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Long-term rates do not react to the +3.2% increase in US GDP

Excessively pessimistic rate markets. Global growth remains solid. Rising inflation and long-term rates. Avoid the European market. Overweight the US market.

Key points

- Long-term rates have not yet reacted to the +3.2% increase in US GDP in Q1
- Rising inflation and long-term rates
- Fed will leave rates unchanged in 2019
- ECB will remain accommodative
- Yields temporarily vanish in euro markets
- UK rates are not factoring in the risk of a no-deal withdrawal
- Positive yield spread for high yield and emerging debt
- Stay overweight the US market

Long-term rates have not yet reacted to the +3.2% increase in US GDP in Q1

In Q4 2018, uncertainty with regard to global growth had a significant impact on investor sentiment and rate markets; investors' mindset in April 2019 appears to be unchanged. The attitude prevailing in rate markets remains particularly cautious. In fact long-term rates fell again in March in most markets, such that many bond indices posted further gains and positive performances. Long-term US government rates dropped back to 2.4% after having reached 3.2% in November 2018. Ten-year US Treasury yields thus lost 80 basis points over four months due to the quasi panic caused by the numerous mentions of the risk of a recession stemming from the inversion of the US yield curve.

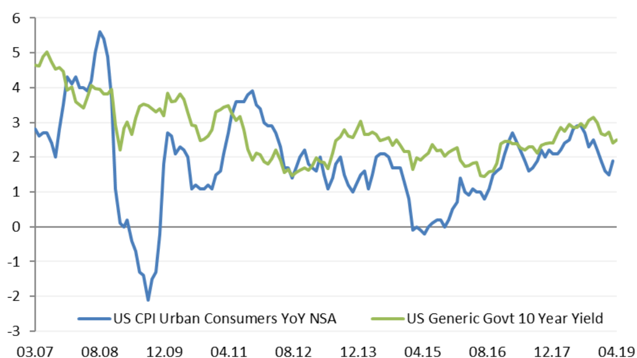
We had already brought up this issue several times, emphasising the irrational thinking of those who were predicting a recession in 2019 based on a micro-phenomenon that temporarily affected a specific segment of the yield curve. Today it is clear that these concerns and doom-and-gloom predictions were unfounded, as we previously explained and demonstrated. However, it is interesting to note that the latest US GDP growth figures for Q1 (+3.2%), which disproved negative expectations, have not yet had any significant impact on rate markets. It is true that, elsewhere in the world, economic conditions are still somewhat concerning, particularly in Germany, which narrowly avoided a technical recession in March 2019 thanks to quarterly growth of 0% (-0.2% in the previous quarter). Ten-year Treasury yields increased only slightly in April from 2.4% to 2.55%, although this initial uptick could herald the adjustment in rates expected given current economic conditions in the US, which remains relatively solid, unless new fears arise following a breakdown of the US-China talks. In the Eurozone, the April recovery is scarcely discernible, as ten-year rates barely reacted, although they once again turned very slightly positive (+0.04%) after a few days in negative territory (-0.07%). Chinese GDP growth of +6.4% and better PMIs were not enough to effect a trend reversal in Asian rate markets. In this sense, rate markets' caution with regard to the real likelihood that the global economy will stabilise and rally in Q2 stands in contrast to the marked optimism of the equity markets and seems excessive. While we think that equity markets' optimism has perhaps exceeded what is probably reasonable given current conditions, it seems that in the rate markets excessive pessimism has led to unwarranted declines in rates, which will likely see some adjustment.

Upswing in inflation and long-term rates

The decline in inflation over the past few months stemmed mainly from the fall in energy prices and will only be temporary. At the beginning of the year, we expected that the positive economic outlook would rapidly lead to a trend reversal with regards to fuel prices and push price indices back up. Since 2019, crude prices have surged +40% by the end of April and should thus start to have an effect on price indices. Rising household income is increasing consumers' purchasing power and businesses' ability to increase their sales prices, thus intensifying inflationary pressures.

We expect that before long inflation will once again exceed the Fed's stated target, although the Fed is unlikely to respond. Wage inflation will thus be a key factor in price index growth in 2019, which could be discernible more rapidly in the service sector. For now, the leading economic scenario in the rates market still seems to be that growth will flag.

Inflation and 10-Year US Treasury Bonds



Sources: Bloomberg, BBGI Group SA

Expectations for Q1 were substantially exceeded, suggesting that conditions in Q2 will continue to be favourable. For now, expected inflation remains close to +2.5% yoy, even though the CPI came in at +1.9% in March (+1.5% in February). With regard to long-term rates, we expect that the improvement in economic conditions will finally cause long-term rates to adjust back to 3%.

Fed will leave rates unchanged in 2019

The Fed was clearly embarrassed by its ninth rate hike in December 2018, announcing that it would adopt a particularly cautious approach in 2019 to avoid the risk of an economic slowdown.

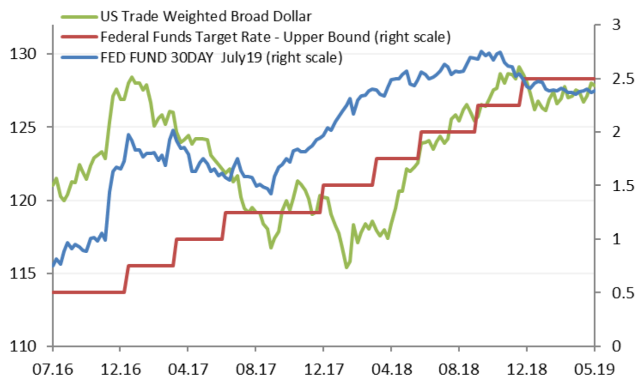
As expected, the status quo was maintained following the latest FOMC meeting on May 1. FOMC members will likely have to wait quite some time before proceeding with a tenth increase. The target rate's current level is now termed 'neutral'. There is thus very little risk that the Fed will raise rates despite the rather satisfactory economic result obtained in the first quarter.

President Powell remained positive with regard to the economic situation in the US during the Fed's last press conference. However, he did note that, while the economy is solid, the slowdown in household spending and corporate investment growth indicates a downturn in global demand. This downturn is nevertheless seen as temporary. The Fed thus logically kept its rates unchanged. This position is consistent with our expectation that the Fed will prefer to delay reacting to rising inflation than to pursue a normalisation policy. The recent decline in price indices since the highs of 2018 before the upturn in March will bolster the Fed's wait-and-see approach. We continue to anticipate that the Fed will exercise considerable flexibility in managing its monetary policy in 2019, although we discard for now the possibility of a rate cut, which is nevertheless suggested by the fed funds futures curve, which shows a 50% chance of a cut at the beginning of 2020.

In our view the flattening of the US yield curve following the decline in long-term rates does not signal a recession in the current context as we have been hearing too often. However, this situation is clearly an inhibiting factor for FOMC members, who are not willing to risk taking action in the absence of an upturn in the economy.

According to the Fed, it is thus no longer necessary to tighten rates in order to check inflation. It does not change its decision to slow its balance sheet reduction programme by lowering the amount it is unwinding its activity from $30 to 15 billion per month and remains prepared to simply stop unwinding if necessary as of September. In so doing, the Fed is clearly demonstrating its willingness to interrupt its normalisation process to factor in the risks of a downturn in global growth. The fed funds target range is still 2.25 - 2.50%.

Fed Funds, Key Rates and Trade Weighted Dollar



Sources: Bloomberg, BBGI Group SA

ECB will remain accommodative

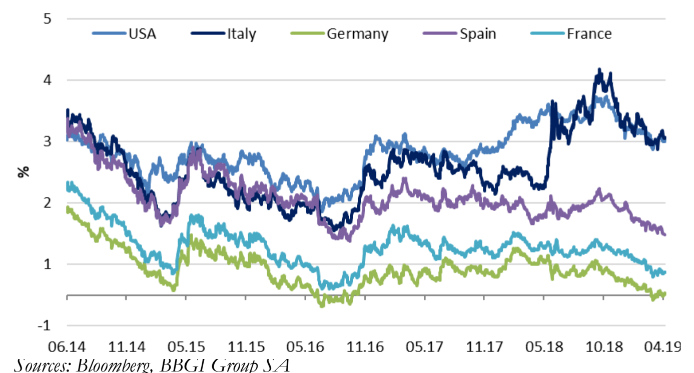
It is obviously not a huge surprise that the ECB changed its perception of the economic situation in Europe somewhat in light of the slowdown in the manufacturing sector and the weakness of the German economy. The growth forecast for the European economy announced at the ECB's most recent press conference had been revised downwards from +1.7% (December forecast) to only +1.1%. Given the risk of an economic downturn in the Eurozone, the ECB had decided to postpone raising target rates until 2020 and to resume policy loans to the banking sector (TLTRO). This announcement does not come as a surprise, as we already expected the economic slowdown at the end of 2018 to result in a deferral of any rate hike to Q4 2019 at the earliest, but with regard to TLTROs, the ECB changed its position rather radically, announcing a resumption of liquidity injections to start in September after terminating its asset purchasing program in January 2019. These liquidity injections will take a new form, as they will be targeting the banking sector, aiming to boost economic activity via an increase in loans to businesses and households. These new bank refinancing operations (TLTROs) could amount to up to 700 billion euros and aim in particular to avoid a contraction in credit. The ECB does not seem particularly concerned and currently deems the economic slowdown to be temporary.

Yields temporarily vanish in euro markets

The economic slump in the EU has had a major impact on euro interest rate markets over the past six months. While the growth outlook steadily declined as leading manufacturing sector indicators dropped, euro long-term rates suddenly changed course, resuming a downward trend reinforced by a concurrent correction in price indices. Indeed, inflation has been decreasing rather sharply in the euro area in the past few months due mainly to the fall in energy prices. The CPI index that had contracted from its October 2018 high of +2.3% to only +1.5% in February rebounded to +1.7% in April. Excluding food and energy, the increase in the CPI in April (+1.2%) is once again the highest in six months.

Investors' perception of where long-term rates should be at the beginning of 2019 shifted significantly as a result of these developments. Following European manufacturing PMI indices, euro long-term rates returned to their historic lows of 2016. The 10-year Bund yield is once again close to zero, indicating a rather extreme degree of pessimism among investors.

Government Ten-Year Yields (%)



Sources: Bloomberg, BBGI Group SA

President Draghi finally had to revise his expectations regarding inflation as well, in spite of his view that the vigour of the job market will put increasing upward pressure on wages, which will ultimately lead to an increase in underlying inflation over the next several months. The ECB forecast was thus lowered to +1.2% for 2019. Current trends point downwards, and the likelihood that longterm rates may rise has for now clearly receded in light of the economic weakness of the euro area. However, current levels of pessimism may already be extreme and are motivated in particular by the poor performance of the manufacturing sector. Leading indicators for the industry will have to stabilise and turn around in order for expectations regarding long-term rates to shift. More than ever we recommend avoiding euro-denominated bonds, as their medium-term outlook is mediocre

Risks of a no-deal Brexit not factored into UK interest rates

The first Brexit deadline on 29 March 2019 came and went without an agreement being reached between the UK and the EU, and no new solution was found in April. The new deadline granted by the EU does not guarantee resolution down the line. The impact of a "no deal" does not seem to have been genuinely factored in by financial markets, which prefer not to consider this outcome, which would be particularly negative for the British currency and the country's economic growth, as well as for inflation most likely, tomention just the key points. Given
the circumstances we fear that thecurrent level of long-term rates (1.2%) is absolutely not suited to an economy that could very quickly fall into stagflation, i.e., slower growth and rising CPI and PPI indices. Especially low yields in pounds are indeed tied to a risk of sudden capital losses and a devaluation of the pound as well as a likely loss of investor confidence. This environment is not particularly attractive, and we recommend discontinuing any exposure to the British rate market.

Positive spread for high yield and emerging debt

The improvement in the stock market climate in Q1 was particularly beneficial for non-investment grade bond markets (+5.4%) and emerging markets (+6.3%), which outperformed. Indeed, these markets benefited from several positive factors in the short term, which led to several significant upswings since the lows of December 2018. Indeed, these market segments had been hit hard by the stock market panic, in contrast to developed bond markets, which benefited from fears of a recession due to their defensive nature.

Risk premiums on high yield bonds in particular, which had been partially reconstituted during the panic, contracted once again as prices rose over the past three months, further reducing the yield spreads of emerging debt. Nevertheless, these two market segments still offer superior and attractive returns from a relative perspective, and will remain sought after by investors looking for yield pick-up in spite of flattening risk premiums. The improvement in the economic outlook for the next few months will further compress risk premiums due to the increase in yields on investment grade issuance. This situation will likely have a negative impact on these markets, although they do have positive yield spreads that could partially compensate for the yield adjustments that will inevitably have to occur.

Stay overweight the US market

The latest fall in yields in March was driven by fears of a sharp economic slowdown as early as Q1 2019. Similarly to the fall in long-term rates in Q4 2018, this latest drop does not appear to reflect a less pessimistic economic outlook. An improvement in PMIs, leading indicators and economic statistics over the next few months will likely cause a significant readjustment in interest rates and a fairly generalised steepening of yield curves in most countries. Overall, this context is not favourable to bond markets, in particular those with low yields in absolute terms. In our international bond allocation we are overweight rate markets with high enough yields to offset, at least partially, the impact of rising rates and steepening yield curves. In the investment grade segment of developed countries, we are overweight the US and short durations.

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