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DEGROOF PETERCAM **ASSET MANAGEMENT**

CIO's View : Tug of war

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September 7th, 2020

STATE OF AFFAIRS

Assessing the path of long-term interest rates as the FED changes its monetary strategy is the main challenge for bond investors across the globe. From Jackson Hole, Fed President Jay Powel has taught us that moving towards 'flexible average inflation targeting' is essentially broadening the inflation bandwidth around the 2.00% midpoint. The moment the Personal Consumption Expenditure (PCE) index starts printing above 2.00%, the FED will not seek to change and tighten its fund policy rate. Speeches of several FED governors since end of August have alluded that 2.5% up to 3.00% inflation prints would not disturb them. It's exactly the averaging that will have to be accounted for in order to achieve a result around 2.00%. We can expect, given a structural sub 2.00% undershooting of PCE inflation series over the past 8 years, that if we observe an inflation overshoot, that we should hope for an overshoot that runs for 3 to 5 years. That would be the optimal scenario. It could well be that, given structural demographic and productivity headwinds, the FED and the US Administration is pushed for more unconventional instrument use over 2020 and 2021 in order to raise the general price level. The FED will have to grow its balance sheets further, allowing fiscal policy to support demand and public/private investment. Can we say that this renewed mandate spells problems for bond investors? Even big problems, because inflation levels well above 2% should unfold a bear market in bonds and destabilise real capital growth aspirations across US bond sectors. The equation we need to solve has many variables:

1. Assessing **when** inflation rates start printing above 2.00%?
2. **For how many years** can such a condition of positive inflation readings above 2% remain in place?
3. **At what level of inflation will the FED lift the policy rate?**

The Statement on Longer-Run Goals and Monetary Policy Strategy issued on August 27th gives no answers. The unemployment level that might instil inflation or non-accelerating inflation rate of unemployment has also been thrown in the bin. Maximum employment relates less to the level of unemployment but more to the quality of labour. So essentially, uncertainty for bond investors went up over the past 2 weeks. That should, over time, translate into a higher risk premium.

- However, it is fair to say that the current US OIS curve (overnight index swap) **leaves no doubt and reveals policy rates to sit around 0.50% in 2030 and unchanged over the next 5 years**. The market tells us that achieving 2.00% inflation aspirations will be difficult, as proven by the dismal inflation track record of the FED over the past decade. Yet, mathematically, the range of inflation paths that sees no policy action has risen. Markets should not fear taper tantrums with inflation at 2.5% or even 3.00%. But, in order to hedge against such potential future episodes, investors are raising their US TIPS holdings. It's best practice. Investors have been piling into inflation linked bonds since April, after the brutal illiquidity driven deflationary scare of March. Over the past week, we already saw some profit taking, pushing current 30 year and 10 year break-even rates (difference between nominal and real US rates) lower by about 10 basis points (bp) towards 1.70% and 1.78% respectively. Rest assured, the market will retest the highs above 1.80% of late and also test the 2.00% level. **One can expect that the lower bound for the 5y5y forward inflation swaps becomes 2.00%.**

The Jackson Hole outcome was the signal to firmly break-through 2.00%. We closed Friday at 2.09%. If global economic growth starts to recover in a more synchronised fashion, we can expect an attack towards the 2.50% level. However, does that mean we should prepare for a bear market in nominal bonds? That is not our base case. Rates are set by marginal demand/supply conditions. The marginal buyer used to be large institutional investors across the globe. Currently, the marginal buyer is the FED. The flexibility word maintains nominal rates range bound. With the Fed Fund rate anchored at the zero bound we might see some more steepening pressure. But the solid anchor will stop long term rates from rising aggressively. We are at least two, maybe three years away from achieving global outcome levels witnessed at the end of 2019. The quantitative easing flexibility will keep term premia suppressed. Rising inflation expectations will translate in stable to lower real rates. As a sudden inflation surge is not our base case, we don't fear a 1994 style bond bear market. **Expect a tug of war between real and nominal rates. A contest that favours real over nominal rate exposure**.

VALUATIONS

- US nominal rates sold off on Friday before the long US Labour weekend. Profit taking in equity markets did not translate into the traditional flight to quality US Treasury bonds. What is described in the above State of Affairs section is puzzling the investment public. Two year rates barely moved, closing at 14bp. 5 year rates backed up to 30bp and 10 year rates settled at 72bp versus 1.47% on the 30y point. In-line non-farm payroll numbers at 1.37 million jobs added (especially on the government side, as private job growth came at 1 million instead of the expected 1.3 million) moved the unemployment rate to 8.4%. Such numbers raise questions as difficult to reconciliate with the continuing jobless claims numbers. Fact is that still more than 11 million jobs have been lost compared to the start of the year. We will monitor closely how the equity/bond correlation evolves over the coming weeks. Will the negative equity/bond return correlation take another pause and jump into positive territory for a while. Our models do not signal that…

- German 10 year rates remain well anchored around the -45bp average seen over the past year. Intra-EMU rate convergence has also paused over the past weeks. The market is digesting supply well. Expect a steady ECB during next Thursday's meeting. Philip Lane's verbal intervention on EUR strength was clear. The ECB will increase accommodation as soon as EURUSD moves into a 1.20-1.25 range.

- It was also back to school for the European corporate bond market, with new issuance hitting the ground at full speed. Demand is solid. Cash balances are getting depleted at high speed. September lines up to become another blockbuster month for primary market activity. 2021 refinancing activity already starts today. High supply in combination with less risk-taking fervour might push credit spreads 10bp to 15bp higher. 'Might' because the ECB corporate bond purchase program (representing a mere 5% of total monthly purchases) has the ability to cement current spread levels. The ECB flexibility might even bring a test of the January lows in view. EUR IG spreads closed around 1.15%. A test of 1.30% carries same probability as a test of 1% over the next few months.

- EUR High yield added another 39bp to performance over the week. Year-to-Date, the sectors recovered to -1.54%. We repeat, with a yield around 3.80% for a 4.43% spread to government, a full recovery is still in the cards. Bond restructuring events are immediately isolated and the HY market place operates with room for contagion effects.

- Good performance of Emerging Market (EM) debt with strong flows, as investors returned to their screens and put their cash to work. New issuance remains limited so far. Local Currency spreads (GBI-EM) tightened by 6bps to 3.80%, while Hard currency spreads tightened by 17bps (to 4.24%). The riskier Sub-Saharan African segments outperformed with a tightening of 23bps (to 6.65%), while investment grade tightened by 11bps (to 2.09%).

- EMFX performed well versus the Euro, posting a 0.50% positive return over the week, with Latin America leading the pack. The Brazilian Real is the best performing currency versus the Euro (+3.10%) since the end of August. August was dismal, so some recovery was expected. The Colombian and Mexican Peso performed strongly as well, with +2.20% and 1.75% respectively. Eastern European currencies were the laggards, with the Hungarian Forint (+1.60%), the Polish Zloty (-1.50%) and the Czech Koruna (-1.20%) all losing ground versus the Euro.

- **Colombia** was one of the best performers, supported by the BanRep's cut in its repo rate by 25bps and the upcoming inclusion of local bonds into the Bloomberg-Barclays Global Aggregate index. This perspective helped to lift inflows into the country's local bond market. Another country to be included in the index is Romania. The no-confidence vote against the current government got aborted as the opposition lacked the number of MPs to support the move. **This should relieve some political pressure. Last but not least, South Africa had a volatile week, especially the Rand in a context of mixed news about the state of its economy and politics. Opposite forces are indeed stretching the Rand in both directions: the dire state of its local economy is being balanced by its outstanding high carry in a low yield world, stronger metal prices and improving external accounts. On top, President Ramaphosa's indication of strength over the ANC during the party's virtual meeting is comforting for investors. High credibility for President Ramaphosa and his Minister of Finance Mboweni is a necessary condition to pave the way for much-needed reforms**.

CONCLUSION

The regime change in the FED's monetary strategy is a wake-up call for global bond investors. It should propel interest for inflation-linked government bonds across regions. Model portfolios are prone to adapt their allocation grids.
Central bank purchase programs lift inflation expectations. They also put a brake on nominal rates rising. Especially with policy rates destined to remain at the effective lower bound over the next three years. At best, real rates have room to drop deeper into negative territory. At worse they remain stable or adjust higher at a slower pace than nominal rates.