

Global Fixed Income Macro

Central bank watcher: time to deliver

- Fed: make life easy and do 50
- ECB: a September to remember
- PBoC: easing by reform?
- BoJ: game theory

Central banks across the spectrum have made a big shift and are now focused on the best way to make their policies more accommodative. But, after all the talking, it's now time to deliver.

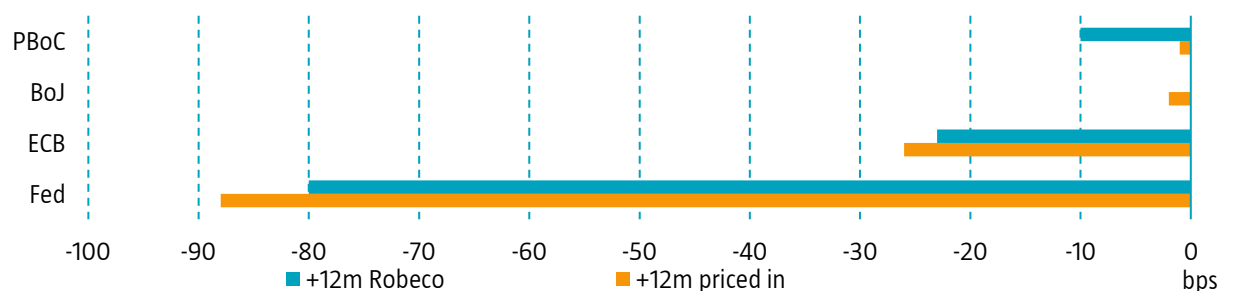
It looks as if the Fed will take the lead among the four major central banks. The ECB and BoJ have hinted at but not yet delivered fresh stimulus in order to not create the impression that they are "outdoving" the Fed and embarking on a currency war with the US. The Fed will almost certainly cut rates in July and pave the way for the others to follow through. The market has started to price in quite a bit of easing, so central banks better deliver or run the risk of a fierce response in risk assets.

Article

For professional investors
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Outlook for central bank rates (change 12m ahead)



Source: Robeco. Based on and money market futures and forwards

Federal Reserve: make life easy and do 50

- Fed to cut by 50 bps by September
- Risks are tilted towards more easing
- Yields to drift lower on a global scarcity of safe assets

An opportunity to get ahead of the curve

The Fed looks set to deliver an ‘insurance’ cut at the 31 July meeting. The main question now is by how much they will reduce rates at this meeting. In our opinion it makes a lot of sense to cut rates by 50 bps, get ahead of the curve and take the angle about the lingering talks about currency intervention. But, their communication in the past weeks has been hinting more towards a 25 bps cut, which makes this the more likely outcome. Some important data have indeed improved since the June meeting, with payrolls and retail sales surprising to the upside, and the US and China agreeing to a sort of “trade truce”. That might tempt them to think 25 bps is enough. We think the market will respond negatively to such decision, but this Fed still looks less in tune with markets than its predecessors.

Unfortunately 25 bps won’t do the job. It will not be enough to convince markets and corporates that the Fed will do everything it can to sustain economic momentum. It will not be enough to put some downward pressure on the dollar and thus stop the rumors about currency intervention. A 25 bps move will also lack the power to lift inflation expectations. Hopefully the FOMC members acknowledge this and cut by 50 bps. If not, the response to a smaller cut will probably force them to cut rates again in September. So, in both scenarios we expect rates to be cut by 50 bps by September. The main risk to this scenario is that the Fed will have to deliver more cuts.

What is priced in for the Fed, versus our expectations

Fed funds rate	2.38	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Change implied by FF Futures (bps)		-45	-65	-74	-88	-95	-101
Our probably weighted expectation (bps)		-55	-65	-70	-80	-85	-85
Our central scenario (bps)		-50	-50	-50	-50	-50	-50

The market has priced in -100 for December 2020. For September this year the market is now very close to our expectation. There is still some room for the Fed to surprise on the dovish side, for instance by immediately ending the balance sheet rundown, but a dovish view is more or less priced in. Still, we would argue against a large repricing of Fed expectations. US domestic conditions remain supported by stable consumer demand, but global economic conditions remain challenging, ongoing trade disputes (with China or Europe) remain a risk and we see little evidence of inflationary pressure. This keeps risk for the Fed funds rate tilted towards the downside, even after an insurance cut.

USTs	Spot yield	12m Fw	Carry*	Hedged to EUR
2yr	1.86	1.74	89	-56
5yr	1.85	1.89	39	-20
10yr	2.07	2.18	27	-5
30yr	2.60	2.64	14	1

* for a 1pd position over 12 months

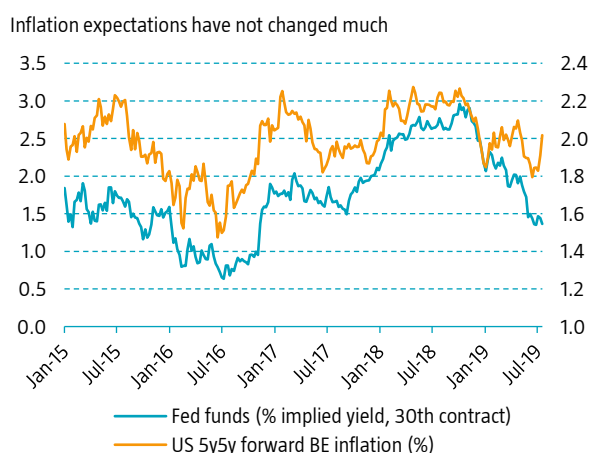
Conditions to remain supportive for US Treasuries

When looking at the US Treasuries market in isolation, arguments against owning Treasuries are easy to find. To name a few: plenty of rate cuts are priced in, FX hedging costs are high, some important data have improved and real rates have reached low levels. Still, we think the motives to go long Treasuries are more compelling: safe assets with a yield are scarce, spreads versus peer markets remain elevated, there is still plenty of uncertainty regarding international trade, the S&P just reached a new all-time high and risk markets might be in for a breather. We continue to favor long positions in US Treasuries and have a preference for futures as an instrument.

Global scarcity of safe assets pushes down term premium, we expect more to come

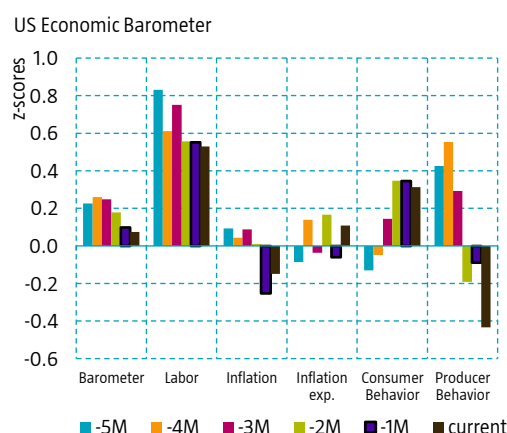
- Since the end of April, 10-year US Treasury yields have declined by approximately 50 bps. Expectations for central bank rates continued to play a dominant role in determining interest rates. Changes in the term premium explain circa 20 bps of lower rates. Longer-term inflation expectations have remained stable during this period.
- The term premium has a cyclical component and it is quite extraordinary for the term premium to decrease in episodes where the market is pricing in rate cuts by the central bank. The decline can be explained by the early ending of the Fed's balance sheet rundown and by speculation about a new round of QE by the ECB. We are of the opinion that central bank policy has a global impact on term premia, as it forces investors out of their home market to seek for yield elsewhere.
- For the coming months we don't expect a rise in the US term premium unless the US economy would slow further and much more rate cuts would be priced in. In that case the whole yield spectrum would come down, but the short end would lead this move. The more likely scenario is a continued grind lower in term premia, driven by a continued scarcity of safe assets.
- We don't expect any big changes in US long-term inflation expectations for now. An accommodative Fed policy should ultimately lead to higher inflation expectations, but inflation pressures are still muted and the market probably wants to see more evidence before believing any sustained pick-up in inflation.
- 100bps in rate cuts have been priced in, but we don't expect a correction there. US domestic economic conditions still look reasonable, resulting from strong consumer demand, but the uncertainty around global growth and trade remain elevated, as is visible in the weakening of business confidence. Risks are therefore tilted towards a greater measure of easing than the 'insurance' cuts that are expected for the coming months.
- To sum up, we expect yields to grind lower, primarily owing to a global scarcity of safe assets, especially those with yield.

Chart 1. Fed expectations are down, inflation expectation are stable



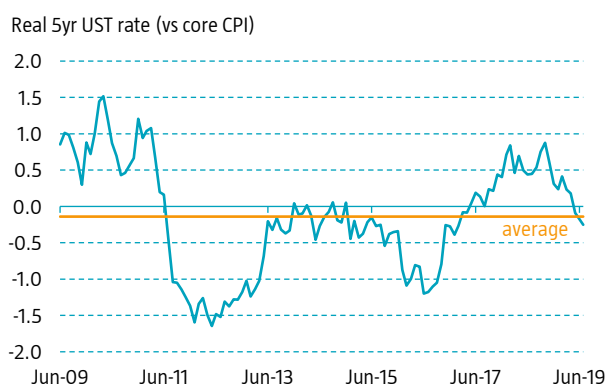
Source: Bloomberg, Goldman Sachs

Chart 2. Economic barometer now a mixed picture



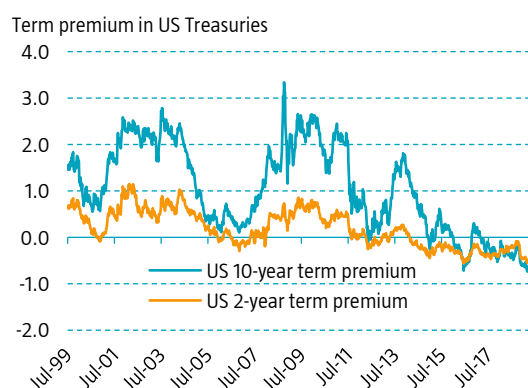
Source: Bloomberg

Chart 3. Real rates are below zero, but close to average levels



Source: Bloomberg, Robeco

Chart 4. The 10-year term premium has declined further



Source: Bloomberg

European Central Bank: a September to remember

- ECB paves way for September stimulus package
- 10-year German yields at record lows thanks to rate cut discount
- Outlook: neutral Bunds – use any further richening to move into swaps or other G10 bonds

Persistent inflation undershoot prompts fresh ECB stimulus

Although growth on the services side of the Eurozone economy is still holding up relatively well, manufacturing activity has slumped even further in recent months. Against this backdrop longer-term inflation expectations, both of financial markets and professional forecasters, have fallen further below the ECB's medium-run target of "below but close to 2%" (see Chart 2 on the next page). To be sure, according to recent [ECB research](#) shorter-term inflation expectations currently are a more important driver of core inflation in the Eurozone, which is still hovering around 1%. But at 0.85% and 1.05%, respectively, the 1-year spot and 1-year/1-year forward inflation-linked swap rates give little reason to cheer.

Consequently, it was no surprise to see ECB President Draghi live up to his reputation and deliver a dovish message at the July ECB meeting. While the ECB didn't deliver a rate cut, as some had expected, they unambiguously paved the way for fresh monetary easing at the next policy meeting on September 12. First of all, the forward guidance on policy rates was changed to now explicitly make reference to the expectation for policy rates at "lower levels" through 1H 2020 – a clear hint at a cut in the deposit facility rate (currently: -0.40%). This could be accompanied by measures to mitigate the side-effects of negative interest rates on the banking system, such as a "tiered system for reserve remuneration". The ECB has also tasked committees to examine options for the "size and composition of potential new net asset purchases". Finally, Draghi stressed that the ECB is "determined to act", in line with its commitment to "symmetry" in the inflation aim. This could allow the ECB to let inflation hover above 2% for a while before withdrawing policy accommodation. The bottom line is that the ECB decided to keep all options open on the forthcoming stimulus.

A rate cut in September seems pretty much a done deal now. We think there is a 50% chance of a 20 bps (rather than 10 bps) move. As we believe the risks are skewed to further rate easing – certainly if a tiered reserve system is implemented – we agree with the market discount of c. 25 bps of rate cuts by Q1 2020 – even though our central scenario is for 20 bps (see table below). That said, we do not exclude the possibility that instead of "tiering", the ECB opts for sweetening the terms of the TLTRO3s as a mitigating measure. On our calculations markets discount a roughly 60% probability of renewed net asset purchases at a monthly pace of EUR 30bn for 12 months. While we agree that the odds of renewed net asset purchases are more likely than not, we feel it is not a done deal yet that large-scale sovereign bond purchases and an increase in PSPP issuer/issue share limits from 33% to 50% are forthcoming. To retain some ammunition the ECB could restart the APP within the existing limits or increase them to 40%, and signal they could expand the program (and limits) further if conditions do not improve. Moreover, we cannot escape the thought that relaunching a carbon copy of QE1 risks eventual disappointment, as QE1 failed to revive inflation expectations in a sustained manner.

What is priced in for the ECB versus our expectations

ECB deposit facility rate	-0.40	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Change implied by OIS (bps)		-11	-19	-23	-26	-26	-28
Our probability-weighted expectation (bps)		-15	-22	-23	-23	-23	-23
Our central scenario (bps)		-20	-20	-20	-20	-20	-20

10-year German yield at record lows thanks to rate-cut discount

The belly of the German curve has kept on trading one for one with the market's pricing of ECB policy, having now rallied towards the -0.7% area. Even at these levels, carry and rolldown are still positive (table above), but more so in 10-year space. Based on the approach we introduced in our previous Central Bank Watcher, we estimate 5 bps of this (still) reflects flight to safety due to the repricing of Italian sovereign risk in May last year (Chart 4), while 15 bps reflects the further richening due to ECB QE scarcity effects since mid-2016.

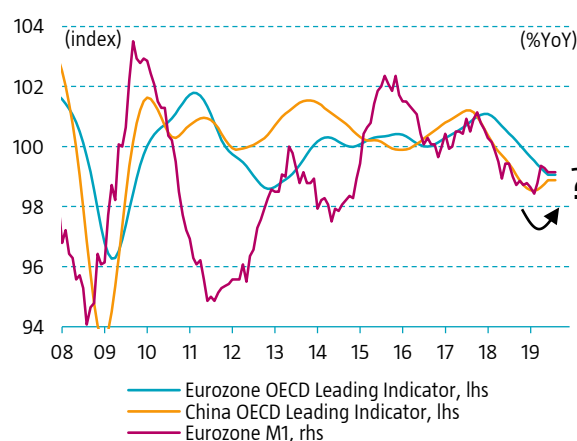
DBR curve	Spot yield	12m Fwd	Carry* (bps)
2yr	-0.76	-0.83	-17
5yr	-0.67	-0.66	2
10yr	-0.37	-0.27	9
30yr	0.23	0.30	4

* for a 1pd position over 12 months

Outlook: neutral Bunds – use episodes of further richening to move into swaps or other G10 bonds

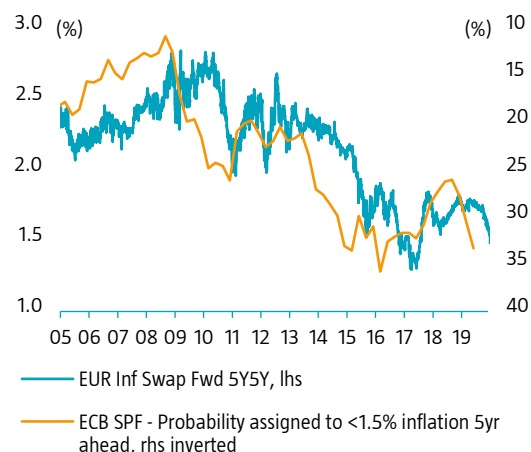
- While our base case scenario sees 10-year Bund yields coming off their historic lows in Q4, on an improving economic outlook (Chart 1) and some repricing of 2-year ahead OIS forwards, we would recommend keeping a neutral position in Bunds for now. This is also consistent with our expectation of episodes of sharp flight-to-safety flows in autumn (due to hard-Brexit fears, lingering Italian fiscal concerns and the threat of tariffs being imposed on US imports of European cars).
- We expect the German 2s10s and 5s10s curves to continue to trade directionally with 10-year outright. We also retain a mild flattening bias on 10s30s, as 2s may struggle to rally much further, implied volatility is still low and the prospect of QE2 will likely reinforce a grab for yield. However, positioning in long-end Germany seems crowded.
- We would use any further richening of German long-term government bonds to contemplate moving into other G10 bonds (such as 30yr JGBs, see BoJ section) or swaps. We doubt ECB QE2 would lead to a sharp widening of swap spreads, given the reduced repo scarcity of bunds and increased search for positive carry.

Chart 1. Eurozone M1 vs China & Eurozone OECD lead indicators



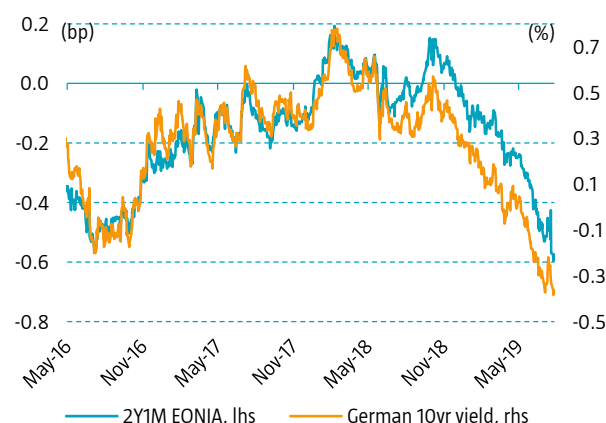
Source: Bloomberg

Chart 2. Long-term inflation expectations at 2016 lows



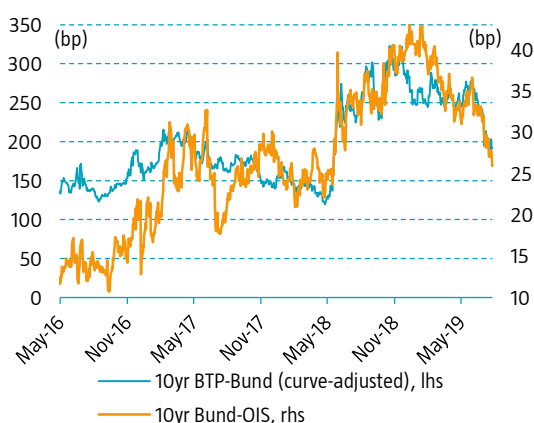
Source: Bloomberg

Chart 3. German 10yr Bund yield vs the 1-mth EONIA rate 2yr forward



Source: Bloomberg

Chart 4. 10yr Bund-OIS vs 10yr BTP-Bund spread



Source: Bloomberg

People's Bank of China: easing by reform?

- Further monetary easing forthcoming...
- ...as underlying economic momentum is still struggling to gather pace
- 5-year CGBs still looking attractive versus USTs

PBoC to use reform to further ease financial conditions for the real economy

Recent activity data indicates that the slowdown in China's economic growth broadly continued in the second quarter. Indeed, while retail sales growth is showing signs of improvement, import growth, car production and the purchasing managers' indices so far have remained at subdued levels. That said, the earlier monetary and fiscal easing measures are starting to slowly feed through, pointing to a cyclical pick-up in activity data over coming months. In fact, broad credit growth in the Chinese economy, as measured by total social financing, has been drifting slowly higher in recent months, driven by a pick-up in bank lending and higher local government bond issuance. Consequently, the closely watched 'credit impulse' metric – here we exclude central government borrowing – rose back into positive territory in June for the first time since early 2017. Note that the OECD's leading economic indicator for China is also hinting at an impending cyclical pick-up in growth.

Even so, plenty of downside risks remain, including a renewed flare-up in the US-China trade dispute and a relapse in bank lending due to the recent turbulence in the Chinese interbank market. Here we take some comfort – especially in light of the large amount of certificates of deposit (NCDs) that have to be rolled in Q3 – from the fact that the spread between yields on NCDs for lower- and higher-rated banks have tightened somewhat (Chart 2). All in all, given the lingering downside risks and still-sluggish employment growth – the manufacturing PMI employment index hit a fresh 10-year low in June – we still expect the PBoC to deploy further monetary easing measures, including further (targeted) cuts in the reserve requirement ratio (RRR) for banks.

As regards policy rates, PBoC Governor Yi Gang recently stated that "lowering interest rates is mainly to tackle deflationary risks", and that, given the moderate inflation (2.7% in June), current levels are "appropriate". However, he also pointed to the pending reform of the interest rate framework that could *indirectly* lead to lower borrowing costs for the real economy: the 1-year Loan Prime Rate (4.31%), which is set to replace the 1-year benchmark lending rate (4.35%) as the key reference rate for loans, could be linked to more market-oriented rates, such as the 1-year MLF or TMLF rates, currently at respectively 3.30% and 3.15% (Chart 3). On the face of it, this makes small 5-10 bps cuts in the PBoC 7-day reverse repo rate on the back of Fed rate easing seem less likely. However, given the downward impact on bank's net interest income from the envisaged reform and the reduction in bank lending rates, we still believe there is a more than decent chance the PBoC cuts the 7-day reverse repo rate. While markets discount 5 bps of easing in 7-day interbank repo market conditions by year-end, we see risks as skewed to somewhat stronger easing (see table below).

What is priced in for the PBoC versus our expectations							
1-month repo NDIRS	2.55	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Change implied by forwards (bps)		-4	-5	-3	-1	-1	0
Our weighted fair value estimate (bps)		-5	-10	-10	-10	-10	-10
Our central scenario (bps)		-5	-5	-5	-5	-5	-5

5-year CGBs still looking attractive versus USTs

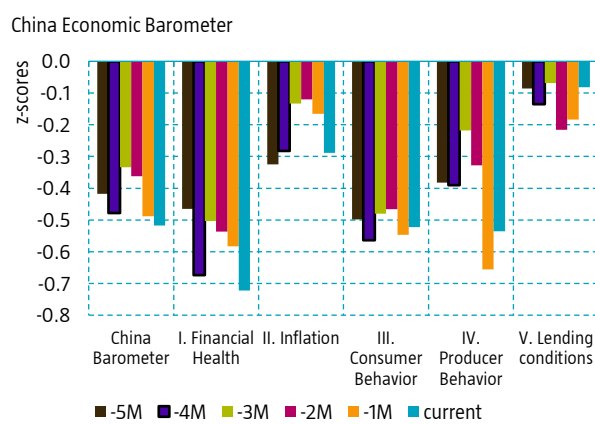
The net decline in the 1-month repo NDIRS and in the 2-year ahead repo NDIRS forwards since the end of April has coincided with a retreat in 5-year government bond yields (Chart 4 on next page), confirming that CGB yields are still predominantly driven by expectations about monetary policy. Meanwhile, with 5-year UST yields having come off their June lows, 5-year UST-CGB spreads have fallen back below 120 bps. With 100 bps of Fed easing already discounted in UST 5-year yields, and the odds of further Chinese rate easing not fully discounted in our view, we continue to favor owning CGBs over 5-year USTs, also taking into account FX hedging costs considerations (for EUR investors) and the fact that the process of Chinese Bond Index inclusion has only just begun.

CGB curve	Spot	12m Fw
2yr	2.78	2.98
5yr	2.98	3.22
10yr	3.16	3.33

Economic momentum still struggling to gather pace

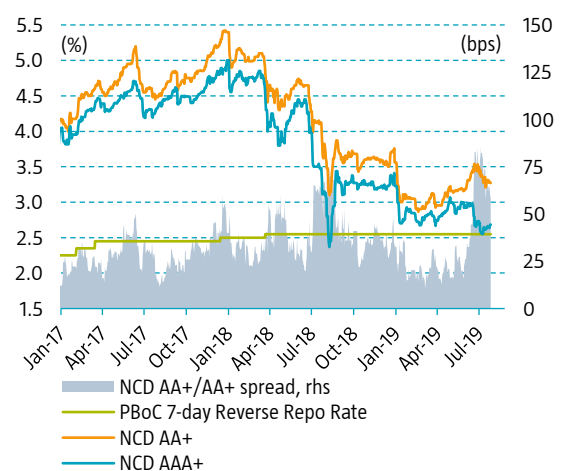
- Our economic barometer for China has failed to improve in recent months, hinting at a still-sluggish growth momentum (Chart 1). This is mainly due to weaker *financial health*, and a lack of improvement in both the *consumer behavior* (with lower employment offsetting stronger retail sales) and *producer behavior* category (due to subdued manufacturing activity data).
- However, as the private sector credit impulse returned into positive territory in June, the *lending conditions* component has showed an improvement, raising hopes of a cyclical pick-up in activity over coming months.
- Still, given the downside risks and subdued employment growth, Chinese policymakers are likely to double down on macroeconomic stimulus to ensure that a sustained growth recovery takes hold.

Chart 1. Economic barometer has weakened in recent months



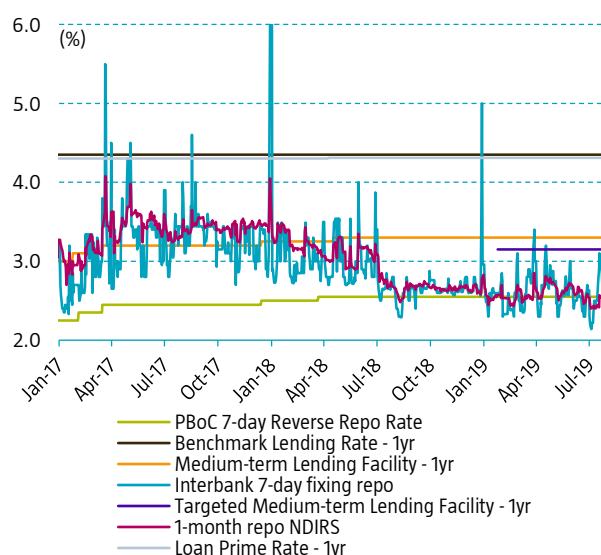
Source: Bloomberg, Robeco

Chart 2: AA+ to AAA+ NCD yield spread somewhat tighter



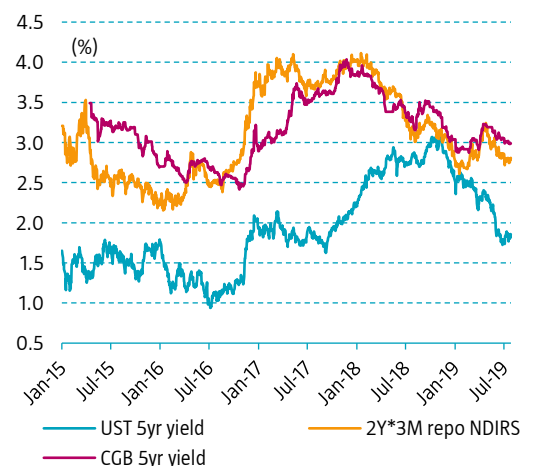
Source: Bloomberg

Chart 3: Repo fixings keep hovering around PBoC reverse repo rate



Source: Bloomberg

Chart 4: 5yr CGB-UST spread has tightened back below 120bps



Source: Bloomberg

Bank of Japan: game theory

- Forward guidance to be extended
- BoJ a policy taker from the Fed and ECB
- 30-year JGBs looking attractive versus 30-year German Bunds

Extension of forward guidance

Muted underlying (core) inflation, a slowing global economy, and a domestic economy that has continued its slowly deteriorating trend ever since the autumn of 2018, are causing headaches for the BoJ. Currently, markets are pricing in 12 bps of easing in the policy balance rate for the next year and a half. Whilst our central scenario continues to be that the BoJ will leave monetary policy – i.e. the policy balance rate, the 10-year JGB target yield and QE purchases (both bond and ETF) – unchanged for 2019, we do expect the BoJ to extend its forward guidance in the upcoming July and September meetings, to acknowledge the mix of low domestic growth and a weaker external environment.

What is priced in for the BoJ, versus our expectation							
Policy balance rate	-0.10	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Change implied by futures (bps)		-5	-7	-8	-10	-11	-11
Our probability-weighted expectation (bps)		-1	-1	-2	-2	-6	-10
Our central scenario (bps)		0	0	0	0	-5	-5

Game theory

From a game theory perspective, it would seem rational for the BoJ to roll out some form of easing at the July or September meetings, considering the risk of yen appreciation if the stepped-up easing by the ECB, the Fed and other central banks were not matched. But, as we have argued in previous editions of the Central Bank Watcher, additional easing to offset pressure on the yen would come at significant cost to the financial sector. Indeed, more easing in the form of additional QE, or lowering of the policy rate or yield target, would depress profitability of the financial sector further and potentially create financial instability for Japan's regional banks. Hence, the BoJ is faced with a trade-off between a strengthening yen versus more pressure on the financial sector.

Therefore, in our view, the BoJ is likely to stick with its basic yet unrealistic expectation for domestic demand to strengthen in the second half of 2019 – and is unlikely to introduce sudden and major easing that would be accompanied by negative side effects. (Aggressively) extending forward guidance appears to be the most likely way to expand easing, as it would achieve this at the lowest possible cost and would limit some of the upward pressure on the yen. It would also give the BoJ some time to assess the medium-term impact on the yen of central bank easing elsewhere. Further monetary policy easing is likely only in 2020. Specifically, we expect the BoJ to extend its forward guidance, signaling that it would maintain the “current extremely low levels” of policy rates to “at least through around end-2021”, thereby adjusting its timeline from its previously indicated “at least through around spring 2020.”

Flattening bias

With growth and inflation momentum clearly settling at lower levels, we would favor holding 15-to-30-year JGBs versus shorter-maturity JGBs. We see the long end of the curve flattening further.

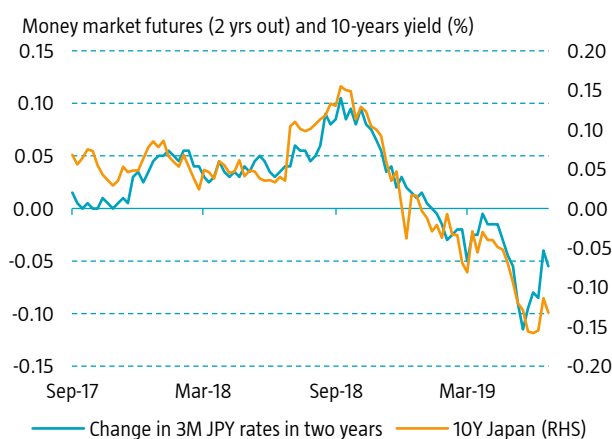
JGB Curve	Spot yield	12m Fw	Carry*	Hedged to EUR
2yr	-0.22	-0.24	-11.7	-11.8
5yr	-0.24	-0.26	-4.8	-4.9
10yr	-0.15	-0.08	2.8	2.8
30yr	0.35	0.38	2.6	2.6

* for a 1pd position over 12 months

Market outlook

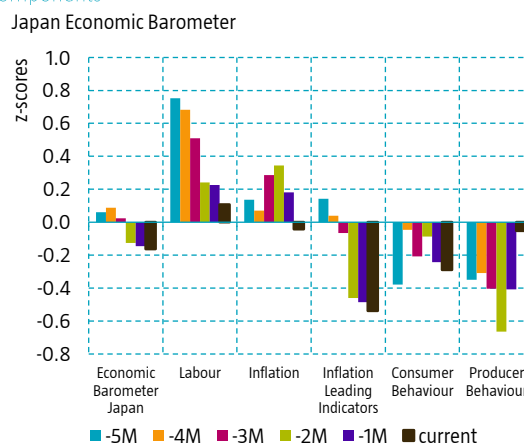
- We see value in being long 30-year JGBs against 30-year German Bunds, for many reasons. Firstly, we think that on a relative basis QE in Japan will have more market impact than in Europe. Secondly, trends in aging demographics are much more pronounced in Japan than in Europe, leading to higher relative demand for fixed income assets.
- Even though the BoJ would like to see a steeper yield curve, we think that there are many reasons why the curve should flatten further, and very strongly so. Reasons include lackluster domestic and global growth, very low but anchored inflation expectations, demographics, and ongoing demand from price-insensitive buyers (QE, regulation, etc.).
- We expect very modest upward movements in Japanese break-even inflation rates, mainly due to the planned VAT hike later this year. Underlying inflationary pressures remain low in our view, due to structural economic trends like changing demographics.

Chart 1. Money market futures price in lower rates



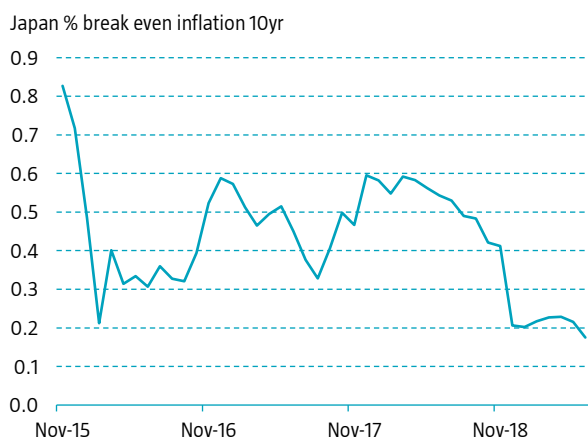
Source: Bloomberg

Chart 2. Barometer shows weakness across almost all components



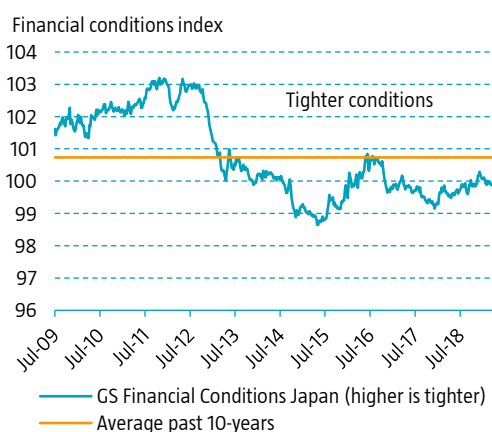
Source: Bloomberg

Chart 3. Break-even inflation at lowest level since 2016



Source: Bloomberg

Chart 4. Financial conditions are stable in Japan



Source: Bloomberg, Goldman Sachs

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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 in 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 September 27, 1996, as amended.

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