Economic Research

WEEKLY ANALYSIS

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The global long rate recovery is taking shape in 2018

The consensus is still sceptical regarding the inflation recovery. The United States could surprise us in 2018. Correlation on rate markets. Be careful of the European market. Rate rise in Switzerland.

Key points

- Upturn in inflation could be the surprise of the year
- Rate hikes and flattening yield curve
- A rise in long-term rates is looming in the euro zone
- UK: The bond market cannot remain indifferent to the pick-up in inflation
- Japan: Bonds are not providing any opportunities
- Switzerland: Inflation finally positive in 2017 after 5 years of deflation
- Focus on short maturities and take a cautious stance on peripheral debt

Upturn in inflation could be the surprise of the year

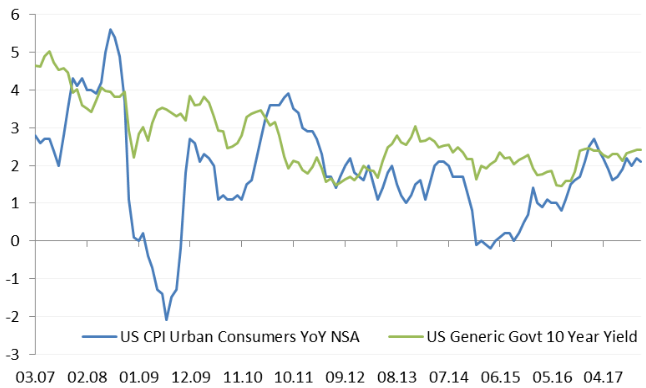
The latest inflation figures published in December (+2.1%) pointed to a stabilisation of price indices slightly above the Federal Reserve's targeted +2%. The year-on-year rise of the index, excluding food and energy (+1.8%) was slightly below expectations and still under 2%.

This shows that inflation has clearly struggled to gain greater momentum in H2 2017, despite statistics that indicated accelerating economic growth in the US.

In this context, it is unsurprising that the general assessment of the risk of an inflation recovery is so mixed. Most observers are sceptical, but year-on-year inflation (+2.8%) is expected to increase considerably according to the University of Michigan indicator.

For its part, the central bank is not showing any signs of worry or impatience, noting instead that temporary factors have for the moment held back an increase in prices. Nevertheless, the strength of the economy and an unemployment rate at a 16-year low will almost certainly trigger tensions and price increases enabling inflation to exceed the set targets. Pressure on wages is slow to materialize, despite a continuously improving job market.

Inflation and 10-Year US Treasury Bonds



Sources: Bloomberg, BBGI Group SA

Contrary to theory, inflationary pressures are still weak, while the unemployment rate has steadily dropped to a historic low of 4%, de facto approaching its full employment level. Nevertheless, the Fed remains relatively serene and convinced that the relation between employment and inflation still exists, even if it appears that the Phillips curve is for the moment clearly flatter than before. Import prices have surged 3.7% yoy mainly due to the increase in oil prices in November. This trend will likely continue in 2018 with the upswing in business activity. Forecasts for expected inflation have progressed at the end of the year, reaching +2.7% yoy and +2.4% on a 5 to 10-year time horizon.

In the US as in most economies, rising inflation was indeed triggered by the increase in crude oil prices that began in 2016 and continued to have an effect in 2017 – a year that was marked by successful policies carried out by central banks to put a stop to deflation and to bring the rate of inflation back towards their targets generally set at 2%. Thus, inflation has returned to a "normal" level, while employment has improved and tensions on the job market have yet to appear.

A series of surprises could mark 2018 owing to multiple factors acting in combination. Indeed, the macroeconomic environment will likely be conducive to wage negotiations and pressures on commodity prices, supporting an increase in production and consumption prices.

Rate hikes and flattening yield curve

A return of inflation in a robust economic environment will likely see long-term nominal rates being adjusted once again in the next few months. After a few quarters of stabilisation, US long rates will likely be the first to kick-start the trend once again. Already several months ago, we noted that the adjustment in 10-year Treasury rates from 2.6% to 2.1% observed until the end of the summer was not at all compatible with our economic growth expectations in the area of +3% and with a normalisation of the Fed's regular monetary policy. We then believed that an increase in long rates would very likely be observed in the second part of 2017 and in 2018.

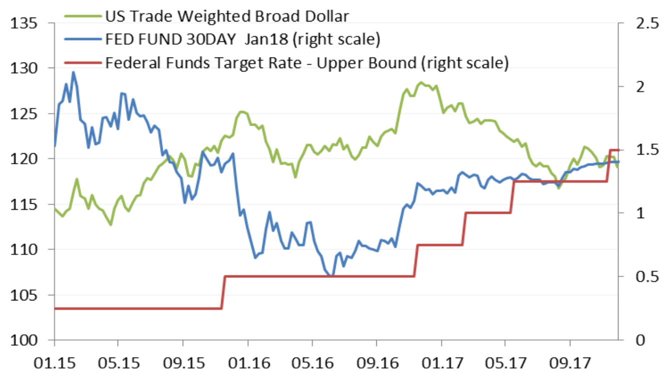
This took the shape of an increase in 10-year rates from 2.1% to 2.5% as of 31 December.

Thus, long-term rates are once again close to the highs they had reached in March and in the upper section of their fluctuation band for 2017. In H1 2018, confirmation of strong economic data will probably be accompanied by an increase in crude oil prices and commodities prices likely to trigger valuation adjustments in the interest rate markets.

During its last meeting, the Federal Reserve proceeded with a further rate hike to 1.5%, as expected. New chair Jerome Powell will take office after the next meeting in January with no risks of significant change in the stated policy. Balance sheet normalisation will remain very moderate, not to say imperceptible. In parallel, the target for key rates (Fed Funds) will likely increase to 2-2.25% in 2018. FOMC members' analysis of the economic conditions and the state of the US economy remained relatively unchanged in December.

We believe that most maturities will be subject to a 0.5% adjustment in the next few months that will push 10-year Treasury rates above 3%.

<u>Fed Funds, Key Rates and Trade Weighted Dollar</u>



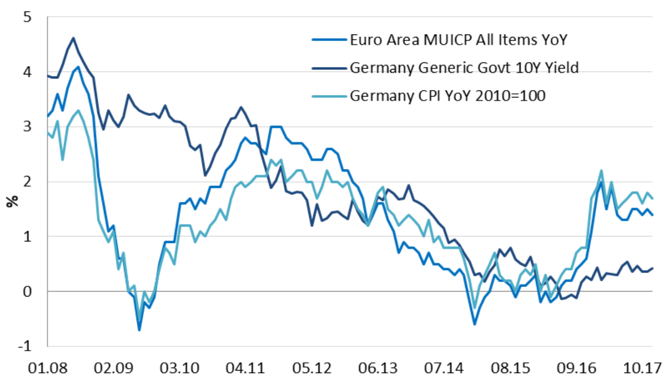
Sources: Bloomberg, BBGI Group SA

A rise in long-term rates is looming in the euro zone

For now, the rise in long-term rates is still entirely hampered by the ECB maintaining the status quo in terms of monetary policy. The position set out by Mario Draghi of continuing the bond purchasing strategy until September 2018, and perhaps beyond that, is extinguishing even the vaguest hopes of long rates changing in step with the changes in fundamental and macroeconomic data. Equally, as changes in inflation are not showing any clear signs of a surge, the need to change interest rates is not overwhelming.

Indeed, for a few months inflation has stabilised at around +1.5%, after a clear recovery from 0% to 2% between June 2016 and February 2017. The rise in the Euro has undoubtedly been key in this recent development, as it was in stabilising energy prices before their latest increase from US $42 to US $60.

<u>Interest Rates - Inflation</u>



Sources: Bloomberg, BBGI Group SA

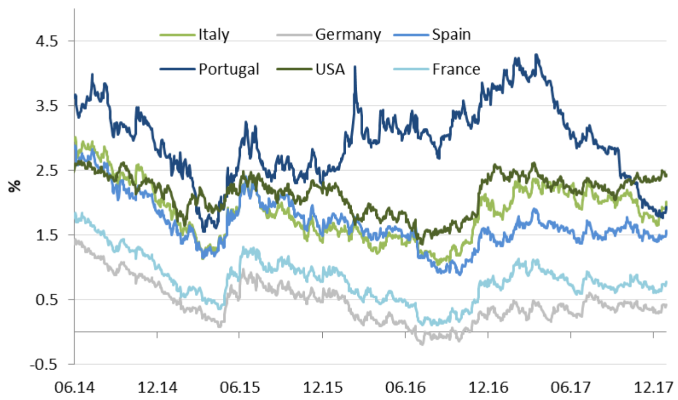
It is certainly too early to see a clear inflation recovery linked to the jobs market, which is still too far from its friction point for wage rises to lead to an increase in prices. The ECB's 2% inflation target will certainly be difficult to hit, even if the central bank continues with its expansionary monetary policy in 2018, and particularly if the Euro stays strong in the long term. Salary costs are developing slowly, and despite the considerable fall in the Eurozone unemployment rate, it is still high in absolute terms.

Unless inflation picks up the pace and there are prospects of price rises, long rates will still be able to be influenced by ECB action. Developments on long rates are now increasingly constrained to a narrow valuation band of less than 20 basis points for German government 10-year rates. They will close the year close to 0.3%. We do not believe that bringing inflation back above +2% is essential in supporting a rise in long term interest rates in Euro.

European rates should certainly enjoy an upward trend, sparked by US monetary policy normalisation and a recovery of long rates in the United States. The long rate differential seems increasingly less-well founded, given the way in which the European economy is catching up. Although the first quarter should still be shaped by some stability on long rates, we believe that it is likely that we will then finally see a stark change in investors' perception of risk.

We recommend not to wait before considerably reducing the bond risk in Euro.

Government Ten-Year Yields (%)



Sources: Bloomberg, BBGI Group SA

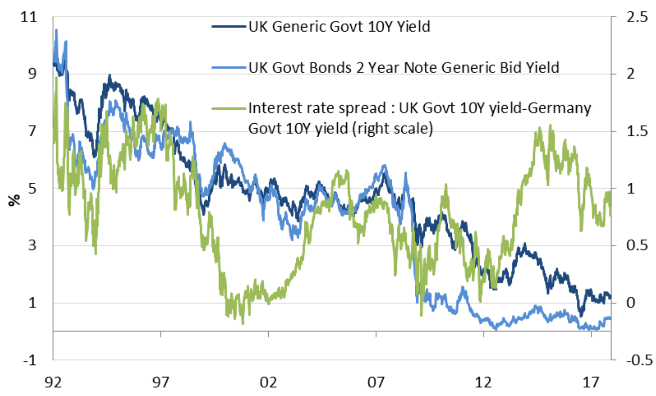
UK: The bond market cannot remain indifferent to the pick-up in inflation

Inflation is rising slowly but surely in the UK. By November, the consumer price index had doubled over twelve months, reaching +3.1%. The CPI index had reached a low in April 2015 at -0.1%. The upturn is significant and even clearer when looking at the trend in the production price index over the same period.

We continue to predict that inflation will exceed the BOE's 2% target in the next several quarters and could even reach 4% by 2020. It is surprising in the context of general price increases that long-term interest rates are not more affected by changes in expectations. Indeed, despite the increase in prices, the yields on UK government debt seem to have followed the trends in international bond markets and do not appear to be reflecting the increase in domestic inflation.

Real yields in pounds are thus relatively stable, even declining slightly from 1.4% in October to 1.3% at the end of November.

UK 10-yr and 2-yr government bond yields



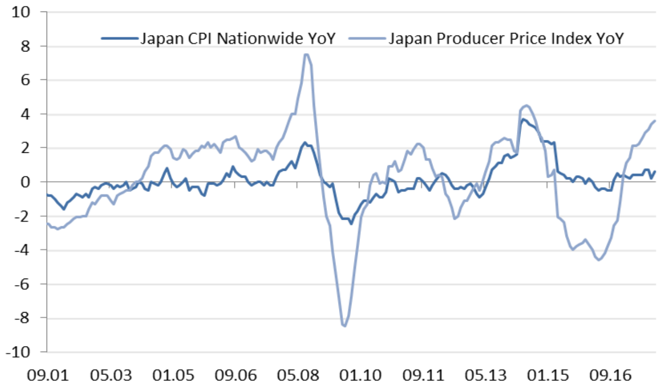
Sources: Bloomberg, BBGI Group SA

Japan: Bonds are not providing any opportunities

The upswing in price indices is already losing momentum, with the domestic CPI index dropping from +0.7% to +0.2% in October. Inflation has thus once again moved away from reaching the BOJ's target. Any hope of a long-term increase in prices still most likely depends on a further decline of the yen. The change in circumstances with regard to inflation is still too recent and too restricted in amplitude to have a significant impact on interest rates. The slowdown in growth and a diminished outlook for 2018 will certainly not contribute to an improvement in price index forecasts.

The Bank of Japan still does not have much room to act in terms of reaching its 2% inflation target. It has not changed its assessment of economic conditions and is maintaining its monetary policy unchanged, i.e., low interest rates and monetary injections. The BOJ is still hoping that economic growth in Japan will be sufficient to drive inflation up toward the desired target. The short-term interest rate target is also unchanged (-0.1%), as is the aim of steering 10-year rates toward 0%.

Inflation (CPI and PPI)



Sources: Bloomberg, BBGI Group SA

The correlation observed with movements in long-term rates will necessitate a slight definitional change in objectives, whereby the BOJ will likely set the lower limit of its target range at 0%. Governor Kuroda is unlikely to change the Bank's policies, which will remain a significant factor in the future decline of the Japanese currency. The Japanese bond market still fails to offer any interesting opportunities.

Switzerland: Inflation finally positive in 2017 after 5 years of deflation

Inflation has presently exceeded 0.8% in Switzerland and will likely strengthen as the franc weakens in 2018. Rising prices will thus facilitate the next interest rate normalisation push in 2018. The bond bubble will hence likely start by deflating, with no immediate sign of panic, before swelling once again.

The yield curve in Switzerland was relatively stable in 2017, but we do not believe this phenomenon will persist in 2018. The lack of any swift action by the SNB should indeed keep short-term rates in negative territory, while due to the influence of long-term rate increases in most markets and of the weakening franc, long-term rates will likely tighten in Switzerland. The rise of the euro will also allow the SNB to consider altering its monetary policy, but we do not anticipate a very rapid change in this regard, as the Bank will for a time remain in wait-and-see mode.

Policy rates are unlikely to change quickly, but the expectations of a change in policy could already push long-term rates up over the next several months.

Focus on quality and short maturities

Focus on short maturities and take a cautious stance on peripheral debt

2018 will therefore be the year of the rebound in interest rates and probably also of the widening of credit spreads. Prudence will be decisive in order to avoid significant losses during this shift in paradigm. The yield on short-term Greek debt is now lower than that of the US Treasury. The performance of the European peripheral debt will certainly be disappointing. Overall, risk premiums are expected to increase in 2018 with the rebound in interest rates. We prefer investment grade bonds in US, Canadian and Australian dollars to the detriment of bonds in euro and yen.

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