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Summary – Bond yields have risen over the last week. Not by much but by enough to wake up investors to the risks of depressed risk premiums and the dangers of central bank dominance. The policy backdrop might not change materially any time soon but there is enough talk about different policy directions for investors to understand that bonds won't stay at these elevated levels forever. It might be that policy becomes more inflationary just as the growth is actually getting stronger. With the political calendar being another source of risk, the bet is that yields will be higher in 2017.

- **Wobble** – Well we've had a wobbly week. Since last Thursday's close, 10-year gilt yields are 13 basis points (bps) higher, US Treasury yields are 10 bps higher and 10-year German bunds have moved from a negative yield of 6.2 bps to a positive 3.2 bps. The European crossover credit default swap (CDS) index has moved up by 9.2% showing that it has not been just a rates move but a credit move as well. At the long end of yield curves, the damage has been the greatest as curves have steepened. For example, 30-year gilt yields are over 30 bps higher than their levels at the beginning of September. All the bond sectors that I typically follow are posting negative returns so far this month as a result of these yield

movements with UK markets suffering the most as they have given back a lot of the yield decline that happened in the weeks after the referendum. Is it more than a wobble? As yet this little episode of bond market jitters can't really be compared to the "taper tantrum" of 2013 or the "bund shock" of 2015. However, following on from some of my comments last week, we should not be surprised by these moves given current valuations and the dependence of those valuations on extraordinary central bank policies.

- **Policy shifts** – Rationalising the moves one has to conclude that there are concerns about a policy shift in terms of a shift in the balance between monetary and fiscal policy or a change in the operation of monetary policy that could redirect the recent trends of markets. But let's put this into context. First, let's take Japan. The Bank of Japan (BoJ) is undertaking a comprehensive review of its monetary policy amid concerns about the negative consequences of too low yields at the long end of the bond market. The expectation in the market is that the BoJ wants to steepen the yield curve in order to help banks and pension funds. There is talk of an "Operation Reverse Twist" which would involve the central bank modifying its asset purchase programme somewhat by reducing the amount of long dated bonds it buys or even selling long dated bonds from its portfolio, while at the same time reducing short term interest rates even more. The market has got wind of this and 30-year Japanese Government Bond (JGB) yields have risen from 6 bps to 60 bps in recent months. This has global interest because we know low long term bond yields and very flat yield curves are not good for banks and long term saving institutions like pension funds and insurance companies. The BoJ will make its announcement in the middle of next week.
- **From austerity to neutral, and beyond?** – Then there is the European Central Bank (ECB) which disappointed some in the markets last week by not announcing any further measures. It is almost like the second derivative of the size of the central bank's balance sheet has become the key signal for market participants – continued increases in the rate of asset purchases are required to keep yields falling. You might think, and I would agree, that looking for further declines in European yields is crazy at this stage of the game, but that is how markets are set-up. They are long bonds and totally reliant on the central bank distortion to continue in order to avoid significant near term losses. This week we held our quarterly fixed income macro meetings and it was pretty clear that the consensus amongst European economic watchers is that quantitative easing (QE) will continue in Europe and will be extended beyond March 2017. The reality is that the ECB is still dominating the markets and that its purchases of corporate bonds are putting downward pressure on credit spreads on both assets that are eligible for purchase and those that are not but are being

bought by investors seeking yield. It is not clear that the ECB will be able to change the composition of its asset purchases so we might again see bund yields head back to negative territory once this current wobble is over.

- **Bored of the Fed** – The US Federal Reserve (Fed) is not likely to hike in September and the most recent run of data, being somewhat on the soft side, supports that view. Watching the Fed has in my view become so boring and there is little interest rate threat from its glacial approach to raising rates back to a more neutral level. The big risk here is a policy mistake as inflation picks up. The Bank of England (BoE) kept its rates unchanged this week but it has only just set off on a new easing path so don't look for any surprises there. Despite the data holding up quite well in the aftermath of the referendum, the considered view has to be that the economy will suffer over the long term from the disruption to trade arrangements if there is anything like a hard "Brexit". This is structural not cyclical and we should think about the prospects for different sectors in the economy, particularly on the manufacturing side, that will face long term challenges in a changing competitive, regulatory and supply chain environment. But for now, the BoE could take rates even lower and will soon squeeze the UK corporate bond market in a similar way to what is happening in Europe.
- **QE is the drug** – So is the bond market justified in wobbling because of radical changes in the monetary policy outlook? Well, to some extent I think it is. It's been a reminder just how much markets are dependent on QE and negative rates and even though no major changes to policy are expected, we know at some point that markets will need to find a new equilibrium in a post-QE world when, presumably growth and inflation are at more comfortable levels. Bonds are expensive, yield curves too flat and inflation is likely to move higher. Higher volatility should result from these periodic panics because every holder of fixed income should have a little bearish devil on one shoulder whispering "this is the real thing" every time bonds do sell off.
- **Less of a drag** – Is there scope for significant change in the policy mix anywhere in the near term? All the talk about using fiscal policy more actively has so far amounted to a bag of nothing, but this does not mean it should be ignored. Japan again could be the experiment where a looser fiscal policy is combined with the BoJ's desire to steepen the yield curve and an increased size of overall QE. A steeper curve, weaker yen and higher equity prices could result from that. The UK may ease up on fiscal policy in the Autumn Statement and we don't really know what the fiscal

environment in the US will be in 2017 – it could be recklessly aggressive under Trump or modestly targeted under Clinton. In Europe the scope for fiscal stimulus is limited by German reluctance and the restrictiveness of the fiscal architecture. It should not be forgotten that most euro area countries are not really in a position to engage in massive fiscal stimulus given their outstanding debt/GDP ratios and budget deficits (I guess the same can be said for almost all developed countries with just a few exceptions). Fiscal policy is not a drag on growth any more but it is hardly a positive contributor either.

- **OK, bonds, we get the risks** – We are not going to get a grand pact between fiscal authorities and central banks that finances a massive wave of public infrastructure investment aimed at long term productivity growth through the issuance of long-term bonds that the central bank buys as part of QE. Or at least it won't be obvious. Japan is the economy that is probably closest to such an outcome. But for bonds it is becoming more and more difficult to hang on to these extreme valuations when there are at least discussions of adapting the relative bluntness of asset purchases and possibly even some actual changes. Whether that means steeper curves, more support for peripheral bonds, or increased supply from government borrowing remains to be seen. One thing is clear, the macro outlook does not necessarily support the extreme compression of term premium that we have had recently. Central banks will continue to dominate bond markets for the foreseeable future, but my view is that it you will be rewarded by focusing on protection rather than expecting continued outsized gains.
- **So much to answer for** – It's only out of habit that I write about football this week. Two consecutive losses for Manchester United and very few signs that the hesitancy and lack of flare evident over the last three seasons has been challenged by Jose Mourinho. I don't think he knows what his best team is and if he does not find out soon then City could end up running away with the League and the Reds will be in a dogfight for a European place again. I'm not optimistic at this stage and have not been bowled over by our summer signings. Still early days, as Chairman Mao said about the effects of the French revolution. It's always difficult to lose to the noisy neighbours but as Paul Scholes is reported to have said, it's a lot of fuss about nothing as United will always be the number one club in Manchester (he added that the number two club is probably the Hacienda and that's been closed for twenty years). Elsewhere, my other team are proving to be far more entertaining, with the Owls coming back from a 2-0 half-time deficit to Bristol City to win 3-2 courtesy of a 94th minute goal. Hillsborough rocking, up to 11th and away to Birmingham tomorrow.