

# Global Fixed Income Macro

## Central bank watcher: to infinity and beyond

- Fed: reluctant cutters
- ECB: Draghi's final act
- PBoC: more to come
- BoJ: wait and see

Central banks are delivering on their easing promises, but monetary policy is not the only game in town. That was the clear message from Mario Draghi after delivering open-ended QE at the ECB's September meeting. While the Fed and PBoC have some scope to cut rates, albeit being reluctant to take meaningful steps, the ECB and BoJ simply do not have much room left for further rate reductions. Particularly in Europe it is now clear that the ball is in the court of fiscal policymakers to deliver the next dose of stimulus.

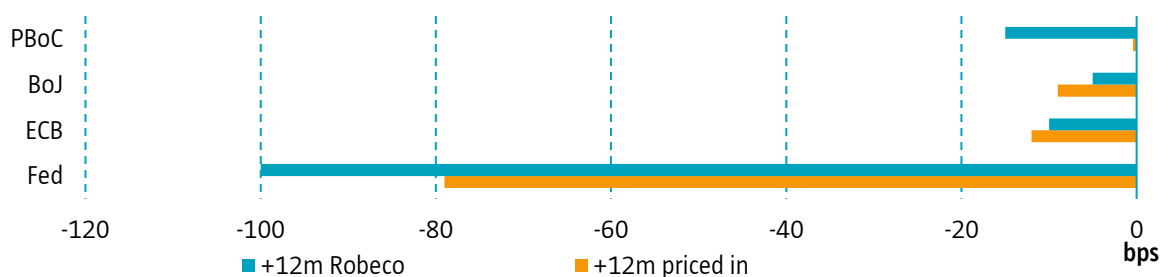
This is expressed in our central bank views: we expect further rate cuts by the Fed and to a lesser extent the PBoC, while the ECB and BoJ are likely to stay on hold for now. In bonds we have seen a strong rally, followed by a bounce in yields. After the dust settles we expect yields to resume their slide, towards earlier lows.

### Article

For professional investors  
September 2019

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### Outlook for central bank rates (change 12m ahead)



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

## Federal Reserve: reluctant cutters

- Fed to cut by 25 bps in September
- Risks remain tilted towards further easing
- Scarcity of safe assets to persist, which should support bonds

### Continuing on a gradual easing path

'Reluctant cutter' used to be a popular nickname for the Reserve Bank of Australia, when it was easing monetary policy at a snail's pace in 2015 and 2016. We expect this moniker to gain popularity again, but this time to characterize the Federal Reserve Bank in its current easing cycle. Yes, the first cut was announced in July and there most likely will be another cut in September, but recent Fed comments suggest that the policymaker will administer its doses of easing with continued reluctance. And who, besides President Trump, could blame Chairman Powell and his colleagues? US growth is slowing, but, other than in manufacturing, the data is not pointing to a collapse. The outlook for trade remains unclear in spite of a possible "temporary trade deal", but it's not the Fed's task to bail out Trump, right? So, why cut by more than 25 bps?

Well, there remains an interesting gap between the theory on how to conduct monetary policy near the zero lower bound – cut quickly and convincingly on early signs of slowdown to avoid a deeper downturn – and the reality when faced with these decisions. The committee seems split on the required magnitude of further easing, with Bullard arguing for -50 bps and George preferring no change at all. Chairman Powell appears to be leaning towards a consensus decision of easing at a gradual pace. Unfortunately this probably implies that we will be stuck for longer in this phase of reluctance and gradualism, prompting the market to demand more easing. Ultimately this could well lead to deeper rate cuts than otherwise would have been the case. This is reflected in our view on the Fed funds rate.

### What is priced in for the Fed, versus our expectations

Fed funds rate	2.13	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Change implied by FF Futures (bps)		-25	-50	-62	-73	-79	-84
Our probably weighted expectation (bps)		-30	-75	-80	-100	-100	-100
Our central scenario (bps)		-25	-75	-75	-75	-75	-75

Our economic barometer for the US, as plotted on the next page, does show the need for precautionary easing. While weakness is most prevalent in the manufacturing sector, some higher-frequency labor market data are showing signs of fatigue as well. There is nothing dramatic in the data, but the whole point of easing early is to make sure that uncertain economic conditions do not turn into something more material.

We expect the Fed to cut rates by another 75 bps, including 25 bps in September. Some further easing should probably be priced in, as risks to that central view are to the downside. Currently, 50 bps in Fed cuts are priced in for September-December and an additional 34 bps for end 2020. For the September meeting we don't expect the Fed to 'out-ease' market expectations, or signal such intentions via its Summary of Economic Projections. Hence we see some risk of disappointment in front-end rates around this meeting, but beyond the next meeting we think that risks are tilted towards more easing than is currently priced in.

USTs	Spot yield	12m Fw	Carry*	Hedged to EUR
2yr	1.74	1.61	83	-47
5yr	1.66	1.68	32	-21
10yr	1.80	1.88	21	-7
30yr	2.28	2.32	12	0

\* for a 1pd position over 12 months

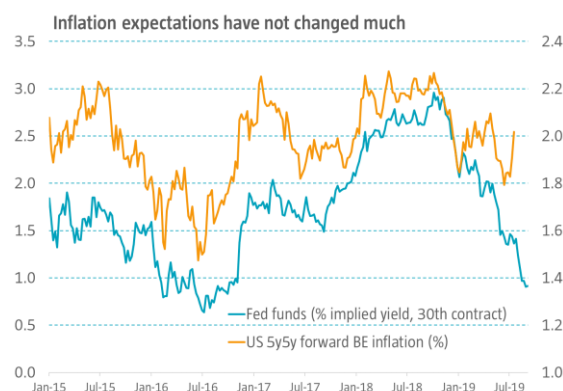
### Safe assets with a yield will continue to be in demand

Treasury yields are now in a process of correcting higher after the August rally. After the dust has settled, we expect a continued bid for safe assets with a yield, in a world where yield is scarce, risk asset prices are near historical highs and uncertainty around economic policy remains elevated. Currency hedging costs remain high for euro-based investments in US dollar assets. This makes long positions at the short end of the curve attractive only if a quick rally at the front end is to be expected. Therefore we have a preference for the longer end of the curve.

### Another push lower in the term premium

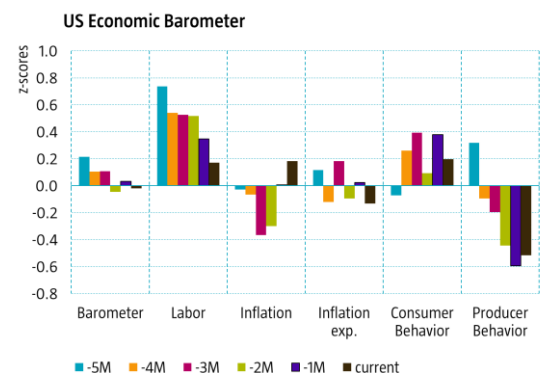
- Since our last Central Bank Watcher, of 26 July, the 10-year US Treasury yield has declined by approximately 30 bps. The move was propelled by a combination of all three interest rate drivers. The term premium, medium-term expectations for real central bank rates and medium-term inflation expectations have all drifted lower.
- The return of central bank bond purchases will have contributed to the decline in the term premium. We regard this as a global phenomenon and, with the ECB restarting QE and the Fed having ended its balance sheet rundown, this will have supported the decline in premium. We expect the term premium to remain at current depressed levels. QE continues and the Fed might even decide to start increasing the size of its balance sheet soon. To be clear, this would not be monetary policy, but a technical decision to avoid reserve scarcity. Excess reserves are gradually declining due to factors such as the growth of currency in circulation. The Fed will probably want to manage this process carefully, as it always has, and increase its balance sheet.
- Expectations for the real terminal fed funds rate are expected to continue drifting gradually lower. The Fed has a desire to structurally lift inflation expectations, which should coincide with lower real yields. In addition, the Fed is not immune to the policies of peer central banks. In a world where developed market central banks are almost unanimously revising down their view on medium-term real policy rates, the Fed will feel pressured to follow, if only to keep dollar appreciation contained.
- We expect little change in US long-term inflation expectations. If anything these should be supported by a more accommodative monetary policy. But, as we expect reluctant easing, it will probably be difficult to convince the market of the inflation-generating capabilities of current Fed policy.
- To sum up, after the dust has settled we continue to expect yields to grind lower, primarily owing to a global scarcity of safe assets, especially those with yield.

Chart 1. Inflation expectations remain stable on balance



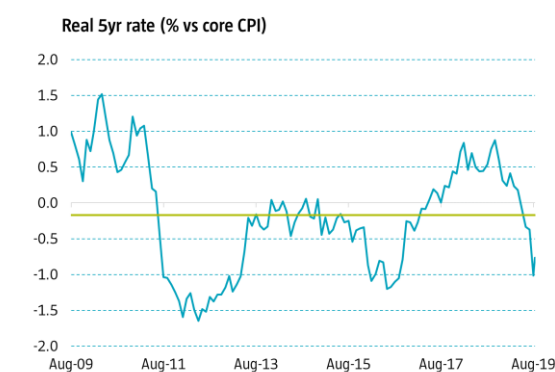
Source: Bloomberg, Goldman Sachs

Chart 2. Economic barometer shows weaker momentum



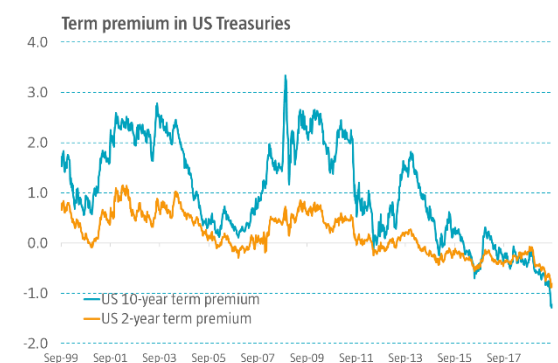
Source: Bloomberg

Chart 3. Real rates are now below zero



Source: Bloomberg, Robeco

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



Source: Bloomberg

## European Central Bank: Draghi's final act

- ECB announces open-ended QE
- Market discount of additional 10 bps of rate easing makes sense
- Most of the action in Bunds will likely be in 10s30s

### Persistent inflation undershoot prompts ECB to launch open-ended QE

Although growth on the services side of the Eurozone economy is still holding up relatively well, manufacturing activity has slumped further in recent months. Meanwhile, core inflation still lingers at around 1%, well below the ECB's medium-term target of below but close to 2%. It was thus no surprise to see ECB President Draghi live up to his reputation at the September ECB meeting by laying out a broad monetary stimulus package that ensures his presidency ends with a bang and not a whimper. Besides a 10 bps cut in the deposit facility rate to -0.50%, the ECB strengthened its forward guidance on policy rates by dropping the previous "mid-2020" calendar guidance and enhancing the state-based link to inflation. It now expects to keep rates at "present or lower levels" until it sees the inflation outlook robustly converge to the target, to the extent that such convergence is reflected consistently in core inflation dynamics.

The ECB also introduced a two-tier system for reserve remuneration and sweetened the terms on the upcoming TLTRO 3 operations. However, it was the "open-ended" nature of the announced restart of net asset purchases (EUR 20bn per month in total from 1 November, with the composition of the purchases by and large the same as before) that led to a strong risk-on rally in Eurozone bond markets. Net purchases are expected to continue until "shortly before" the ECB starts raising rates which, in turn, is state-dependent on inflation dynamics: markets currently do not envisage rate hikes happening before 2022. This would imply cumulative net purchases of more than EUR 500bn.

A key question in this regard is whether new bond issuance – especially in some core countries including Germany – will be enough to accommodate this, in light of the self-imposed 33% issuer and issue share limits for the government bond-buying programme. According to Draghi, there is "significant headroom to go on for quite a long time", but we are not so sure that net QE could continue until 2022 without there being an increase in the limits. In any case, this will be Christine Lagarde's business (she will take over the baton from Draghi as per 1 November). The bottom line is that financial repression in the Eurozone has entered a new phase, allowing fiscal policy, as Draghi also stated, to become the main instrument for economic stimulus.

Before the ECB meeting around 30 bps of rate cuts had been fully priced by Q2 2020; after the 10 bps cut and following some repricing, c. 10 bps of that remains. Given the downside risks to growth and the easing bias in the ECB's forward guidance on policy rates ("i.e. at present or lower levels") we broadly agree with the market's discount (see table).

### What is priced in for the ECB versus our expectations

ECB deposit facility rate	-0.50	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Change implied by OIS (bps)		0	-2	-7	-11	-12	-15
Our probability-weighted expectation (bps)		0	-4	-10	-10	-10	-10
Our central scenario (bps)		0	0	0	0	0	0

One caveat on the interpretation of the OIS (or EONIA) forward rates is related to possible side effects from the announced Swiss-style [tiering scheme](#). Under this scheme the volume of bank reserves in excess of the minimum reserve requirements that will be exempt from the -0.50% deposit facility rate will initially be set at six times a bank's minimum reserve requirements, and will be remunerated at a rate of 0%. Some fear that Italian banks with unused excess liquidity allowance, estimated at around EUR 40bn, will bid up for cash in the interbank market and hence put upward pressure on EONIA and its successor €STR. However, we are not sure how keen banks in Northern Europe, where most of the excess liquidity resides, would be to re-establish interbank relationships with their peripheral counterparts and also doubt whether the impact on €STR and hence EONIA (from 2 October EONIA will be calculated as €STR plus a fixed spread of 8.5 bps) will be significant.

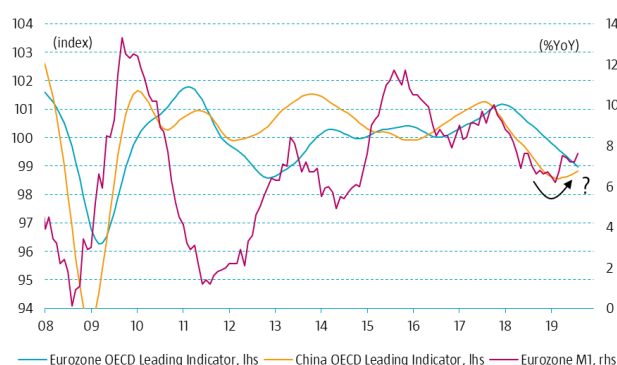
DBR curve	Spot yield	12m Fwd	Carry* (bp)
2yr	-0.72	-0.84	-13
5yr	-0.73	-0.74	0
10yr	-0.50	-0.42	7
30yr	0.07	0.07	3

\* for a 1pd position over 12 months

### Most of the action in Bunds will likely be in 10s30s

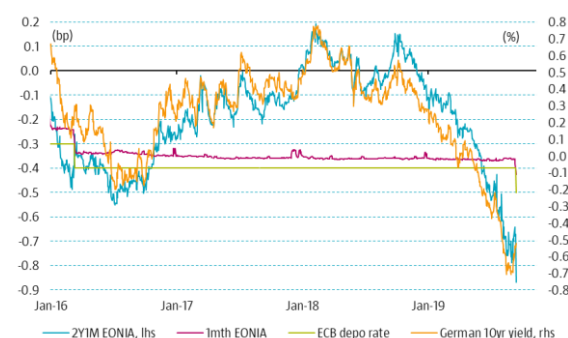
- While our base case scenario sees 10-year Bund yields edge up somewhat further in Q4, given the signs of a bottoming out in the business cycle (Chart 1) we would recommend a neutral position in Bunds for now. This is because 2-year ahead EONIA forwards – which have been correlating closely with 10-year outright in recent years (Chart 2) – will struggle to rise much (further) in our view, given the ECB’s pledge to keep rates at “current or lower levels” until core inflation is much closer to the target and given the open-ended nature of QE. Moreover, given the lingering US-China trade conflict and no-deal Brexit risk, new episodes of flight to safety could well be forthcoming.
- Notwithstanding the divergence on the day of the ECB September meeting, we expect the German 2s10s to continue to trade directionally with 10-year outright (Chart 3). Most of the curve action will likely be in 10s30s, which will probably oscillate between steepening on the back of reflation hopes, fiscal stimulus considerations and lower volatility, and flattening due to expectations of QE-induced scarcity and a search for yield. For choice, we will be retaining a mild steepening bias over coming months.
- We would use any renewed richening of German long-term government bonds to contemplate moving into other G10 bonds (such as 10-year SGBs, 10-year ACGBs or 30-year JGBs; see BoJ section) or swaps.
- We continue to doubt ECB QE2 will lead to a sustained widening of swap spreads, given the lower monthly net pace, reduced repo scarcity of Bunds and increased search for positive carry. Note that the narrowing in swap spreads over recent months can be largely explained by the tightening of BTP-Bunds (Chart 4).

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



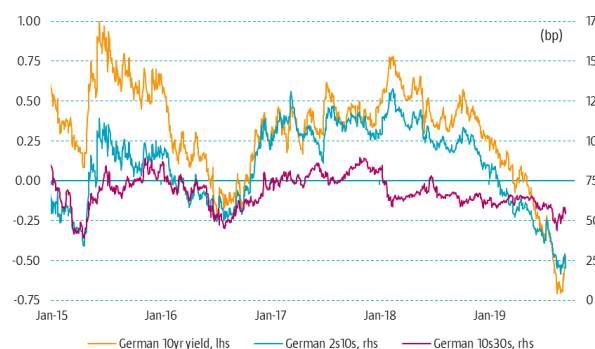
Source: Bloomberg

Chart 2. German 10yr yield vs the 1-mth EONIA rate 2yr fwd



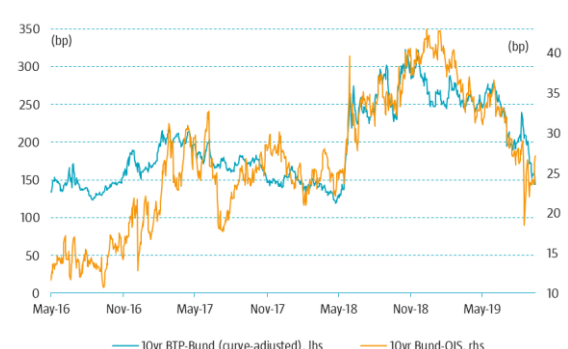
Source: Bloomberg

Chart 3. German 10yr Bund yield vs 2s10s and 10s30s



Source: Bloomberg

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



Source: Bloomberg

## People's Bank of China: more to come

- Additional (targeted) monetary easing is forthcoming...
- ...as underlying economic momentum is still struggling to gather pace
- Further rally in 5-year CGBs probably requires rate cuts

### PBoC uses reform to ease financial conditions for the real economy

As we predicted in our previous Central Bank Watcher, from July, the PBoC has used the reform of its interest rate framework to lower borrowing costs for the real economy: the loan prime rate (LPR) – from which new loans are priced – is now explicitly linked to medium-term lending facility (MLF) rates. The latter are much lower than the benchmark lending rates with which most existing loans have been priced. The LPR (potentially) can be adjusted on the 20<sup>th</sup> of each month; accordingly, we saw the 1-year LPR already falling by 6 bps in August, to 4.25% (Chart 3). The PBoC recently also announced a 50 bps cut in the reserve requirement ratio (RRR) for financial institutions, taking effect on 16 September, and an additional RRR cut of 100 bps targeted for city commercial banks, to be phased in on 15 October (50 bps) and 15 November (50 bps). This will free up an estimated RMB 900bn of liquidity and will likely put further downward pressure on interbank money market rates, which recently nudged back towards the PBoC 7-day reverse repo rate.

Looking ahead, with growth data remaining unconvincing, with lingering downside risks related to the US-China trade dispute, and with PPI inflation tending to lead the closely watched credit impulse metric (Chart 2), we are fairly convinced that additional monetary stimulus will be forthcoming. Besides another (targeted) RRR cut by year-end, we are also braced for at least one MLF cut, perhaps as soon as later this month. Moreover, given that the envisaged reduction in lending rates for new bank loans (to corporates) will have a dampening effect on banks' net interest income, we believe there is also a more than decent chance that the PBoC will cut its 7-day reverse repo rate – a move which is not yet discounted by markets (see table below). That said, as deposits are the main source of bank funding, any downward shock to banks' net interest income can only really be dampened if deposit rates are lowered: the average deposit yield is 1.8%, 30 bps more than the 1-year benchmark saving rate (BSR) of 1.5%. Lowering the BSR, however, may be challenging for the time being, given the pork-price-induced rise in consumer price inflation.

What is priced in for the PBoC versus our expectations							
1-month repo NDIRS	2.62	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Change implied by forwards (bps)		6	0	2	1	0	0
Our weighted fair value estimate (bps)		-5	-15	-15	-15	-15	-15
Our central scenario (bps)		-5	-10	-10	-10	-10	-10

On the interbank market front, we take some comfort from the further spread tightening between yields on certificates of deposit (NCDs) for lower- and higher-rated banks. But the Bank of Jinzhou's proposed AT1 coupon cancellation earlier this month is a timely reminder that there remain vulnerabilities in the financial system.

### Further rally in CGBs probably requires rate cuts

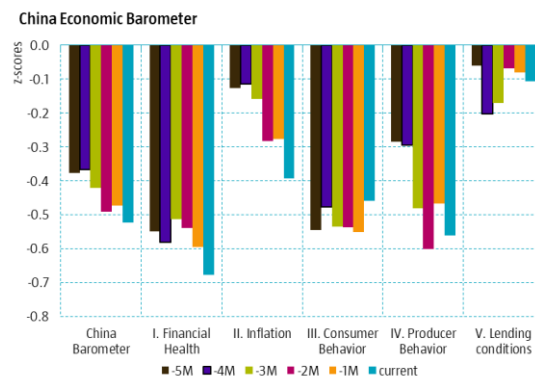
Yields in 5-year CGBs have trended sideways over recent weeks, in line with the implied 3-month repo NDIRS 2-year forward, which is hovering around the PBoC 7-day reverse repo. A further rally in 5 to 7-year CGBs probably requires rate cuts to be discounted, which we believe will happen later this year. Another reason to stick to our overweight in CGBs is that the process of including the Chinese Bond Index into global indices has only just begun. It was announced on 4 September that China's government bonds will be phased into various JPM bond indices from February 2020, and an inclusion announcement from FTSE Russell appears likely later this month. With 5-year UST yields having come off their early September lows, 5-year UST-CGB spreads have fallen back below 140 bps. With 100 bps of additional Fed easing already discounted in UST 5-year yields, owning cash bonds in China still seems attractive relative to USTs for EUR investors, also taking into account FX hedging costs.

CGB curve	Spot	12m Fw
2yr	2.69	2.80
5yr	2.92	3.11
10yr	3.06	3.23

### Economic momentum still struggling to gather pace

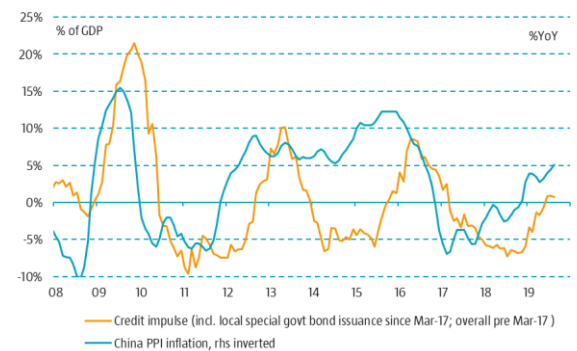
- Our economic barometer for China has failed to improve in recent months, hinting at a still-sluggish growth momentum (Chart 1). This is mainly due to weaker *Financial Health*, and a lack of improvement in both the *Producer Behavior* (i.e. subdued manufacturing activity data) and *Inflation* – the latter reflecting rising underlying disinflationary pressures.
- However, with the ‘credit impulse’ no longer in negative territory (Chart 2) – as reflected in the less negative readings on *Lending Conditions* – and with *Consumer Behavior* (including consumer sentiment and the underlying pace of retail sales) showing tentative signs of improvement, we remain hopeful of some cyclical pick-up in activity over coming months. We would also note that the OECD’s leading indicator for China improved for a fifth straight month in July.
- Still, given the lingering downside growth risks, especially on the manufacturing side, and ongoing subdued employment growth, Chinese policymakers are likely to retain a clear loosening bias to ensure that some cyclical growth recovery takes hold.

Chart 1. Economic barometer has weakened further..



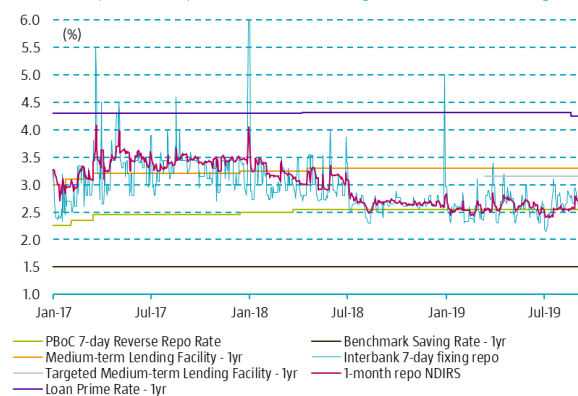
Source: Bloomberg, Robeco

Chart 2: ...but ‘credit impulse’ is back in positive territory



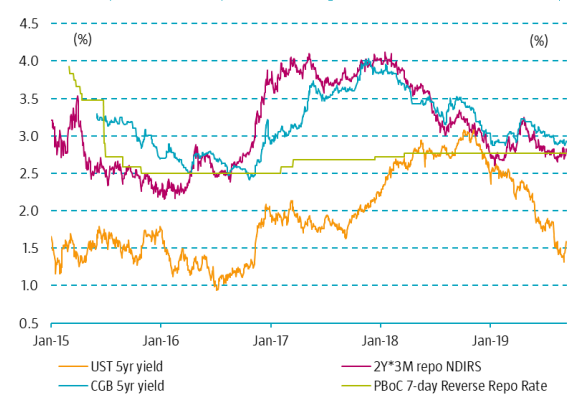
Source: Bloomberg

Chart 3: 1-year loan prime rate (LPR) edged lower in late August



Source: Bloomberg

Chart 4: 5yr CGB-UST spread has tightened back below 140bps



Source: Bloomberg

## Bank of Japan: wait and see

- Forward guidance to be extended
- BoJ a policy taker from the Fed and ECB...
- ...but keen to adopt a wait-and-see approach

### Extension of forward guidance

The BoJ is expected to maintain the status quo at its next meeting, on 19 September. This applies to all available policy tools, including policy rates, yield targets and asset purchases of ETFs and government bonds. While the ECB has moved towards a new round of monetary easing, with the Fed expected to follow, the trade-weighted yen is holding up very well. We believe this will allow Japanese policymakers to keep their additional easing options in reserve while sticking to their strategy of extended forward guidance, with perhaps a small rate cut somewhere during the next year.

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)		-6	-7	-8	-8	-9	-9
Our probability-weighted expectation (bps)		0	0	-1	-1	-3	-5
Our central scenario (bps)		0	0	0	0	-5	-5

### Stuck in a hard place

The Japanese economy remains a mix of very muted underlying (core) inflation and low growth, primarily driven by global industrial recession, increased geo-political risks and a weak domestic economy. Markets currently are pricing in 9 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 September meeting, to acknowledge the mix of low domestic growth and a weaker external environment.

The BoJ indicated recently that cutting the policy balance rate further below zero is always an option. In our view, though, there is a big hurdle in the way of such a move. A cut in the policy balance rate would likely lead to downward pressure on the yield curve, and especially on lending rates, which would raise further concerns about the stability of Japanese banks. Moreover, a further lowering of rates would induce financial institutions to take more risks in investing and lending, leading to heightened vulnerability in the financial sector.

Finally, we would also argue that the cost of further negative rates would be transferred to firms and consumers through the imposition of fees on their bank deposits, which would have an adverse effect on lending and consumption. The same argument would apply to policy moves such as cutting rates on the Loan Support Program into negative territory, to additional tiering and to more asset purchases. The BoJ really is stuck between a rock and hard place.

And yet, the BoJ is likely to only cut rates and take countermeasures against the negative side-effects if the yen were to surge sharply (panic) or if the economy falls into a recession – which we expect in the second half of 2020. Furthermore, a sharp surge in the yen in the case of a global event leaves no room for the kind of rational assessment noted above. In concrete terms, we think a rapid yen appreciation, such as a 6-8% rise in the trade-weighted yen, could be such a case. We also think the ETF-purchase amount could be raised if the stock market falls sharply.

### Long end remains very attractive

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

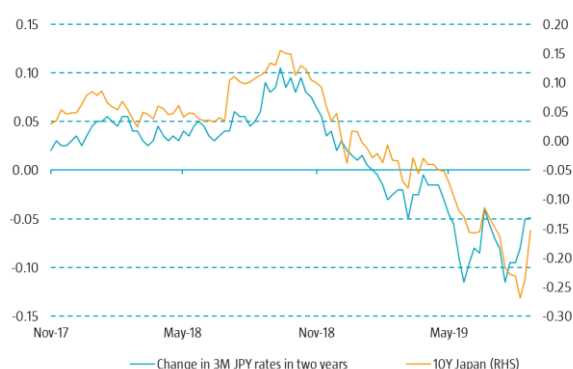
JGB Curve	Spot yield	12m Fw	Carry*	Hedged to EUR
2yr	-0.25	-0.25	-14.6	-14.6
5yr	-0.26	-0.28	-6.4	-6.4
10yr	-0.16	-0.07	3.7	3.6
30yr	0.33	0.37	2.4	2.4

\* for a 1pd position over 12 months

## Market outlook

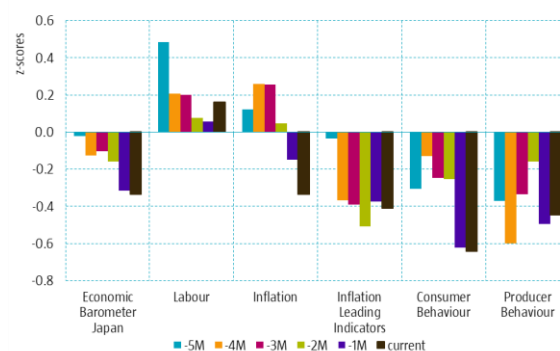
- We see value in being long 30-year JGBs against 30-year German Bunds, for many reasons. Firstly, we think that, on a relative basis, QE in Japan will have more market impact than in Europe. Secondly, trends in aging demographics are much more pronounced in Japan than in Europe, leading to higher relative 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, 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 views.

Chart 1. Money market futures price in lower rates



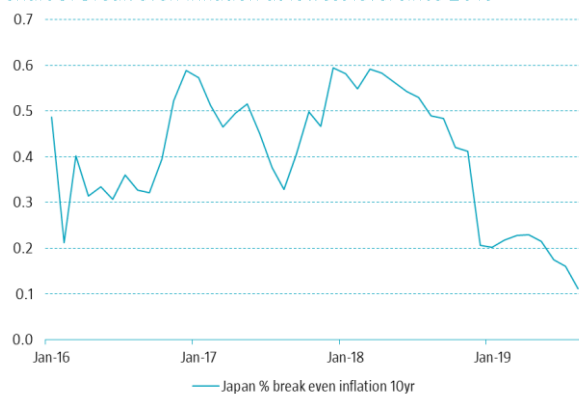
Source: Bloomberg

Chart 2. Barometer shows weakness across most components



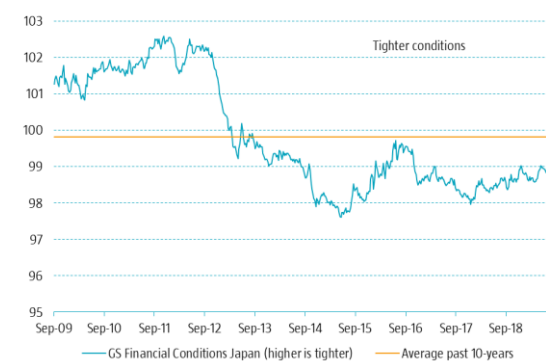
Source: Bloomberg

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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