WEEKLY ANALYSIS

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Interest rate markets are benefitting from rising uncertainty

Temporary easing in international bond markets. Correlations remain high among major markets. Inflation still moderate. Avoid the Eurozone and the high yield segment.

Key points

Interest rate markets broadly benefitting from uncertainty in October

US market offers very attractive opportunities

Long-term interest rates likely to tighten in the Eurozone

Adjustment of long-term rates in the UK

Prospects still poor in Japan

Favour the US market over the Eurozone and avoid high yield

Interest rate markets broadly benefitting from uncertainty in October

The marked return of uncertainty in October broadly benefitted interest rate markets, which have garnered renewed investor interest over the past few weeks. After the rapid increase in 10-year US Treasury yields to above 3% in the wake of the Fed's latest monetary policy decision, long-term rates have indeed eased somewhat in the US. Thus, 10-year yields slid from their 3.25% peak reached in October back down closer to 3%. This new, temporary easing in long-term rates also occurred in other markets; German Bund rates thus conceded 0.25%, while UK government bond yields fell from 1.7% to 1.4%. The trend was less marked in Switzerland, with a decline of merely 0.15%.

Concerns with regard to an economic slowdown in 2019 following the implementation of further tariffs by US president Donald Trump are in part responsible for these developments. Regarding the US market, economic fundamentals continue to be positive, in spite of rising uncertainties and a slightly more cautious outlook for 2019. In this end-of-year context, yields in dollars remain among the most promising fixed income investment opportunities.

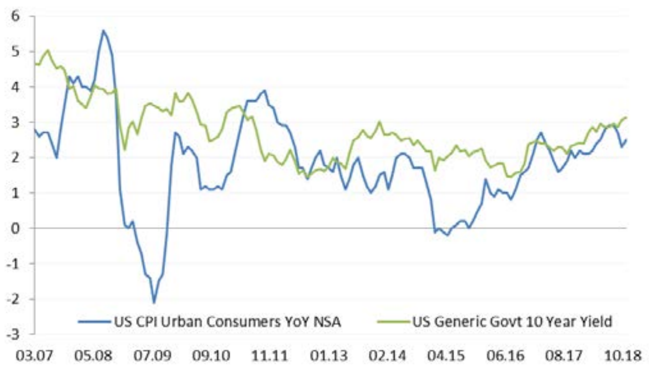
US market offers very attractive opportunities

Exceptional GDP growth of 4.2% in the second quarter had casts doubts on the evolution of monetary policy. Until this last hike of 0.25% in key rates, the US central bank maintained that its policy remained accommodative. In its last decision released at the end of September, however, this time the bank aimed to send a new signal, without actually precisely characterising the state of its monetary policy. Thus, the Fed is conveying increasingly clearly that the normalisation process is well underway and that rates are gradually nearing the levels expected given the current growth context. The bank still seems to be committed to managing monetary policy with a steady hand, minimising any risk to current economic growth to avoid stoking concerns of excessive action.

The Federal Reserve is confident and further raised its GDP growth outlook from +2.8% to +3.1% in 2018 and from +2.4% to +2.5% for 2019, without significantly changing its assessment of current and future economic conditions, however. US growth is still considered strong, which was confirmed by the release of Q3 figures showing GDP growth of +3.5%. The situation is similar with regard to inflation; the

Fed's assessment remained unchanged, and recent data suggest that it will stabilise above 2.5%. According to the Fed, current job market strength is unlikely to have a major impact on inflation, which is now considered to be approaching its objective. In parallel, inflationary expectations also decreased slightly from +3% to +2.8% yoy. In the longer term, expected inflation over 5-10 years stabilised at +2.6%. The production capacity utilisation rate remains high (78.4%), while unemployment lingers at 3.7%, likely its quasi full employment rate. In our opinion, the next upswing in inflation should subsequently be bolstered by pressure in the job market, which seems to be slow to materialise, even though the market is nearing full employment. The increase in the hourly wage rate, up +3.1% in October, is thus somewhat troubling and, in our view, supersedes the risks of a surprise upswing in inflation.

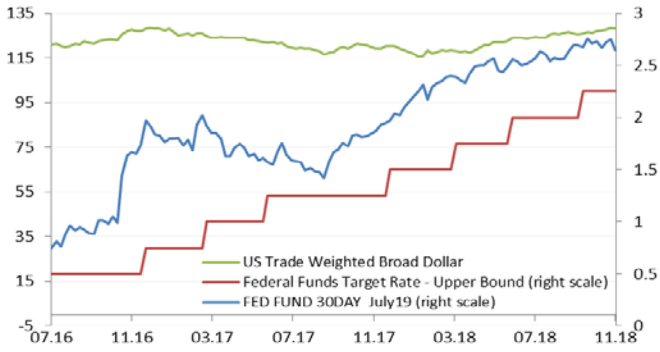
Inflation and 10-Year US Treasury Bonds



Sources: Bloomberg, BBGI Group SA

As predicted, long-term rates increased to 3%, and we currently believe that they are likely to exceed this level eventually. Inflation, likely the main catalyst of the increase, is currently not high enough to trigger a further increase in 10-year rates. However, in the slightly longer term, the increase in budget deficits could contribute to the increase in long-term rates. The strength of the US economy is reviving expectations of key rate and long-term rate normalisation. For several months, yields on 5-, 10-, and 20-year maturities had converged towards 3%, resulting in a flattening of the yield curve and eliminating the risk premium on longer maturities. As we ponder what an appropriate level for long-term rates should be given the strong growth environment and with inflation exceeding the Fed's target, uncertainty is rising and pushing long-term rates slightly higher. In the short term, the risk premium on long-term rates will likely reconstitute, which could drive 10-year rates up to between 3-3.5%.

Fed Funds, Key Rates and Trade Weighted Dollar



Sources: Bloomberg, BBGI Group SA

The latest developments in the US bond market are particularly interesting. Yields observed all along the government and corporate yield curves are offering real investment opportunities. We think that the increase in government bond yields currently offers an excellent opportunity to diversify into the fixed income segment. Indeed, current yields protect the investor from a potential continuation of the recent upward trend, which is not the case in the Eurozone for example. The US market will thus likely fairly rapidly benefit from the renewed interest of investors seeking quality yields in a safe currency and see a risk transfer and an inflow of funds coming from the European market.

With regard to credit default risk, in this context we recommend rapidly reducing exposure to the US high yield market, which is exhibiting significant risks of imbalance and price corrections as risk premiums readjust. The increase in yields on investment grade issuances will likely attract funds that were until now invested in the more risky segment of the market. Thus, the current risk premium, which is at a 10-year low and close to levels observed just before the 2007-2008 financial crisis, could undergo a significant and brutal readjustment.

Long-term interest rates likely to tighten in the Eurozone

The ECB is pointing to vigorous inflation in the Eurozone. President Draghi seems convinced that the job market will show increasing signs of upward pressure on wages, which will lead to an increase in underlying inflation over the next few months. It is indeed true that, trends are positive and that wages have increased somewhat faster in Q2 (+2.2%). Unemployment has reached a 10-year low (8.1%), while the employment rate (67%) is at an all-time high. Inflation reached +2.2% in October, which seems to confirm the ECB president's view, although its core component slowed down to +1.1% over the same period. We think this latest development somewhat contradicts the ECB's assessment and could contribute to delaying the next rate hike to year-end 2019. This development also affects the perception of long-term rates' normal levels, which is tied to inflationary expectations, the growth rate, and the ECB's quantitative policy. The change announced by the ECB will alter supply and demand dynamics going forward.

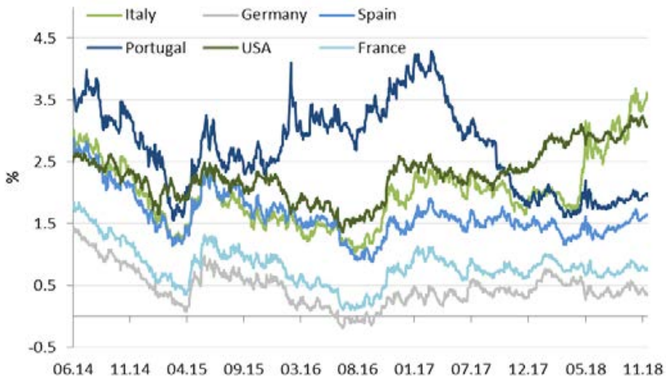
ECB asset purchases had been absorbing almost all net new issuance of sovereign bonds in the Eurozone; the termination of these purchases will boost yields. Given the favourable economic context, the fall in demand will undoubtedly result in an increase in long-term rates at the beginning of 2019.

Interest Rates - Inflation

Sources: Bloomberg, BBGI Group SA

The 10-year German Bund yield reached 0.55% before dropping back to 0.35% and will now react more sharply to any inflation-related news. After a long phase of consolidation around 0.5% for 10 year terms, German government bond yields will likely tighten once again and rise back up to 0.75%-1% at the beginning of 2019. The Italian crisis remains a factor, likely temporary, that could hamper or interrupt this trend. The depreciation of the euro against the dollar is also an important variable with regard to evaluating the appreciation potential of long-term rates. We now think that this factor is no longer an impediment to the logical adjustment of the yield curve in the Eurozone. Even though the ECB's decision is not a surprise, we believe that its true impact will only be felt over the next several months. Only then will investors fully take into account the risk of price corrections. We recommend not waiting to further reduce exposure to euro bond risk.

Government Ten-Year Yields (%)



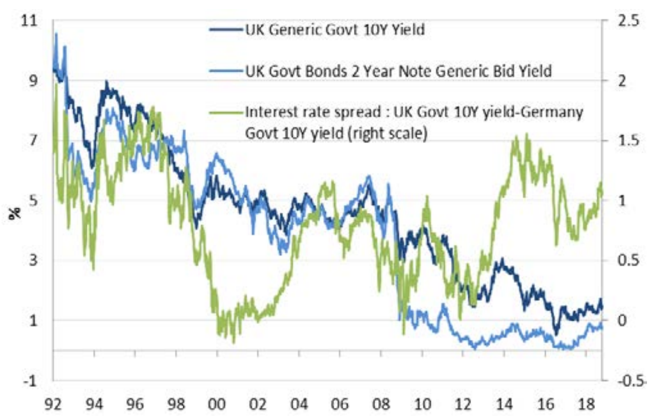
Sources: Bloomberg, BBGI Group SA

Adjustment of long-term rates in the UK

The latest inflation figures for October indicate a +2.4% increase in the CPI, slightly below expectations. The +2.7% increase in the CPI was indeed much larger than expected. This increase is of course not welcome, as it will offset the rise in nominal wages and will thus not lead to a rise in purchasing power. Moreover, the production price index also rose by +3.1% yoy. Price index growth is thus not yet showing the hoped-for signs of subsiding, both with regard to the CPI and PPI. We continue to predict that inflation will stabilise above the BOE's 2% target, and we continue to pay attention to the risks of a potential long-term interest rate adjustment in the event of a still relatively unlikely upturn in economic activity.

However, in this context, we believe that the bond market will likely be more affected by domestic fundamentals and by uncertainties related to Brexit. While the slowdown in the UK economy is indeed significant, it is nevertheless not substantial enough to warrant long-term rates remaining so much lower than inflation over the long term.

UK 10-yr and 2-yr government bond yields

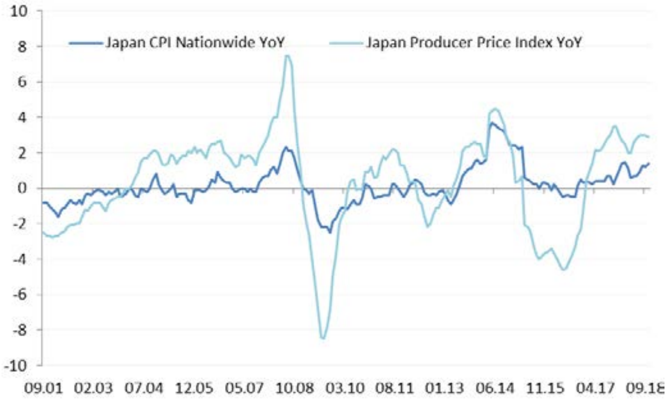


Sources: Bloomberg, BBGI Group SA

Prospects still poor in Japan

The upswing in the price indices in Q2 was welcome. Indeed, they slackened only for as long as the yen was appreciating. Inflation (CPI) rose above 1%, establishing itself at 1.4% in October. An upswing in prices was conditioned upon on a depreciation of the yen, but inflation is still far from the BOJ's target (2%), and production prices are not showing sufficient momentum to establish a more robust trend overall. However, the current context is clearly not favourable to the bond market, which still fails to offer attractive prospects to foreign investors.

Inflation (CPI et PPI)



Sources: Bloomberg, BBGI Group SA

Favour the US market over the Eurozone and avoid high yield

Very different economic conditions favour the US over the Eurozone. In the US, rising rates are pushing long-term yields above 3%, as we were expecting. We believe that the US economic context warrants this adjustment, which will likely subside and stabilise around 3.5%, in particular if US growth decelerates as expected in 2019. In the Eurozone, the ECB's European government bond purchases kept long-term yields low in 2018, but once the bank terminates purchases come 1 January 2019, sharp imbalances are likely to emerge. European countries' refinancing needs, which continue to be high, will come up against reduced investment demand. An adjustment shock with regards to yields may be unavoidable in order to rebalance the market. Thus, we think that the increase in yields on US government debt currently offers an excellent opportunity to diversify into the fixed income segment. Indeed, current yields protect the investor from a potential continuation of the recent upward trend, which is not the case in the Eurozone for example. The US market will thus likely fairly rapidly benefit from the renewed interest of investors seeking quality yields in a safe currency and see a probable risk transfer and inflow of funds coming from the European market.

With regard to credit default risk, in this context we recommend rapidly reducing exposure to the US high yield market, which is exhibiting significant risks of imbalance and price corrections as risk premiums readjust. The increase in yields on investment grade issuances will likely attract funds that were until now invested in the more risky segment of the market. Thus, the current risk premium, which is at a 10-year low and close to levels observed just before the 2007-2008 financial crisis could undergo a significant and brutal readjustment.

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