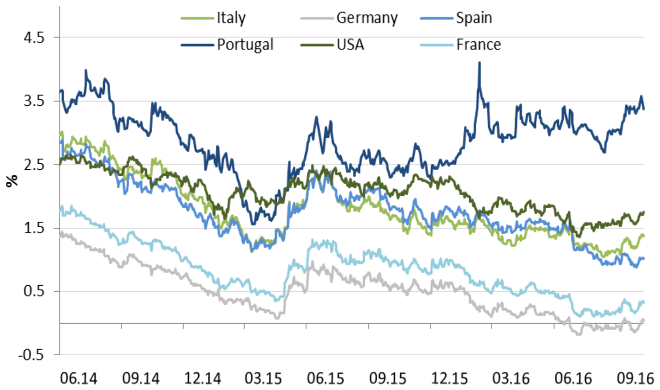
Brexit may constitute an inflection point for long-term interest rates

The outcome of the British referendum impacted fixed income markets in the third quarter yet again. The shock was brutal and unexpected across interest rate markets and extended into the first days of July.

The Brexit bombshell triggered a drop in sovereign yields in most countries, including countries with no obvious connection to the British vote.

Naturally, investors' reaction to this new source of uncertainty was reflexively to reallocate risk to less volatile assets, to the detriment of equities in particular. Bond markets thus immediately jumped on this opportunity. In the UK, government yields fell from 1.6% to 0.5%; in the Eurozone, the Bund sunk into negative territory (-0.2%); in the US, yields dropped from 1.7% to 1.3%. Risk premiums occasionally recovered slightly amidst the general downward trend. The increasing prevalence of very low and sometimes negative yields further reduced the rare remaining investment opportunities in the bond markets.

Government bonds – 10-year yield (%)



Sources: Bloomberg, BBGI Group SA

The drop in yields at the start of the summer ultimately did not last. It was even followed in some cases by very significant rebounds, as in the United States in particular, announcing a sharper trend reversal on long-term rates than the current pace of normalization of policy rates.

A rapid return of confidence in the Eurozone and even in the UK occurred just as economic data were providing a little more visibility and a positive economic outlook. In the US, ten-year rates reverted back to their pre-Brexit levels. However, it still took three months of gradual and consistent rate increases to erase the drop that occurred between 23 June and 5 July.

The trend is not as clear for German long-term rates, although they did tick up from -0.2% to 0.01%. In the UK, the risk of recession has been somewhat forgotten, and rates have also rebounded from 0.5% to 0.95%. The trend reversal is ultimately fairly evident in most markets.

Brexit may thus constitute an inflection point for long-term interest rates.

Inflation could become the next determining factor for fixed income markets

The zero or negative interest rate policy is reaching its limits. Central banks' capacity to act is diminishing, even if the ECB and the BoJ are staying committed to their respective liquidity injection policies. We believe that investors will now gradually change their focus and pay more attention to rising inflation rates.

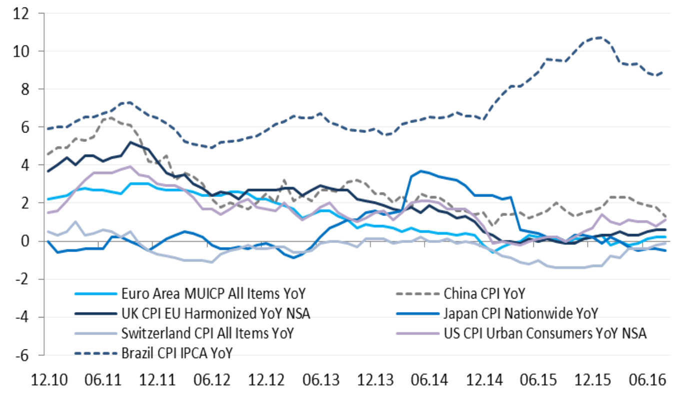
For several years, central banks have injected trillions into the financial system, hoping to stimulate growth and boost inflation. Only a few months ago, in 2015, fears centred on deflation risk in Europe, Japan, Switzerland and other regions of the world. The trends in commodities and oil prices first pushed price indices into negative territory. However, for several months, inflation has been gradually increasing and is now back above zero.

Both broad indices and those excluding food and energy are now progressing in the same direction. Markets have become used to very low inflation figures over the past several years. We believe that this will change markedly in 2017. The rise of inflation is partly due to base effects that will amplify during the first quarter and then stabilise. However, in the US in particular, expected inflation is already higher than the Fed's target. Inflation ex food and energy is already approaching its target rate.

In 2017 it is quite possible that endogenous (wages) and exogenous (commodities) factors combine to push price indices above the target generally announced by central banks. It is crucial to note that such developments will have a significant impact on rate markets. A clear trend reversal in inflation, in particular if it occurs in a context of gradually improving economic conditions, will have an impact on investors' assessment of risks and opportunities.

Rapid readjustments of expectations could trigger significant rate shocks in the bond markets in the next few quarters. In our view, inflation could become one of the new key factors determining the course of the rate markets.

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

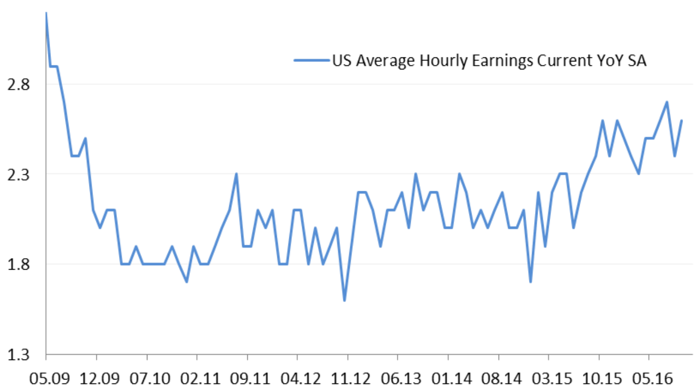


Sources: Bloomberg, BBGI Group SA

USA: inflation will be bolstered by rising wages

In the US, monetary policy will remain unchanged until December. Indicators continue to point to a strengthening economy, but perhaps not sufficiently to trigger swifter action by the FOMC. However, in our view the key element that will influence long-term dollar rates is increasingly of a domestic nature. The rise in oil prices will obviously trigger an increase in inflation in the next few months, but the American economy should be the first to note an increase, albeit limited, in wages. The Fed is impatiently waiting for this to occur to demonstrate the effectiveness of its policies and will likely be somewhat lax in fighting a possible rise in the price indices.

Hourly Earnings growth - USA

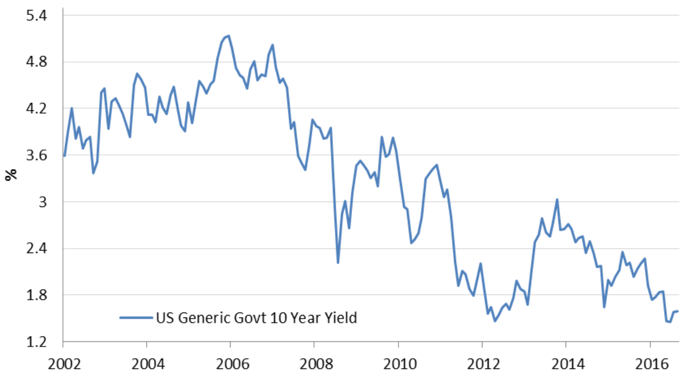


Sources: Bloomberg, BBGI Group SA

To date, wage increases have not been spectacular, although they have risen +2.6% year-over-year. The job market remains strong, even though job creation has sometimes seemed less robust than hoped for. For several weeks the unemployment rate has not really decreased, stabilising at 5%. We expect that the job market will continue to show signs of strength in the fourth quarter, which will in turn impact prices. Inflationary pressures will likely take hold more firmly, as wages start to increase more decisively.

In this context, long-term US rates seem too low to us and will likely correct significantly in the near future. The American elections could become a triggering factor in terms of an increase in rates, but price indices are most likely to impact interest rates in the coming months. Ten-year Treasuries could rise from 1.6% to 2.0% in the next six months.

US Government bonds – 10-year yield (%)



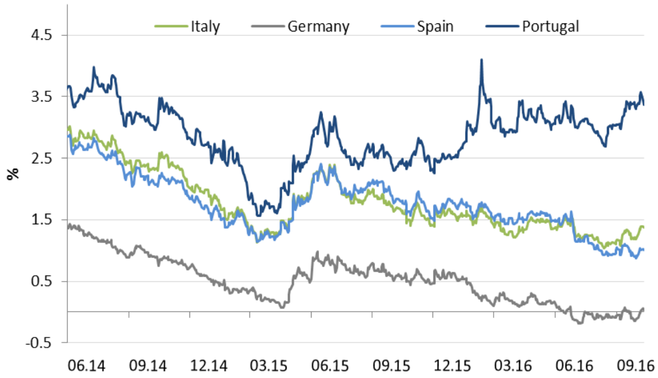
Sources: Bloomberg, BBGI Group SA

Eurozone: Beware the trend reversal

In Europe, the job market obviously is not as dynamic as in the US. However, the rise in inflation is also noticeable and partly linked to the increase in commodities prices. Since 2012, inflation was gradually decreasing, portending risks of deflation, which materialised on core indices in 2015. The increase in both price indices (core and ex food/energy) that started in the summer of 2015, following the correction of the euro, should continue in 2017. This factor should nevertheless weaken in intensity. On the other hand, the ECB's liquidity injections will continue and should bolster growth and inflation expectations. The ECB is anticipating a 1.2% increase in prices in 2017.

We expect a slightly higher increase due in particular to our favourable outlook on oil prices. From a relative point of view, European rate markets are facing different issues than dollar rate markets. Rates are close to zero or negative and are thus more vulnerable to profit-taking and any form of reallocation of risk. Recall that German Bund yields had surged from 0.15% to 1% between May and June 2015, when inflation climbed back above zero.
We thus recommend focusing particularly on the risks of long-term rate increases that are intensifying at year-end with the improving economic outlook and upward trend of inflation.

European Government bonds – 10-year yield (%)

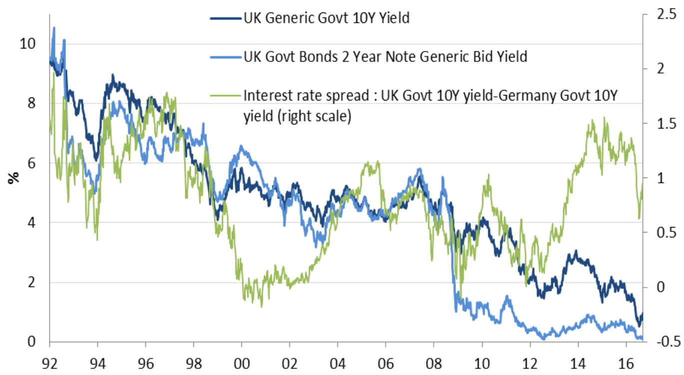


Sources: Bloomberg, BBGI Group SA

UK: The bond market euphoria is over

In spite of the pound's tumble and rising inflation in August (+0.3%), price indices have not expanded significantly to date, namely, +0.6% year-on-year and +1.3% for the index excluding food and energy. However, the +7.6% year-on-year rise in imported prices following the fall of the pound and the increase in oil prices should transfer to core price indices.

UK Government bonds – 10-year and 2-year yield (%)



Sources: Bloomberg, BBGI Group SA

In this context, ten-year rates reached new historic lows, dropping below their January 2015 floor to a mere 0.5%, before gradually coming back up since mid-August. This situation is absolutely extraordinary, as it does not appear to be taking into account the significant risks of an increase in interest rates and risk premiums, which are logically linked to Brexit and the immediate downgrade of UK government debt from AAA by the rating agencies.

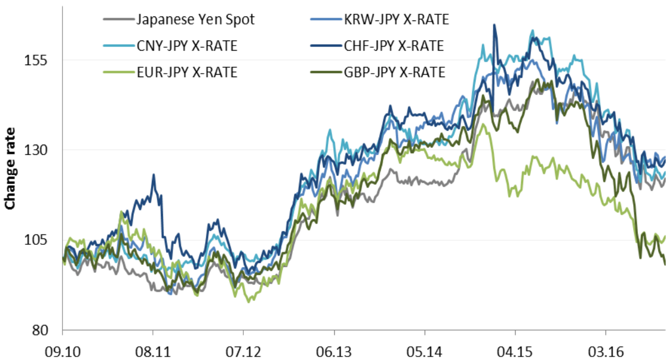
Nevertheless, this situation is a key element bolstering the economy, even though the current euphoria is unlikely to last. We recommend avoiding taking a premature position in the UK market.

Japan: A worthless market

The BoJ's last meeting did not provide any fresh outlook on the Japanese bond market. The positive surprise in GDP growth is unlikely to radically change investors' perceptions.

Indeed, it is still too early to assume that the economy has recovered sufficiently to free itself from a low rate policy. The bond market will thus likely remain anaemic, and Japanese rates continue to fluctuate within a very narrow band. Moreover, implicit volatility is approaching its lowest historical levels.

JPY Exchange rate



Sources: Bloomberg, BBGI Group SA

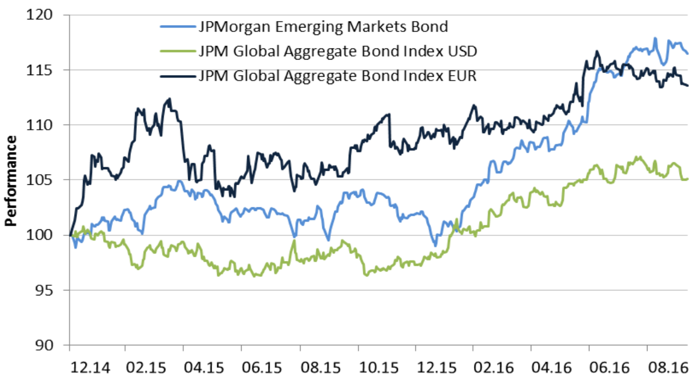
This situation should favour carry trades in dollars, euros and other currencies. However, for now we still are not observing any positive induced impact on the exchange rate. The yield spread is expected to increase, however, penalising the yen. But the absence of a Fed Funds rate hike in the US is likely preventing this development for the moment.

Emerging markets: Up 15% already

Emerging bond markets have benefited until now from the decrease in yields in developed countries. Since the beginning of the year, we have been noting that this segment of the bond market was still offering one of the rare opportunities for capital gains and decent yields. This is less and less the case after prices jumped +15% in emerging markets overall.

The upswing in commodities will likely bolster the currencies of producer countries, thus also improving their current account balances. The trend reversal in oil and industrial metals prices could change investors' perceptions of the prospects of those emerging countries most penalised and facilitate an adjustment of expectations. However, while emerging market bonds may still provide an attractive source of diversification in the current context, they have also become more risky. They will not be immune if perceptions regarding developed markets change. Profit-taking thus seems reasonable at these levels, in our view.

YTD Performance of Emerging markets corporate bond indices (rebased at 100)



Sources: Bloomberg, BBGI Group SA

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