Economic Research

WEEKLY ANALYSIS

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Bonds markets still relatively unaffected by US interest rates at 3%

Higher expected inflation in the USA. Warning on the interest rate markets. The European cycle is still hesitating. Confederation yields finally settle above zero.

Key Points

- US Treasury long rates above 3%
- Gradual rise in expected inflation
- Reversal of the long-term rate cycle in the euro area
- British long-term rate at 2%
- Still no prospect for the Japanese market
- Focus on short maturities and take a cautious stance on peripheral debtors
- Normalization Swiss long-term rates begins
- Steepening of the yield curve continues
- Inflation reaches its highest level since March 2011
- Focus on quality and short maturities

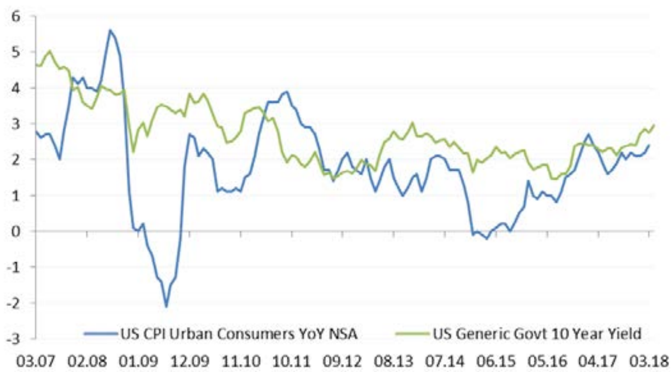
US Treasury long rates above 3%

Renewed inflation in a robust economic context should quickly lead to new adjustments to long-term nominal rates over the coming months. After remaining stable for a few quarters, US long rates were the first to spark the trend. As much as a few months ago, we had pointed out that the 2.1% correction to 10-year Treasury rates was not compatible with sustained economic activity and regular monetary policy normalisation on the part of the Fed.

Our forecasts of long rates rising to around 3% have played out in the meantime, but this came in the context of a likely boost to the economy. However, although we still believe that in the long-term long rates should exceed 3%, it is likely that in the short-term the volatility seen on equity markets, as well as risks of disappointments regarding growth over the coming months could lead to a period of consolidation of these rates at just below the 3% threshold.

The risk of rate rises coming thicker and faster in 2018 has fizzled out for now, new forecasts for 2019 tend to confirm the concerns raised in February.

<u>Inflation and 10-Year US Treasury Bonds</u>



Sources: Bloomberg, BBGI Group SA

Gradual increase in expected inflation

The latest inflation figures (+2.4%) published in March surpass the Federal Reserve's +2% target. The index's year on year rise excluding food and energy (+2.1%) exceeds slightly the objective of 2%. They have hit the target and should gradually move beyond it in a sustainable way. The upward trend has remained modest at the start of year, but leading indicators and the situation on the jobs market seem to suggest that the trend will be bolstered over the coming months. Expected year on year inflation has risen more starkly than monthly figures, coming in at +2.7% in March. In the longer-term, expected inflation for the next 5- 10 years is also higher, standing at +2.5%. This trend cannot pick up the pace without an increase in salaries, which is taking its time despite the labour market being close to full employment. In contrast to the theory, inflationary pressures are still weak, even though the unemployment rate has stabilised at 4.1%.

2018 could be a year of surprises due to a combination of factors acting together. Indeed, the macro-economic context should foster new salary negotiations and spark tensions on commodity prices, propping up a price rise.

At its last meeting, the Federal Reserve was more confident than ever in US growth prospects, and has increased its forecasts for 2018 from +2.5% to +2.7%, and those for 2019 from +2.1% to +2.4%. In its analysis of current conditions, it highlighted a temporary dip in the trend in the first quarter, which does not cast doubt over its vision for the year as a whole. The core of the analysis remains focused on labour market conditions, which continue to show an increase in new jobs and a fall in the unemployment rate. The latter could even drop to 3.8% in 2018, and perhaps 3.6% in 2019.

The Fed's vision for inflation has gone unaltered in Mai. It seems likely the PCE (Personal Consumption Expenditures) Index will rise above the 2% target in 2018, with no manifest risk of the target exceeding quickly and to a considerable degree.

Reversal of the committed rate cycle in the euro zone

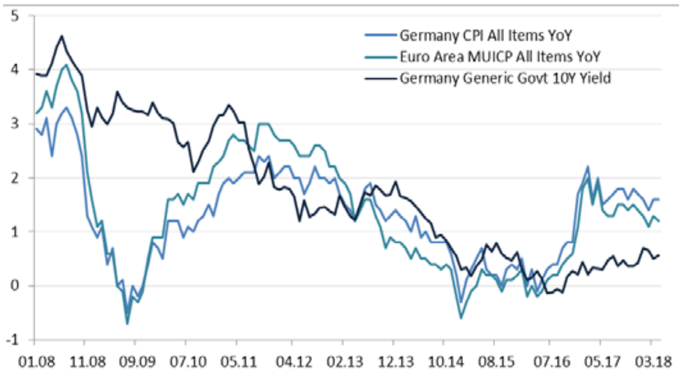
In the euro zone, the rise in long rates is still being held back by two essential factors- inflation and monetary policy. The ECB's decision not to change its monetary policy and to continue with its bond purchase strategy has put a dampener on any adjustments that should otherwise have taken place in the current context of robust economic growth.

The second factor- inflation- is also preventing a rise in long rates due to its recent weakness. This is key, as in the absence of inflation, the need to adjust interest rates is far from pressing. Indeed, inflation has been gradually tailing off since its peak in the 1st quarter 2017 (2%), and now only stands at 1.3% year on year.

The euro's weakness against the US dollar will certainly be the main factor enabling new, more robust inflationary forecasts, and a rise in long rates thereafter.

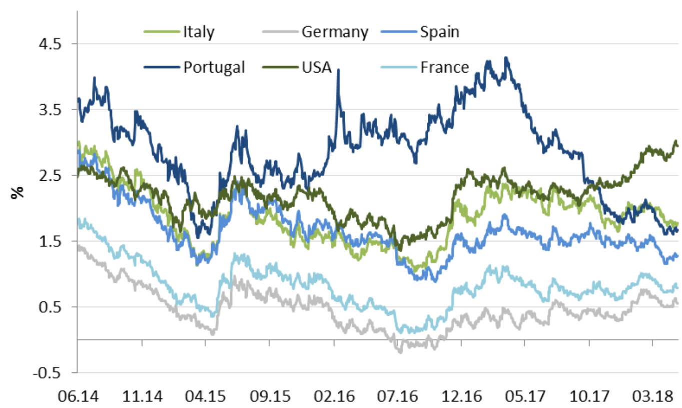
It is certainly too early yet to see a clear inflation recovery linked to the jobs market; it is still too far from its friction point for wage rises to contribute to an increase in prices. The ECB's aim of bringing inflation up to 2% will certainly be difficult to achieve, even if the central bank continues with is expansionary monetary policy in 2018, and particularly if the euro remains stronger in the longer term. Salary costs are proving slow to budge and, despite its significant drop, the Eurozone unemployment rate remains high in ab-solute terms. However, inflation should gradually rise back towards 1.7% by the end of the year.

Interest Rates - Inflation



Sources: Bloomberg, BBGI Group SA

Government Ten-Year Yields (%)



Sources: Bloomberg, BBGI Group SA

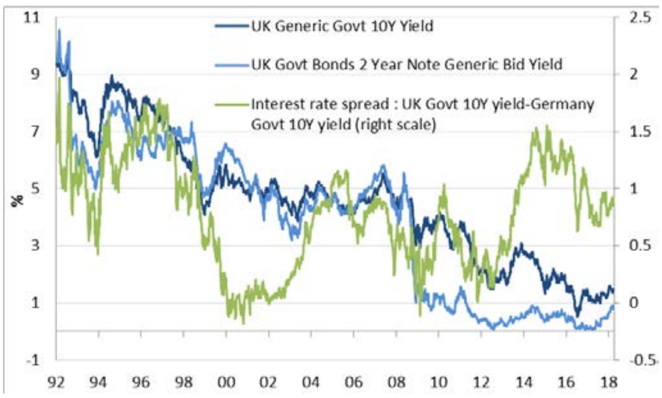
Nevertheless, Eurozone long rates should not be able to cut loose from the upward trend sparked by US policy normalisation and the recovery on long rates in the United States.

The long rate differential seems to us to be less and less well founded given how well the European economy's growth rate has caught up. After a 1st quarter still shaped by somewhat stable long rates, we believe that it is now likely that we will finally see a clear change in investors' perception of risk. We recommend considerably reducing the bond risk in euros without delay.

British long-term rates at 2%

The BOE released its one-year (+2.9%) and five-year (+3.5%) inflation forecast, indicating an expected increase. However, inflation has stabilised somewhat over the past months, clocking in at 2.5% yoy in March. Pressures have not intensified; production prices even fell from +19.3% to +4.2% over twelve months. We continue to predict that inflation will stabilise above the BOE's 2% target in the next quarters.

UK 10-yr and 2-yr government bond yields



Sources: Bloomberg, BBGI Group SA

It may seem surprising that long-term interest rates are not experiencing larger shifts in this context. The UK bond market is likely to soon be somewhat more affected by domestic fundamentals and the approaching 29 March 2019 deadline.

The rise in 10-year yields we had mentioned in our latest investment strategy reached 1.6% before stabilising above 1.4%, but these levels still seem low in the present context and should rise to 2%.

Weak signs of rising inflation in Japan

The upswing in price indices was petering out at year end 2017, but could pick up again in H1 despite, as signalled by the CPI's +1.1% increase in March following the +1.5% increase in February.

The best hope for a lasting rise in prices is for the yen to depreciate, although tightness in the job market may now finally have an effect on wages and prices. Indeed, the unemployment rate fell to 2.5% in March. The BOJ could thus shortly see its expectations finally materialise, although we are still far short of the stated 2% target. A weaker yen remains a crucial factor in terms of boosting corporate earnings and wage growth.

In this context, the Japanese bond market still fails to offer any interesting opportunities for foreign investors.

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

The Year 2018 has thus begun in a strong macroeconomic context on the international level by new tensions on long-term rates and the expected rebound in interest rates in most countries.

We should also see next H1 the widening of credit spreads. Prudence will there-fore be decisive in order to avoid significant losses during this shift in paradigm.

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.

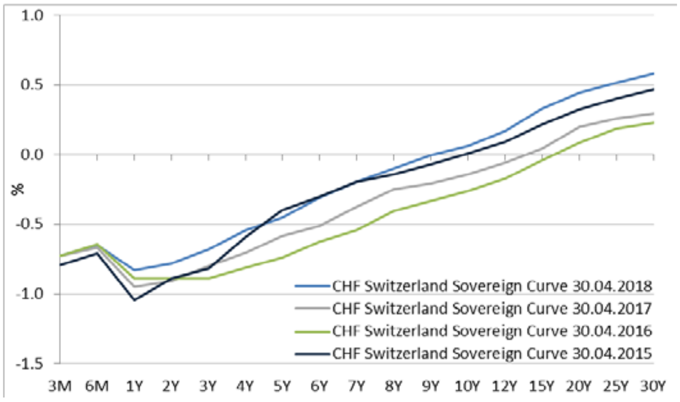
Normalization Swiss long-term rates begins

Last year was mostly a year of horizontal consolidation during which Swiss bond markets did not post a performance, but neither did the speculative bubble burst, as had been so often predicted for several years. This situation will certainly not last in 2018. We have already been seeing a first significant shift in long rates for a few weeks now, which has finally brought Swiss long rates above 0%. In just a few weeks, long rates have leapt 40 basis points, and now clearly seem to be on a lasting upward trend however slow. The rise of Swiss long rates at the start of this year heralds a faster pace of interest rate normalisation in Switzerland. This upward movement on ten-year rates is not isolated, of course, and is reproduced across the whole rate curve.

Steepening of the yield curve continues

The SNB's monetary policy of negative key rates is still influencing the very short part of the Swiss rate curve and is preventing any increase in yield on the very end of the curve. Ever since the start of this first shift (30/06/2016) short-term maturities have naturally had a muted reaction, whereas longer-term maturities have risen by 70 basis points for between 7 and 12 years. Further, the yield correction stood at 80 basis points for 15-year maturities. The rate curve is now steepening, as we mentioned in previous analyses, and should do so to a greater degree in 2018. In this context, the long rate differential for the German Bund and Swiss bonds has not really changed, although it is a little higher (0.53%) than on 30th June 2016 (0.4%) when it was at its lowest level. This trend should continue in 2018, especially given the improvement in the European trend and the plan to end the ECB's bond purchases. Yield for ten-year Swiss bonds stood at 0.18% when it was announced that the 1.20 Euro-Swiss franc floor would be dropped. It hit 0.15% on the 25th April 2018, when the Euro/CHF exchange rate had hit 1.20.

Switzerland Sovereign Yield Curve



Sources: Bloomberg, BBGI Group SA

Inflation reaches its highest level since March 2011

Swiss inflation posted one of its strongest months of growth since 2011 in February (+0.4%), and now sits at +0.6% year on year. This trend should be bolstered by the weakening of the Swiss franc. It should therefore prop up the next phase of interest rate normalisation in 2018. We have already stated that the bond bubble should start to deflate, though with no immediate signs of panic, before picking up the pace. We believe that this new faster-paced phase has already begun.

Focus on quality and short maturity

Negative real interest rates should be temporary and gradually correct as long-term rates rise above inflation. However, they will remain negative in 2018, foretelling another upcoming correction in the valuation of bond markets. We favour quality and short maturities.

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