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The Investment Engineers

CENTRAL BANK WATCHER

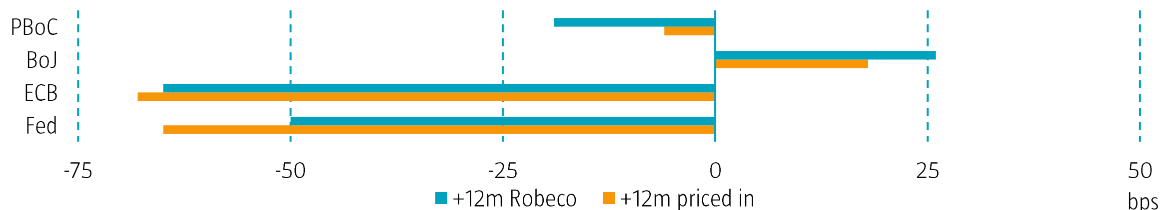
Peaking and tweaking

- Fed: leaning back
- ECB: external tightening
- PBoC: not the time to take it easy
- BoJ: it's a mad old world

The rise in long-term yields and broader tightening of financial conditions has been noticed by central bankers. At both the recent ECB and Fed meeting this was mentioned as one of the factors behind their decision to keep rates on hold, in addition to signs of moderating inflation pressures.

To preserve tighter conditions, central bankers will likely avoid sounding too dovish. Still, central bank rates in the US and Eurozone have likely reached their peak. It would take a re-acceleration of inflation pressures in combination with easier conditions for the Fed to restart hiking. The bar for the ECB seems even higher, given the very weak growth backdrop. In Japan, monetary policy is gradually shifting towards tighter conditions. The recent further tweak of the yield curve control policy prompted an underperformance of the 5-10-year segment of the curve. We foresee that this direction and pace of travel in policy and curve will continue. The policy outlook remains different for the PBoC, where we anticipate stable to lower policy rates over the medium term.

Figure 1 – Outlook for central banks policy rates



Source: Bloomberg, Robeco, change 12m ahead, based on money market futures and forwards; 6 November 2023

CENTRAL BANK WATCHER NOVEMBER 2023

Marketing material for professional investors, not for onward distribution

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The Federal Reserve: leaning back

- Powell hints at reluctance to tighten further
- Fed rates looking steady in H1 2023
- Value has been building in US rates

Fed puts things on hold for the time being

The chances of the Fed hiking again have declined. This much is clear from the November FOMC meeting. The Fed continues to have a tightening bias, according to chair Powell, and economic projections by the FOMC members still show one additional hike, however, the tone of the press conference after the meeting was different. In his response to questions chair Powell often chose the dovish answer. This was not always the most obvious response and thus seemed to be a deliberate choice, for instance when he was discussing the job market or recent wage data. Powell's comments were not made in isolation. In the weeks prior to the meeting a range of Fed speakers also reflected a reluctance to hike again. The Fed still has a hiking bias, but the bar for execution has clearly risen. This has a lot to do with the rise in long term yields, the broader tightening of financial conditions, as well as wider credit spreads and lower equity prices, that have occurred since their last hike on 26 July. FOMC members welcomed this move, as the whole aim of hiking is to tighten credit and financial conditions. Powell suggested that a persistent tightening of financial conditions could be a substitute for Fed hikes. The rally in both bonds and risk assets that followed his remarks did of course raise some questions on that persistency. Still, it will now probably take a combination of both strong economic data and lower long-term bond yields to persuade them to hike again. Therefore, this is no longer our base case. Further hikes cannot be ruled out, but we have lowered the odds for this scenario from 60% to 30% and now expect rates to remain on hold for a while.

Table 1 - What is priced in for the Fed versus our expectations

Fed funds rate (% upper bound)	5.50	Dec-23	Mar-24	Jun-24	Sep-24
Change implied by FF Futures (bps)		1	-3	-33	-65
Our probably-weighted expectation (bps)		5	5	-5	-50
Our central scenario (bps)		0	0	0	-50
Fed funds rate central scenario (% upper bound)		5.50	5.50	5.50	5.50

Source: Bloomberg, Robeco; 6 November 2023

If our inflation and below consensus growth outlook proves correct, the first cut could arrive in the middle of next year. Not hiking now means the Fed will probably feel the need to keep rates stable for quite some time. This makes July our base case for the first cut, a full year after what appears to have been their last hike. Risks remain tilted towards a delayed start to easing.

Treasury offering some support as QT remains in place

Since the announcement of increased bond issuance last August, the US Treasuries market has shown higher sensitivity to any news that suggests a further increase of debt supply. As a result of this anxiety the market responded positively when US Treasury, on 1 November, announced to leave the auction sizes of its 20-year US bonds unchanged and increase the auction sizes of 10- and 30-year bonds by a modest amount. The announcement illustrates the Treasury's willingness to incorporate feedback from the primary dealer community, which reduces some uncertainty around market conditions. In January the Treasury is expected to announce buyback operations. This is not monetary policy, nor is it aimed at impacting the overall level of rates, but the operation should improve liquidity for specific off the run Treasuries.

Importantly, don't expect any changes to the Fed's balance sheet rundown (QT). Reserves are still ample and the FOMC seems happy with the current pace of reductions (maximum USD 95 bln p.m. in total). The sell off in Treasury bonds over the past months and the widening of MBS spreads appears to have had little impact on their stance on QT. Expect this policy to remain in place until at least Q3 next year.

Table 2 - US Treasuries curve

USTs	Spot yield	12m Fw	Carry*	Hedged to EUR
2yr	4.87	4.35	234	144
5yr	4.53	4.40	96	58
10yr	4.59	4.60	57	36
30yr	4.77	4.73	28	17

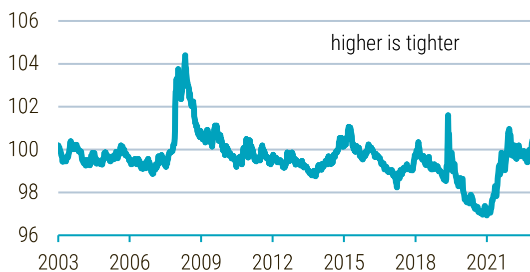
*For a 1pd position over 12 months

Source: Bloomberg, Robeco; 6 November 2023

Steepening trend set to continue

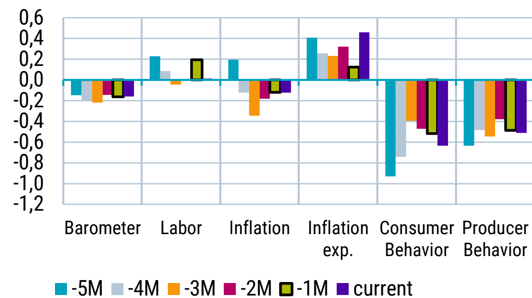
The past months have brought a significant upward correction in yields and steepening of the curve. The OIS market has come so far as pricing in long-term forwards for 1-year yields of more than 4% and from this we can conclude that the market is working with an assumed neutral that exceeds our expectations by at least 100 bps. We might be wrong on this estimate, but a 100 bps difference is a lot and suggests valuation is building in US rates. We are aware of that upward shifts are possible in neutral rate estimates and the market could deviate from these anchors for periods of time. Therefore, it is helpful to see shorter-term valuation models that incorporate a.o. Fed pricing also pointing towards increased relative value in 10-year US Treasuries. This supports the case for overweight positions. Heightened volatility and relentless momentum are counter arguments, which we think should be reflected in position sizes. Some spread trades are also becoming more interesting. For example, long 10-year US versus Canada looks attractive. As the rates outlook is gradually shifting, we see room for a further normalization of the US curve, although the steepening trend may well experience some hiccups after such extensive moves. The figures below illustrate that producer confidence has declined. Inflation has been trending lower, albeit at a more modest pace. Job creation remains robust, but wage growth is gradually cooling.

Figure 1 – Tighter financial conditions



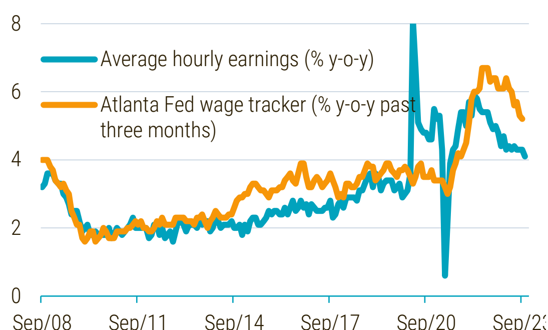
Source: Goldman Sachs, Bloomberg, Robeco; 6 November 2023

Figure 2 – Barometer shows declining producer confidence



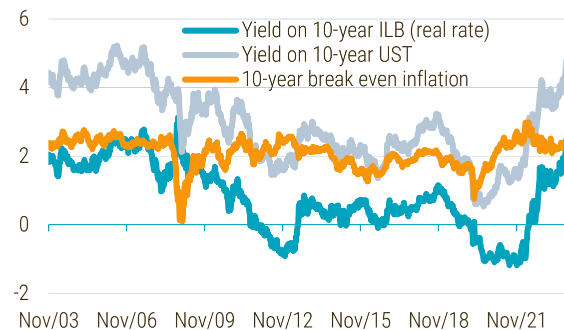
Source: Bloomberg, Robeco; 6 November 2023

Figure 3 – Wage growth continues slowing



Source: Bloomberg, Robeco; 6 November 2023

Figure 4 – Higher real yields



Source: Bloomberg, Robeco; 6 November 2023

European Central Bank: external tightening

- Externally-led rise in long-end yields reinforces the view that ECB rates have peaked
- Discussion on earlier end to full PEPP reinvestments delayed not shelved
- Bracing for retracement in yields and further curve normalization into 2024

Taking a breather

For the first time since June 2022, and after 10 straight rate hikes, the ECB's Governing Council "unanimously" decided to keep policy rates unchanged at their last meeting in October. "*Inflation is still expected to stay too high for too long, and domestic price pressures remain strong,*" but "*past rate increases continue to be transmitted forcefully into financing conditions,*" and "*most measures of underlying inflation have continued to ease*". Moreover, the statement reiterated that policy rates are at levels "*that, maintained for a sufficiently long duration, will make a substantial contribution*" to a timely return of inflation to the target. This suggests that most ECB policymakers believe that policy rates have reached a plateau and don't need to be raised further.

ECB President Lagarde reinforced this at the press conference by stressing that "*we have to be steady, we have to hold,*" and that more tightening is still in the pipeline for the economy due to the policy lags involved. Notably, she highlighted how the rise in US government bond yields has dragged Eurozone yields higher, while adding that this 'external' tightening of financial conditions was a spill over that needed to be taken into account. This probably explains why the council, despite earlier hints from hawkish governors, had not discussed a possible earlier end to reinvestments under the PEPP[1]– currently this is not scheduled before the end of 2024. That said, for the time being, the ECB seems determined (like many other DM central banks) to signal that their inflation fighting job is not yet done – and that holding does not fully rule out further hikes. Bear in mind that the ECB could still (instead) tighten their policy stance further by shifting from a full to a partial reinvestment of maturing securities held under the PEPP. A discussion could start as soon as December – we would not expect this to kick in before 2H 2024.

Table 1 - What is priced in for the ECB versus our expectations

ECB deposit facility rate	4.00	Dec-23	Mar-24	Jun-24	Sep-24
Change implied by OIS (bps)		1	-8	-36	-68
Our probability-weighted expectation (bps)		1	-10	-35	-65
Our central scenario (bps)		0	0	-25	-50
ECB depo rate in central scenario (%)		4.00	4.00	3.75	3.50

Source: Bloomberg, Robeco; 6 November 2023

Table 2 - DBR curve

	Spot yield	12m Fwd	Carry* (bp)
2y	2.96	2.26	-83
5y	2.54	2.30	-34
10y	2.65	2.61	-9
30y	2.92	2.88	-6

* for a 1pd position in cash bonds over 12 months

Source: Bloomberg, Robeco; 6 November 2023

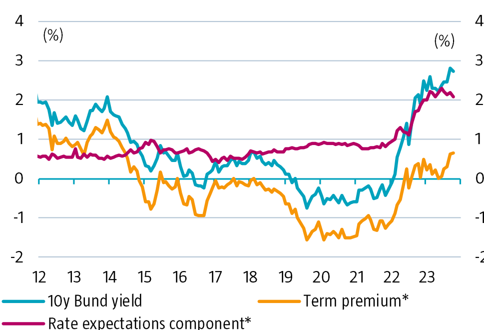
[1] As of July 2023 the ECB has already discontinued the reinvestments under the older QE program, the APP

Looking ahead, we think that – notwithstanding the near-term prospect of a plateau – the ECB's depo rate will be back in 'neutral' territory (which we see somewhere in the 1.75%-2.25% area) sooner than markets (and the ECB) anticipate. Indeed, we continue to question the market's belief that the ECB's rates policy will stay restrictive for many years to come, despite the projected further drop in inflation towards 2% in the course of next year (Figure 3). Specifically, our central scenario still sees the ECB cutting interest rates by the middle of next year.

Still bracing for retracement in yields and further curve normalization into 2024

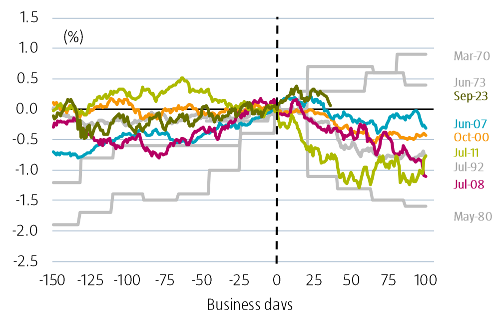
- Since the lows of mid-March, when bond markets were under the spell of the US regional banking crisis, German bond yields have been on an uptrend. However, while 10-year Bund yields reached a new cyclical high of 3% in early October, the 2-year yield did not breach the peak from early March. The sell-off in longer-dated bond yields was, to a large extent, driven by the rise in US treasury yields in the wake of resilient US economic data and issuance considerations. This helped push the term premium in Bund yields to fresh highs (Figure 1).
- Although yields have come down from their peak levels, we think current valuations in the 5- to 10-year space still warrant a constructive stance on EUR duration. Indeed, at around 2.75% – term-premium adjusted – the EUR 5-year OIS rate 5-year forward still strongly exceeds the 2% median analyst estimate of the long-term 'neutral' ECB depo rate, to which Chief Economist Philip Lane apparantly subscribes. One could argue that a looser fiscal policy regime rationalizes an uplift in the long-term neutral rate – which we agree with. But a market-implied neutral policy rate of close to 3% is a bridge too far in our view.
- Curve-wise, we remain barced for further re-steepening, although we do see a risk, especially in 2s10s, of some re-flattening near term. As for swap spreads over Germany, given the prospect for more QT, there is potential remaining for further tightening, especially in 5- to 10-year tenors. However, front-end swap spreads are particualry at risk of widening in bouts of 'risk-off' in financial markets.

Figure 1 – Term premium on the move



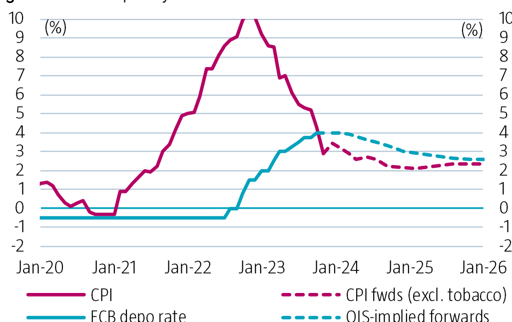
Source: ECB, Robeco; 6 November 2023 * estimates based on FED ACM model; special thanks to our colleague Roderick Molenaar

Figure 2 –10-yr yield changes around last ECB/Buba hike (t=0)



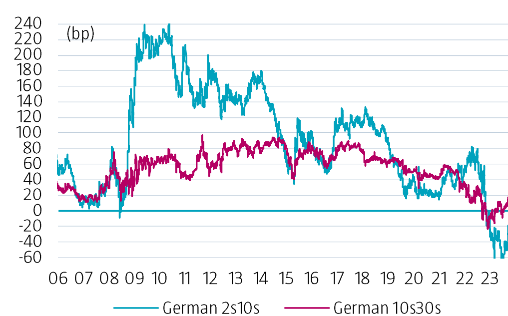
Source: ECB, Robeco; 6 November 2023

Figure 3 – ECB policy rate and inflation forwards



Source: ECB, Robeco; 6 November 2023

Figure 4 – German 2s10s and 10s30s yield curve



Source: ECB, Robeco; 6 November 2023

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People's Bank of China: not the time to take it easy

- Further rate cuts delayed as fiscal policy loosens
- Secular downtrend in China bond yields intact
- We await further yield back-up before adding duration

Policymakers have their hands full

While the official real GDP data for Q3 suggests that the Chinese economy has gained momentum, other activity data are less encouraging. Indeed, our Economic Barometer, which captures a very broad range of low- and high-frequency data, has remained in the doldrums (see Figure 4).

In any case, ongoing stimulus efforts by policymakers demonstrate that worries about the economy remain. In September the PBoC followed up earlier easing measures with another cut in the reserve requirement ratio (RRR) of banks that are yet to face a 5% RRR, which helped push up credit supply in September. Still, growth in the net flow of credit per unit of GDP remains depressed, as our 'credit impulse' indicator reveals (see Figure 3). Moreover, demand for homes outside of Tier-1 cities is struggling to turn the corner. Against this backdrop it is little wonder that the NPC standing committee approved RMB 1 trillion in additional central government bond (CGB) issuance quota to support infrastructure investment in October. Moreover, and importantly, at the end of October the Central Financial Work Conference saw policymakers pledge to address the debt woes of local government(s) (funding vehicles) – who are impeding higher interest rates.

Fortunately for the PBoC, the inflation backdrop is such that monetary policy can remain accommodative for the time being. Looking ahead, we expect the PBoC to try to steer money market rates – which came under upward pressure in September and October – back to the lower end of the policy rate corridor (consisting of the 7-day reverse repo rate and 1-year MLF rate), possibly via another RRR cut. Meanwhile, the weak CNY will likely keep a lid on the potential for near-term rate cuts. However, looking beyond the next few months, we continue to see downside risk to market pricing of policy rates (see Table 1 below).

Table 1 - What is priced in for the PBoC versus our expectations

PBoC 7-day reverse repo (%)	1.80	Dec-23	Mar-24	Jun-24	Sep-24
Change implied by forwards (bps)		8	-8	-10	-6
Our probability-weighted expectation (bps)		-2	-8	-14	-19
Our central scenario (bps)		0	-10	-10	-20
PBoC 7-day reverse repo in central scenario (%)		1.80	1.70	1.70	1.60

Source: Bloomberg, Robeco; 6 November 2023

Since reaching their year-to-date lows in August, Chinese government bond yields have moved higher, led by the shorter end of the yield curve – as market expectations for further near-term rate cuts were (rightly so in our view) scaled back. Towards the end of October the 10-year CGB yield was approaching levels where we (as mentioned in our previous *Central Bank Watcher)* would turn more constructive again, i.e. at 25 bps or more above the 1-year MLF rate. However, since then 10-year yields have nudged lower again, so for now, we opt to stay tactically underweight CGBs cross-market against DM government bonds. Perhaps the upcoming rise in CGB issuance can help bring yields to above-mentioned levels, as we remain of the opinion that the secular downtrend in Chinese rates remains intact.

Table 2 - DBR curve

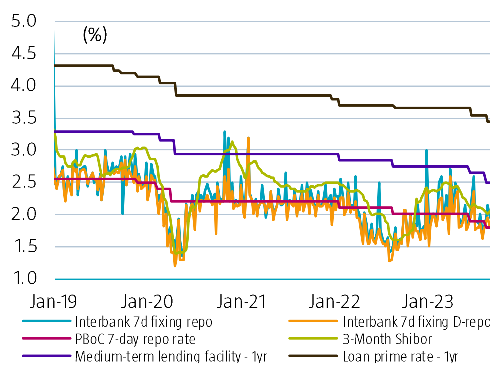
	Spot	12m Fw
2yr	2.37	2.51
5yr	2.52	2.69
10yr	2.66	2.75

Source: Bloomberg, Robeco; 6 November 2023

Economic Barometer: no improvement yet

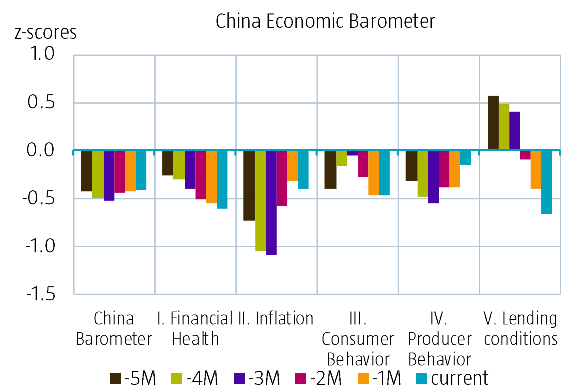
- Our Economic Barometer for China remains indicative of weak growth circumstances, with all components still in subpar territory (Figure 2). What stands out in terms of recent changes are the increased signs of weakness in the 'Lending Conditions' component. This reflects a further tightening in broader financial conditions, a rise in sovereign CDS spreads and still-feeble credit growth (from an impulse perspective).
- The Z-score for 'Producer Behavior' actually improved somewhat despite a renewed weakening in the PMI data. Rising industrial production, electricity usage, and railway freight traffic helped.
- Meanwhile, the Z-score for 'Consumer Behavior' continues to be held back by weak PMI employment data and home sales as well as the still subdued marginal-propensity-to-consume metric (based on household demand deposits relative to savings deposits). The latter subcomponent's lingering weakness is testament to the view that despite the shift to services spending post-reopening, Chinese consumers remain cautious overall.
- Meanwhile, the Z-score for 'Inflation' improved thanks to a pick-up services price inflation and a slower pace of negative PPI inflation. With core inflation running at slightly below 1%, in our view it is too early to fret about broad-based deflation taking hold in China.

Figure 1 – Selected policy and money market rates



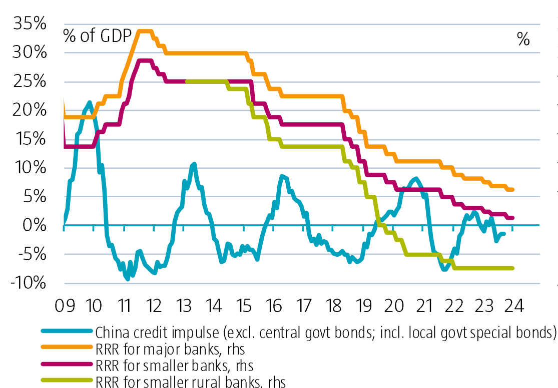
Source: Bloomberg, Robeco; 6 November 2023

Figure 2 – Economic Barometer: stuck in the doldrums?



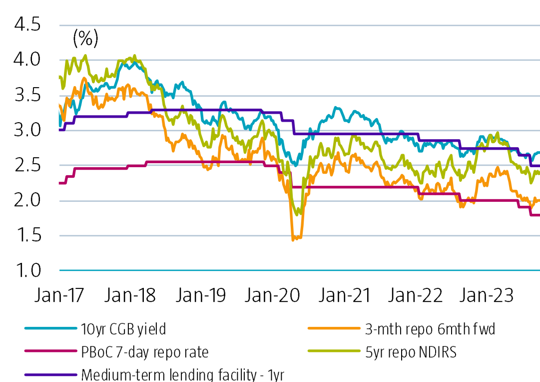
Source: Bloomberg, Robeco: 6 November 2023

Figure 3 – RRR of banks and credit impulse



Source: Bloomberg, Robeco; 6 November 2023

Figure 4 – Selected short-term and long-term rates



Source: Bloomberg, Robeco; 6 November 2023

Bank of Japan: it's a mad old world

- Another small tweak
- Inflation outlook likely to be upgraded
- The end of negative rates

Another small tweak

At its recent monetary policy meeting on October 31st the BoJ decided to again make its Yield Curve Control (YCC) policy more flexible. Expectations for this meeting were mixed with the majority of BoJ watchers expecting the status quo to be maintained and only a small number calling for aggressive changes to YCC, some even suggesting to abolish it altogether. Prior to the meeting expectations shifted quite meaningfully based on the reports by Nikkei on October 30 that the BoJ would make material changes to its YCC policy. When looking at the outcomes we can conclude that once again the BoJ only made a small tweak. The most important point of this policy revision is that the reference fluctuation range in the 10-year JGB yield, which was set at around 0.5%, has been amended to a 1.0% upper bound, effectively removing the lower bound. Hence, YCC can be seen to have shifted back to a yield cap policy. Furthermore, the BoJ has decided to end the daily unlimited fixed operations at 1.0%. Markets might interpret this as a signal that the strict YCC cap is no longer in effect, given the BoJ no longer needs to purchase large amounts, even if the 10-year JGB yield reaches 1% or more. In theory we might agree with the market's interpretation, but we would rather err on the side of caution. What matters more for BoJ interventions is not necessarily the 10-year JGB yield itself, rather the pace of the sell-off. If the pace of yield rise is rapid, we feel that the BoJ will likely need to step in and stabilize the JGB market through unscheduled JGB purchasing operations or regular fixed-rate operations. During the press conference Governor Ueda confirmed the need for this optionality in the toolbox.

Inflation outlook likely to be upgraded

The inflation outlook will be key, in particular the outlook for the core inflation rate is gaining attention by the day. The core inflation outlook has been revised upwards to 3.8% (from 3.2% in July) for 2023. The outlooks for 2024 and 2025 have also been upgraded from 1.7% and 1.8% respectively to 1.9% for both years. One might argue that core inflation is embedded in the forecasts, and one could even argue that Japan has finally exited their deflation era in full. Moving forward we expect revisions to gradually increase as soon as the January 2024 Outlook report, given the current inflation trend and strong momentum in next year's Shunto spring wage negotiation. If this happens, the inflation outlook will be consistent with the 2% price stability target or will come very close. If the positive news about the results of next year's Shunto continues until January, we believe achieving the 2% price stability target with wage increases will be within sight.

Table 1 - What is priced in for the BoJ versus our expectations

Policy balance rate (%)	-0.10	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Change implied by futures (bps)		2	4	11	18	22
Our probability-weighted expectation (bps)		3	10	14	26	33
Our central scenario (bps)		0	10	10	25	25
Policy balance rate in central scenario (%)		-0.10	0.00	0.00	0.15	0.15

Source: Bloomberg, Robeco; 6 November 2023

The BoJ has suggested that it would need to achieve its 2% inflation policy target before considering ending negative interest rates. This implies establishing a virtuous cycle between wages and prices, whereby both mutually increase, which is seen as very important. There is evidence in the 2023 Shunto wage negotiations that rising prices leads to higher wages. If in turn prices do rise further and lead to a rise in wages, the BoJ could be convinced its target is met. The impact of rising wages should lead to higher service inflation and indeed the latter has been true since the start of this year. Interestingly, the BoJ attributes the bigger part of the rise in services inflation to the second-round effects of higher input costs on raw materials and energy, with only a minor part attributed to higher wages. We take a different view, once wages start to rise because of higher prices then a price-wage spiral begins. When looking at the 2024 wage demand we see evidence of even steeper demands for higher

wages, this reflects that the price-wage spiral is gaining a lot of momentum. Experience in other Internationally developed markets (Europe and United Kingdom) suggests that it takes considerable effort for central banks to get that under control. In our view the BoJ is increasingly behind the curve, high prices and high wages with mutual causality warrant a central bank to err on the side of caution.

The end of negative rates

Shunto results this year and next year are similar to those seen before deflation took hold in Japan. We consider this evidence that Japan is shifting towards a new inflation equilibrium. We expect core inflation to settle between 1 and 2% for the medium term. In our view, this implies that before the end of the year the BoJ will likely exit their negative interest rate policy by implementing a 10 bps hike. We continue to think that in Japan the YCC is here to stay and will be impossible to abolish given financial stability risks. Still, we think the BoJ is keen to further normalize the longer end of the curve by changing the YCC from a 10-year point towards a 5-year point, or to widen the bandwidth on the 10-year point to +/-150 bps.

We consider all meetings for the remainder of this year as live for changes in both the YCC and policy rate. With so much YCC and policy change, the outcome will be that the 7-year JGB yield trades close to a 1% yield by the end of the year, and the 10-year JGB yield closes to 1.25%. In all scenarios we expect 10s30s to flatten further given the large upward pressure on 10-year JGBs. As JGB yields adjusted higher over the course of 2023 relative to other markets, and considering the FX-hedged basis is the superior investment for domestic Japanese investors compared to other global fixed income asset classes, we continue to look for a stronger yen versus other major currencies. As the BoJ begins to make changes to YCC, and while other global central banks approach their respective terminal rates later this year, we see value in taking long positions in the yen.

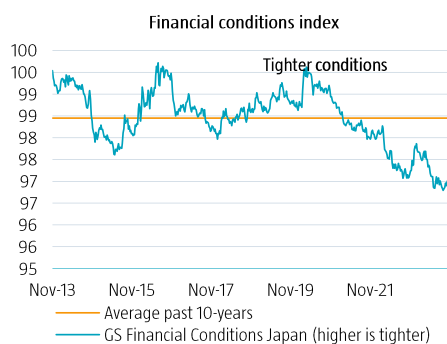
Table 2 - JGB curve

JGB Curve	Spot yield	12m Fw	Carry*	Hedged to EUR
2yr	0.13	0.31	14.2	16.2
5yr	0.42	0.61	18.9	19.7
10yr	0.88	1.10	17.1	17.5
30yr	1.82	1.90	9.9	10.1

* for 1pd position over 12 months

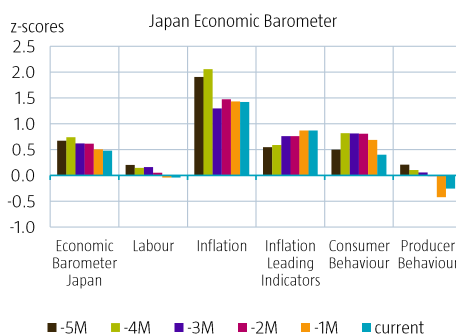
Source: Bloomberg, Robeco; 6 November 2023

Figure 1 – Still loose financial conditions



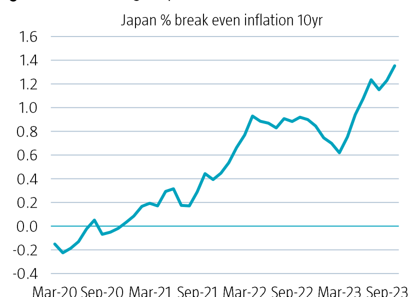
Source: Goldman Sachs, Bloomberg; 6 November 2023

Figure 2 – Strong inflation momentum



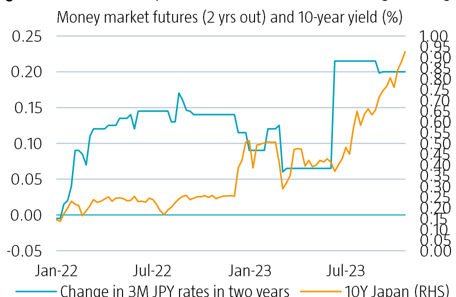
Source: Robeco, Bloomberg; 6 November 2023

Figure 3 – Strong improvement in breakevens



Source: Bloomberg; 6 November 2023

Figure 4 – Markets price in small amounts of tightening 2 years out



Source: Bloomberg; 6 November 2023

Important information

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No securities commission or similar authority in Canada has reviewed or in any way passed upon this document or the merits of the securities described herein, and any representation to the contrary is an offence. Robeco Institutional Asset Management B.V. relies on the international dealer and international adviser exemption in Quebec and has appointed McCarthy Tétrault LLP as its agent for service in Quebec.

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Generally, no offer or sale of the Shares is permitted in Malaysia unless where a Recognition Exemption or the Prospectus Exemption applies: NO ACTION HAS BEEN, OR WILL BE, TAKEN TO COMPLY WITH MALAYSIAN LAWS FOR MAKING AVAILABLE, OFFERING FOR SUBSCRIPTION OR PURCHASE, OR ISSUING ANY INVITATION TO SUBSCRIBE FOR OR PURCHASE OR SALE OF THE SHARES IN MALAYSIA OR TO PERSONS IN MALAYSIA AS THE SHARES ARE NOT INTENDED BY THE ISSUER TO BE MADE AVAILABLE, OR MADE THE SUBJECT OF ANY OFFER OR INVITATION TO SUBSCRIBE OR PURCHASE, IN MALAYSIA. NEITHER THIS DOCUMENT NOR ANY DOCUMENT OR OTHER MATERIAL IN CONNECTION WITH THE SHARES SHOULD BE DISTRIBUTED, CAUSED TO BE DISTRIBUTED OR CIRCULATED IN MALAYSIA. NO PERSON SHOULD MAKE AVAILABLE OR MAKE ANY INVITATION OR OFFER OR INVITATION TO SELL OR PURCHASE THE SHARES IN MALAYSIA UNLESS SUCH PERSON TAKES THE NECESSARY ACTION TO COMPLY WITH MALAYSIAN LAWS.

Additional information for investors with residence or seat in Mexico

The funds have not been and will not be registered with the National Registry of Securities or maintained by the Mexican National Banking and Securities Commission and, as a result, may not be offered or sold publicly in Mexico. Robeco and any underwriter or purchaser may offer and sell the funds in Mexico on a private placement basis to Institutional and Accredited Investors, pursuant to Article 8 of the Mexican Securities Market Law.

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The Superintendencia del Mercado de Valores (SMV) does not exercise any supervision over this Fund and therefore the management of it. The information the Fund provides to its investors and the other services it provides to them are the sole responsibility of the Administrator. This Prospectus is not for public distribution.

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Robeco is deemed authorized and regulated by the Financial Conduct Authority.

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The sale of the Fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. The Fund must not be offered or sold to the public in Uruguay, except under circumstances which do not constitute a public offering or distribution under Uruguayan laws and regulations. The Fund is not and will not be registered with the Financial Services Superintendency of the Central Bank of Uruguay. The Fund corresponds to investment funds that are not investment funds regulated by Uruguayan law 16,774 dated 27 September 1996, as amended.

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