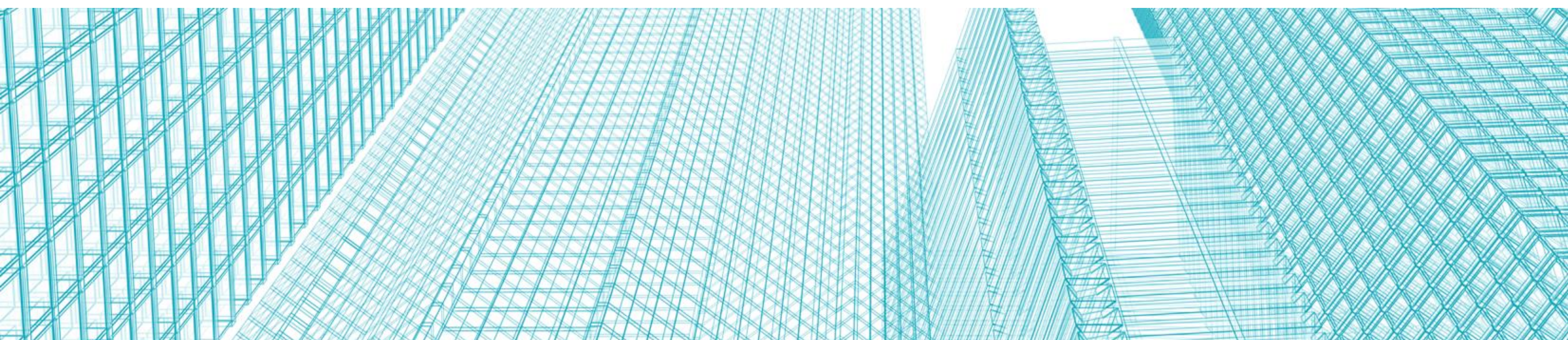
ARTICLE
For professional investors
October/November 2018

ROBECO
The Investment Engineers



Central Bank Watcher

Robeco Global Fixed Income Macro Team

- ECB: Why risk an early end to the recovery?
- Fed: Enough priced in for now
- PBoC: Juggling different objectives
- BoJ: Time to change the 10-year JGB's target range?

Tightening in tougher conditions

In our new Central Bank Watcher, we examine the policy and actions of the world's major central banks (Federal Reserve, European Central Bank, People's bank of China and the Bank of Japan). The Robeco Global Macro team looks at expectations for growth, inflation and the term premium, for example, and analyzes monetary policy and geopolitics to see how these will affect the macro outlook and financial markets going forward.

According to Rikkert Scholten, after the recent rally in bonds, there is some room to price in a more hawkish trajectory for both the Fed and the ECB, but this remains limited. Yes, we expect continued hikes by the Fed and a start of the tightening cycle by the ECB, but these expectations are largely priced in already. Does this situation imply that central banks have taken the art of guidance to the next level, or will it mean that unexpected events – more volatile oil prices, a spike in inflation, further deterioration in Italy have far more impact?

'Limited room to price in a more hawkish rate path'

Close to perfection

Between now and the end of 2019, 70 bps in rate hikes are priced in for the Fed. This is still 30 bps below what is expressed in the Fed's most recent dot plot, but as markets tend to have difficulty in pricing in dots further out, we judge the current pricing to be about as good as it can be. Only a higher dot plot would justify a further move upward in short-term yields.

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But, with inflation expected to remain close to target and the first signs of risky assets coming under pressure, we don't think there will be much appetite to push up the dots.

As for the ECB, the first rate hike has already been endorsed by Draghi and has been priced in by the market. So probably no surprises here either. The deposit facility rate is likely to be increased by 15 bps in September or October 2019. We are less optimistic on core inflation than the ECB, with a forecast of 1.2% by the end of the year (compared to the ECB's forecast of 1.5%). Although inflation expectations are generally stable, a volatile oil price, for example, could throw a spanner in the works. As could the political backdrop in Europe, which is an area of focus for the region. However, despite the imminent end of the ECB's bond buying program, it still has a card up its sleeve in the form of its reinvestment policy. This can offer the central bank a tool to continue to help the markets out with liquidity if things start to go sour.

Term premium set to decompress

With an upward trajectory for short-term rates already priced in and stable inflation expectations, we expect the term premium to be the main factor driving bond yields in the coming period. The US is further advanced in the tightening cycle, is seeing a rapid increase in net issuance and has a much larger free float of sovereign bonds than Germany, for example. As a result, we expect US Treasuries to be the most vulnerable market when it comes to rising term premiums and so we expect the US Treasury curve to steepen. For Germany there is less room for curve steepening at this point in time.

The Chinese curve has flattened recently and the spread between Chinese government bonds and US Treasuries has tightened significantly. China is not unique in trading at a low yield relative to the US. Canada, Germany, Australia and the UK are in the same camp. But many EM countries would experience wider spreads if their currency depreciated as much as the renminbi has, China, however, is different. This shows that Chinese government bonds are acting as a true safe haven. We expect continued divergence in economic conditions between the US and China and see room for this spread to tighten further.

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ECB: Why risk an early end to the recovery?

- Hawks gain the upper hand?
- Reinvestment policy will be a key factor
- Bund free float will contain term premium

Towards a more hawkish ECB?

The ECB's October press conference was slightly hawkish in tone, with President Draghi again sounding confident on the future path of inflation. Despite the risks clouding the horizon for financial markets (emerging market weakness, protectionism, the end of QE and the resulting volatility), he characterized risks to the growth outlook as 'broadly balanced'. We think this risk assessment reflects a change in the balance of power among the ECB's Governing Council members, with the hawks gaining the upper hand. A trend which could continue until the Draghi steps down in October 2019.

Monetary 'life after QE'

Their positive assessment of the growth and inflation outlook, means the ECB is on track to end its QE policy in December. So from 2019 onward, the key policy instruments will be confined to adjusting forward guidance on the future path of interest rates. One important aspect going forward will be the reinvestment policy, which has not yet been clearly defined in terms of how long it will continue and the degree of flexibility.

Draghi made it clear that the capital key calculation (based on each country's economy and population) will remain the basis for reinvestment, something that does not benefit Italy and could cause additional friction. Current expectations are for a two-year reinvestment period and we expect the ECB to remain non-committal about exactly when it intends to start shrinking its balance sheet. The reinvestment policy gives them an extra 'accommodative tool' to fall back on in the event of weak inflation figures or market turbulence. At the October press conference Draghi also mentioned initiating new targeted longer-term refinancing operations (TLTROs) as a means of providing additional liquidity

Stable Eurozone inflation expectations

A first rate hike in Sept-Oct 2019 is already being priced in to a large degree and we see limited scope for markets to price in a more hawkish ECB in the coming months. We also see little risk of core inflation surprising on the upside and estimate a level of 1.2% at the end of the year, compared to the ECB's forecast of 1.5%. Potential Draghi successor Olli Rehn recently stated, "The dynamic between inflation and economic slack appears to have changed; closing the output gap no longer seems to accelerate the rate of inflation as it once did." A view in line with a prudent ECB approach when it comes to tightening monetary conditions.

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What is priced in for the ECB Deposit Facility Rate, versus our expectations

29-Oct-18	Dec-18	Mar-19	Jun-19	Sep-19	Oct-19	Dec-19
Implied rise OIS (bps)	0	0	1	6	11	12
Our expectation (bp)	0	0	0	0	15	15

It is rather surprising how stable Eurozone inflation expectations are. The 5y5y inflation expectations did not budge after recently released strong and broad-based wage growth figures. The same is true of the inflation forecast implied in inflation-linked bond prices. Looking ahead, we see limited scope for inflation expectations to push 10-year Bund yields significantly higher in the next quarters. Only a stronger recovery in oil prices could trigger an inflation surprise on the upside.

Term premium effects subdued by Bund free float

We see limited scope for 10-year Bund yields to move above 0.60% - 0.70% by end-2018, but the path of the term premium will be a key factor in driving Bund yields higher in the longer term. Global liquidity has started to shrink, which should exert upward pressure on term premiums in major developed markets. In addition, the duration of the ECB's sovereign bond holdings should decline over time – with reinvestment alone, it will be difficult to keep the duration constant. This means that the duration risk that QE removed from the market will gradually return and decompress the term premium.

This pressure is likely to be less significant for Bunds than for Treasuries, given the tiny free float (less than 15% of outstanding Bunds are in private hands), which will limit the potential upside of the Bund term premium. The Eurozone's position in the business cycle will also contain the term premium: when central banks start to hike, this is usually associated with a declining term premium.

Political uncertainty in Italy

The extent to which Bund yield dynamics have been driven by the political uncertainties in Italy this year is striking. Something which has caused bank stocks to underperform significantly. We think Italian risk will continue to exert downward pressure on Bund yields for the time being. The market is also prepared to pay a much more to hedge against the Bund yield ending below 0.1% than above 0.6% by the end of the year. There is still a perception that Italian risk could trigger a flight to quality, pushing Bund yields down significantly.

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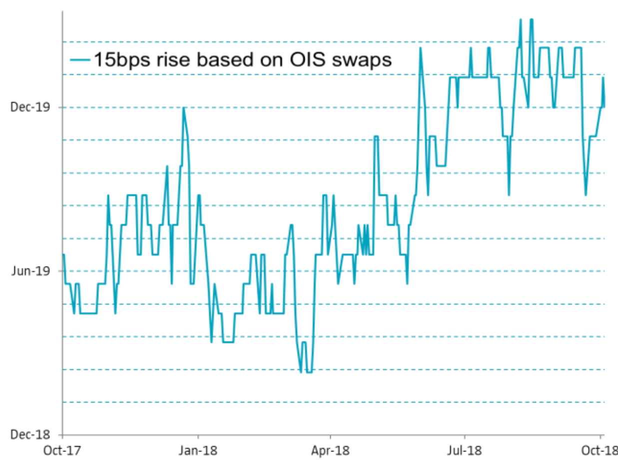
Slightly more hawkish ECB until Draghi steps down; inflation outlook muted

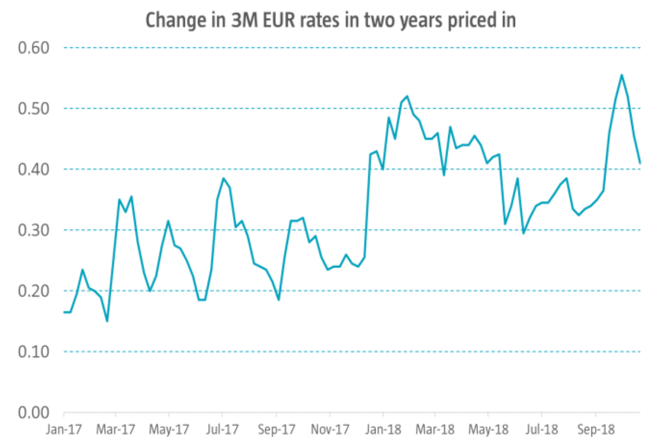
- A first ECB rate hike in September/October 2019 is priced in to a large degree.
- For the next two years, Euribor futures price in around 40 bps in rate hikes.
- Inflation expectations have remained surprisingly stable, as reflected in inflation-linked bonds.

Chart 1. Expected date of the first ECB rate hike (15 bps rise)



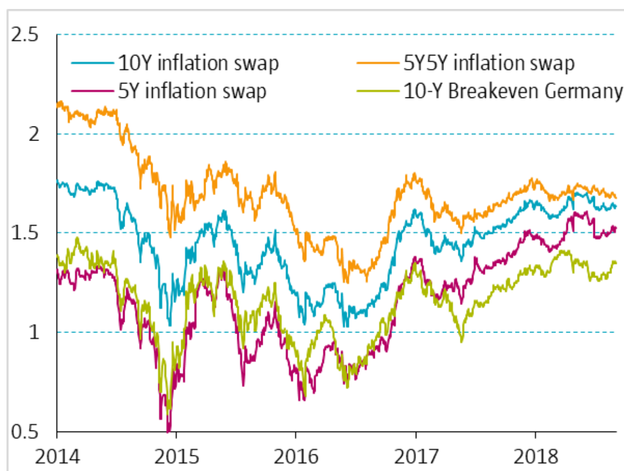
Source: Bloomberg

Chart 2. ECB rate hikes: what is priced in? (implied in futures)



Source: Bloomberg

Chart 3. Marked-based measures of inflation expectations



Source: Bloomberg

Chart 4. Inflation forecasts in traders' inflation-linked bonds

Source: Bloomberg

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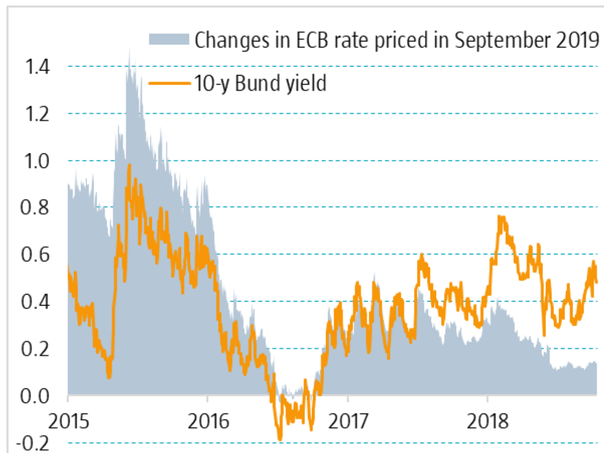
Recent heightened volatility in 10-year Bund yields

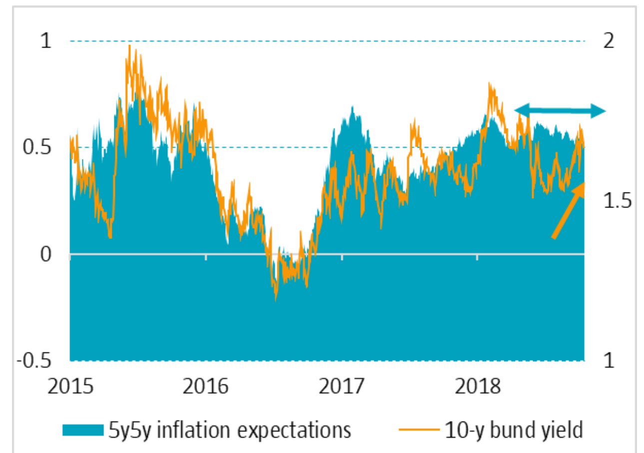
- We analyze sovereign yields using three main components, (i) monetary policy (ii) inflation expectations (iii) term premium. Inflation expectations (blue area, Chart 6) have remained relatively flat and stable throughout 2018 and thus do not explain the 10-year Bund yield's volatility in recent months. The main drivers appear to have been the 10-year Bund term premium (purple area, Chart 7) and the expected change in monetary policy in Q1 (grey area, Chart 5).
- The tiny Bund free float will contain term premium decompression in Europe.
- Bunds have proved highly susceptible to the 'Italy' effect', as shown in Chart 8.

Chart 5. 10-year Bund yield and expected monetary policy



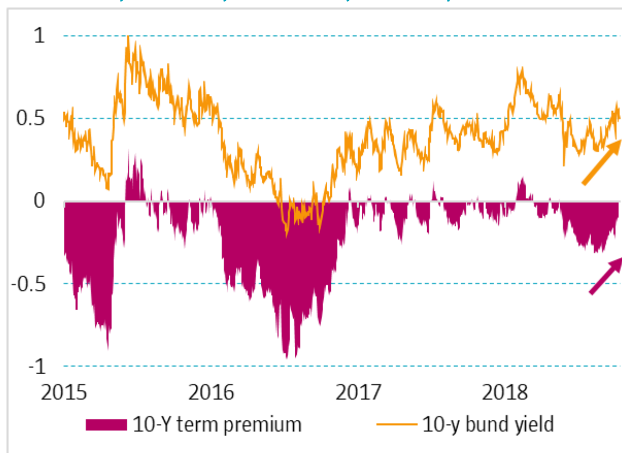
Source: Bloomberg

Chart 6. 10-year Bund yield and inflation expectations



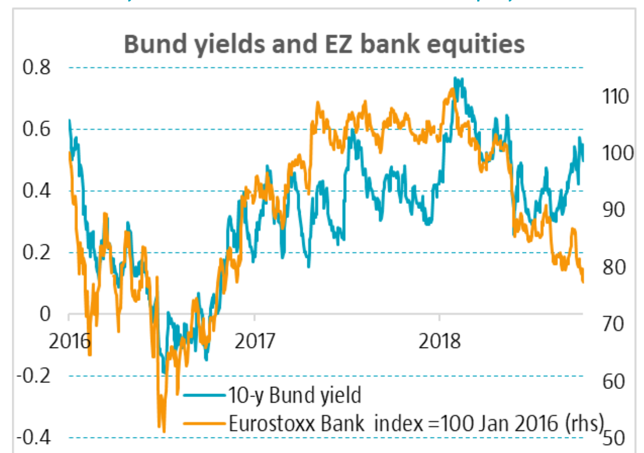
Source: Bloomberg

Chart 7. 10-year Bund yield and 10-year term premium



Source: Bloomberg

Chart 8. 10-year Bund and Eurozone financial equity index



Source: Bloomberg

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Fed: Enough priced in for now

- Economic growth continues above trend
- External factors and broader risk-off sentiment likely to slow Fed actions
- Yield curve set to steepen

US economy – full steam ahead

There are plenty of reasons for the Fed to continue hiking in the coming quarters: for 2019 we expect growth to remain above the 1.9% FOMC trend level; we see core inflation rising to 2½% by June next year and Fed Chair Powell is very optimistic on the economy, "There's really no reason to think that this cycle can't continue for quite some time, effectively indefinitely". We think the Fed will hike in December and in March, but we expect a pause in Q2 and Q3. This is not really priced in at the short end, so we expect the US curve to steepen.

Fed dot plot nearly priced in

The market is pricing in 70 bps in rate hikes up to the end of 2019. This is still 30 bps below the Fed's dot plot, but we judge its current pricing 'close to perfection'. After the recent rally in bonds, yields might bounce back slightly, but only a higher dot plot would justify a further upward move in short-term yields. We do not think that is likely. The FOMC is aware that it only has a limited set of policy options and inflation is still close to the target level. This makes it easier for the Fed to pause if risk sentiment deteriorates again and more severely contaminates US credit and equity markets.

The slowdown in China and the rundown of the Fed's balance sheet are likely to result in more emerging market stress. US bank excess reserves are declining, and the monetary base adjusted for inflation was down more than 6% YoY in September and could be down 9% by Q1 next year. The pain of scarcer US dollar funding, as a lot of the excess liquidity came their way in the past. We expect this to lead to a broader risk-off sentiment, which will extend to US equities and credits.

Room for the curve to steepen

At current interest rate and balance sheet levels, the Fed is paying USD 38 billion per year to banks in interest on overnight excess reserves. These payments are seen by many in Congress as a gift to banks; not a popular concept. So if, at some point, the Fed has to choose between continuing the balance sheet rundown and hiking rates, this should be an easy choice.

In our view the combination of gradually building inflation pressures and three additional hikes already nearly priced in, makes it easier for long-term rates to move higher relative to the short end of the curve. Therefore we have a preference for steepeners, especially in the

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belly of the US curve as valuations look attractive, carry is positive and cases of inversion in this segment of the curve have been historically rare.

Our quant model suggests an overweight duration stance, given the momentum in bonds, modest inflation pressure and some slowdown in economic sentiment. We agree, but given valuation levels we allocate more risk to curve steepening positions.

What is priced in for the Fed, versus our expectation

29-Oct-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
2.13					
Implied rise in bps	25	41	55	63	67
Our expectation	25	50	50	50	75

Note: The Fed will probably change its main target rate from the effective fed funds rate to SOFR (collateralized overnight lending rate), but this has limited implications for monetary policy.

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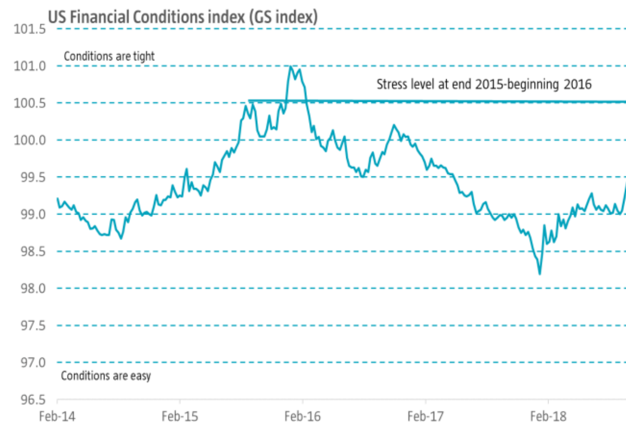
Plenty of arguments for the Fed to tighten, but no need to be more aggressive

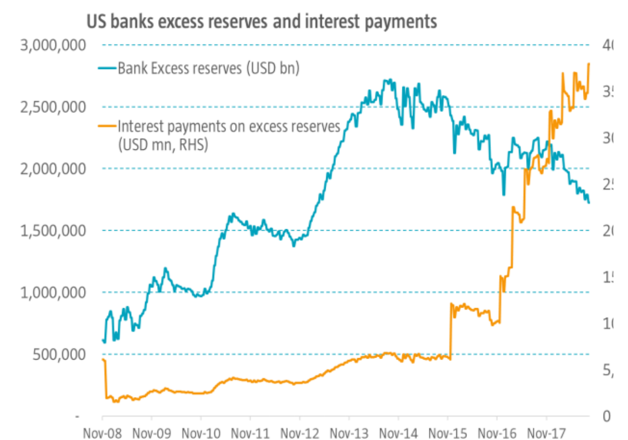
- On balance, financial conditions have not tightened since the Fed started hiking in December 2015.
- Forward inflation expectations have remained close to 2% since 2017.
- Core CPI should rise to 2½% in June. Rents have been the main driver of inflation and we expect this to continue (+3.5% for the coming months), combined with somewhat higher services inflation.

Chart 1. Financial conditions are still loose



Source: Bloomberg

Chart 2. Interest payments on excess reserves are rising



Source: Bloomberg

Chart 3. Forward inflation is flat

Source: Bloomberg

Chart 4. Inflation to remain slightly above 2 percent

Inflation display

	9/30/2018	Dec-18	Jun-19
Commodities/goods	1.1	1.5	0.6
Food and beverages	1.4	1.0	1.0
Non durables (energy)	4.8	7.0	0.0
Apparel	-0.6	0.5	3
Household furnishing	-1.2	-1	-1
Durables	-0.7	-0.5	0
Services	3.0	2.9	3.1
Rents	3.3	3.5	3.5
Household insurance	1.7	1.5	1.5
Gas and electricity	-1.2	-0.5	-0.5
Water, sewer, trash	3.5	3	3
Household operations	6.2	6	6
Transport services	4.1	3	3
Medical care services	1.7	2	2.5
Recreation services	1.7	2	3
Edu and comm services	0.9	1	1
Other personal services	3.3	3	4
CPI	2.3	2.4	2.1
Core CPI	2.2	2.2	2.5

Source: Bloomberg

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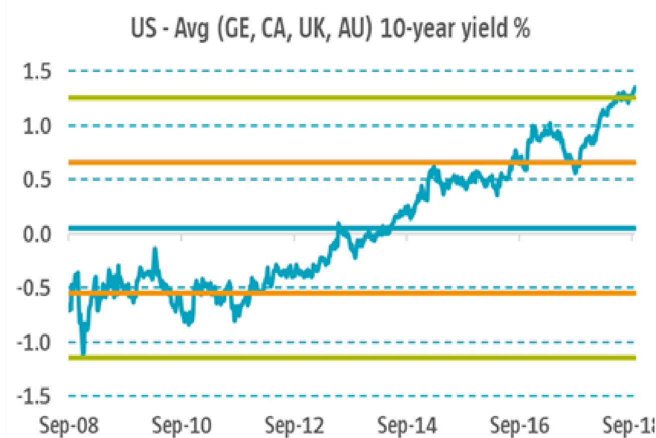
US 10-year yields moving into cheap territory

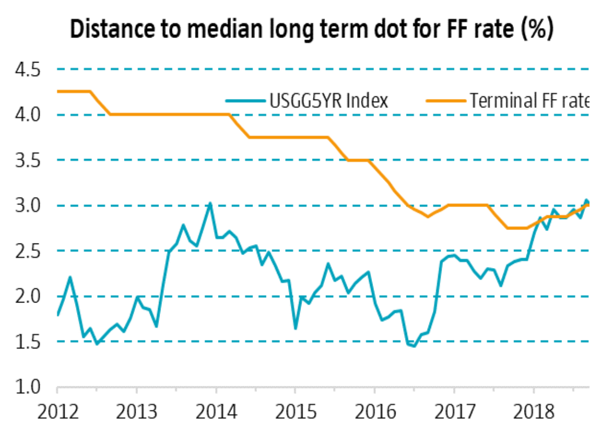
- 10-year US yields are now moving into cheap territory, although this is almost fully explained by differences in central bank expectations.
- The 5-year rate has already reached the expected terminal fed funds rate, so further yield rises should lead to steeper curves.
- The term premium in 10-year US Treasuries has recently started to rise.

Chart 5. 10-year yield is 2 stdv high vs DM peers



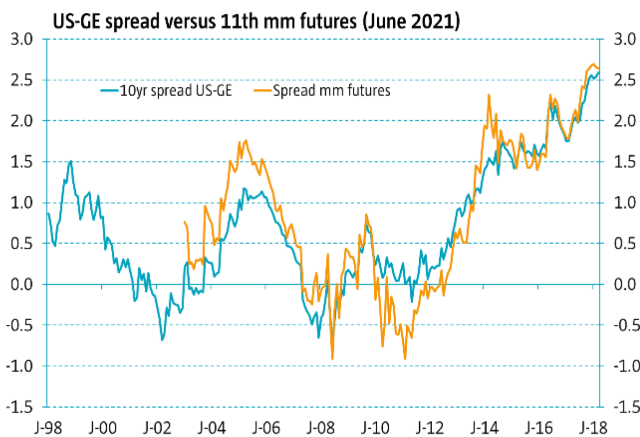
Source: Bloomberg

Chart 6. 5-year yield is now above the terminal rate



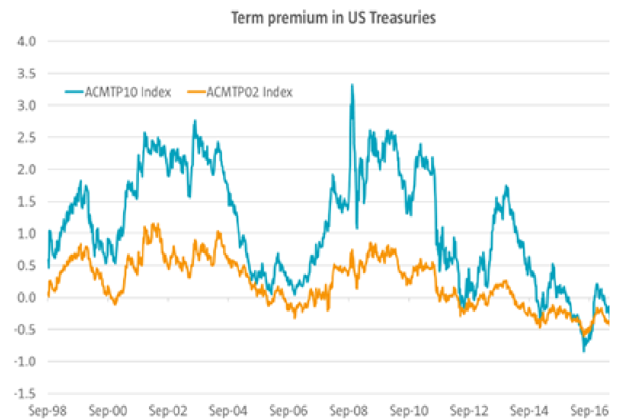
Source: Bloomberg

Chart 7. Fed-ECB expectations explain 10-year spread



Source: Bloomberg

Chart 8. Global QE has pushed term premiums to lows



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PBoC: Juggling different objectives

- RRR remains China's most important monetary tool
- Ongoing credit restrictions; but some form of stimulus required
- Chinese government bonds – the new safe haven?

Monetary policy the Chinese way

According to Chinese law, monetary policy aims to create "stability of the value of the currency and thereby promote economic growth". There are several characteristics that make Chinese monetary policy quite distinctive. The state plays a dominant role in resource allocation and owns the main commercial banks. The central bank uses regulation such as credit quotas to steer credit growth, but is subordinate to the State Council when it comes to policy decisions. This makes the amount of required reserves (RRR), the differences in RRR between smaller and larger banks and the size of the medium-term lending facility (MLF) more important monetary policy tools than the level of interest rates.

More RRR cuts and weaker renminbi on the cards

The RRR cuts of 7 October were intended to cushion the effects of the government's longer-term deleveraging ambitions, which have proved successful in curbing the growth of the shadow banking sector. However, as credit becomes more scarce, the PBoC wants to prevent the SME segment from suffering the consequences of 'crowding out effects'. While growth has slowed, recent plans to ramp up infrastructure mean that bank loans have been going to local governments rather than SMEs. The PBoC aims to tackle this by reducing the RRR for both major and smaller banks. There have been three cuts this year and the RRR for major banks is now below the 2009 level of 15.5%. The ratio for smaller banks was brought back to 12.5%, compared to a 2009 low of 13.5%.

Going forward we think more RRR cuts will be needed. First of all, because the PBoC will continue restricting credit for targeted segments of the economy and will have to try to contain the associated 'collateral damage'. Second, because we think the economy needs some stimulus since growth is likely to slow further. Third, we expect the current account balance to be in deficit in 2019. The surplus has already declined by 2 percentage points since 2016, to only 0.5% GDP.

Market pricing in slightly higher rates, we disagree

The trade war with the US is obviously not helping. Chinese companies may also start paying down their US dollar debt as renminbi interest rates are now almost equalling US dollar levels. We expect to see portfolio inflows into the country with the inclusion of Chinese government bonds (CGBs) in international bond indices, but this flow could be counterbalanced by Chinese investors ongoing desire to diversify into foreign assets. We

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expect these trends to lead to a combination of a weaker currency and further cuts in the RRR. We implement this view via a short position in Asian currencies (including renminbi) versus a euro US dollar basket.

Liquidity conditions in the Chinese interbank market have improved. The 7-day repo rate is an important proxy for liquidity and it dropped to 2.7% in mid-October, having moved in a range of 2.3-2.9% since July. The PBoC has clearly been facilitating liquidity since then, as in Q1 and Q2 the repo rate spiked to 3.5-4% on several occasions. It is now close to where it was during the economic downturn in 2015 (2.3%) and we don't think the PBoC will want to bring rates below that level. We expect the PBoC to steer liquidity towards keeping the repo rate stable at 2.5%.

A new sovereign safe haven?

Since the start of the year, the spread between Chinese government bonds and US Treasuries has tightened by 110 bps to 40 bps, bringing the spread back to the December 2016 levels. The tightening reflects the weakening economic conditions this year and the fact that Chinese banks are no longer forced sellers of CGBs. China is not unique in trading at a low yield relative to the US. Canada, Germany, Australia and the UK are in the same camp. But, while many EM countries experience wider spreads as their currency depreciates China is different. This shows that Chinese government bonds are acting as a true safe haven.

We expect continued divergence in economic conditions between the US and China to dominate the spread. Flow wise we expect two opposing forces: foreign CGB demand should increase as a result of their inclusion in international bond indices, while supply in renminbi corporate bonds will probably increase, as issuance of US dollar bonds is less attractive at current yield levels. On a net level, we expect a further tightening of the spread between Chinese and US government bonds.

What is priced in for the PBoC versus our expectations

16-Oct-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
2.66					
Implied rise (bp)	0	9	7	10	14
Our expectation MT	0	0	0	0	0

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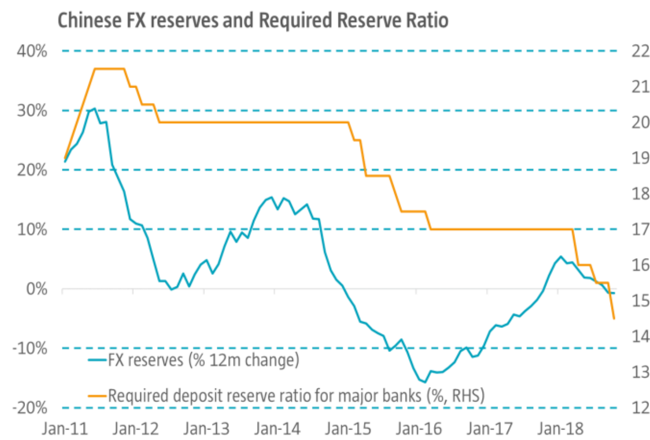
Signs of deleveraging

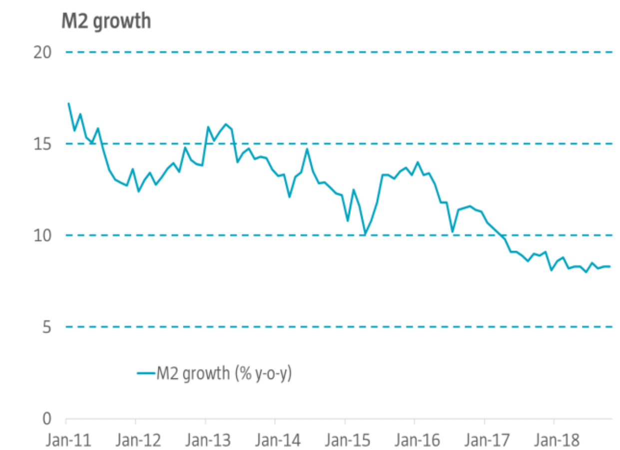
- Since February, foreign currency reserves have been declining again.
- Money growth has slowed from 14% in 2016 to 8% this year. Recent data show a stabilization of M2 growth at 8.3%.
- The PBoC has been succesful in bringing down the growth of the shadow banking sector.
- Industrial metal prices are reacting strongly to any changes in Chinese growth. They fell 15% between April and August and have not recovered since.

Chart 1 . Reserves are under pressure again



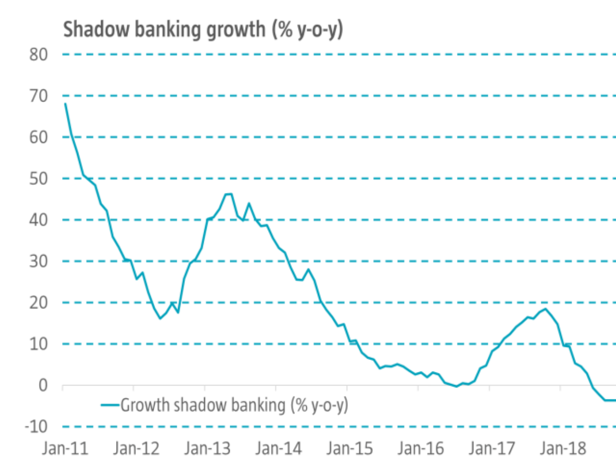
Source: Bloomberg

Chart 2. Money growth is slowing as a trend



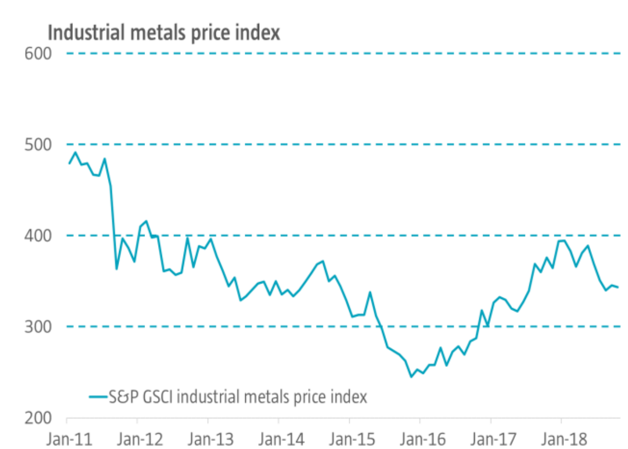
Source: Bloomberg

Chart 3. Shadow banking growth has turned negative



Source: Bloomberg

Chart 4. No recovery so far in industrial metals prices



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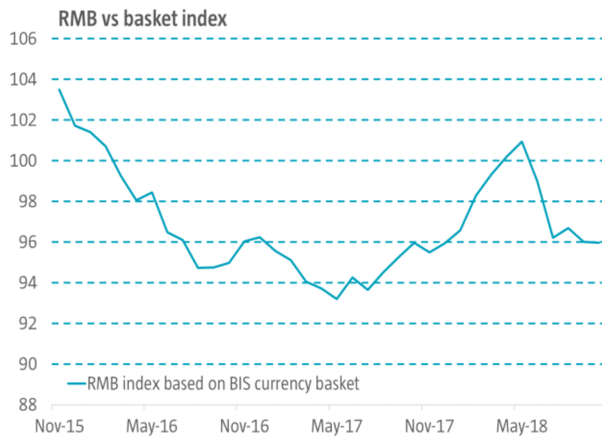
Renminbi has not depreciated much yet

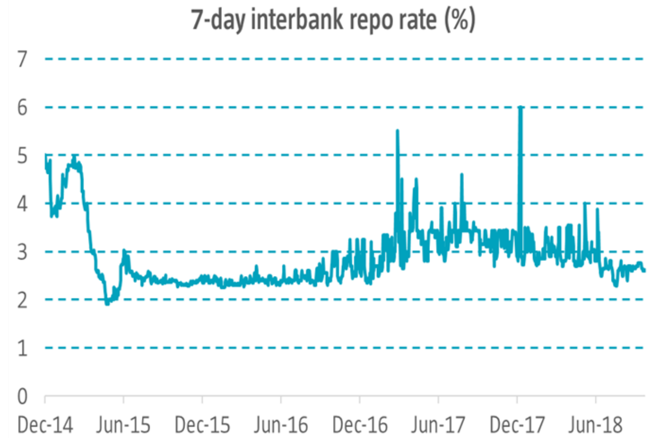
- The renminbi appreciation versus a basket of currencies came to an abrupt end in June. It has depreciated 5% since then, but remained fairly stable in recent years.
- Interbank liquidity has improved significantly since July. The repo rate has not spiked since then and rates are near their 2015 lows.
- Inflation has remained contained, the main factor driving inflation has been food prices.
- The spread between CGBs and US Treasuries has narrowed significantly, after forced CGB selling by banks came to an end.

Chart 5. RMB has weakened 5% vs BIS basket



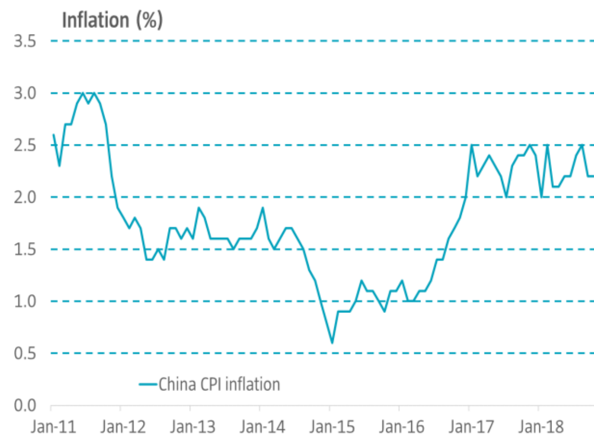
Source: Bloomberg

Chart 6. Repo rate almost back at the 2015 lows



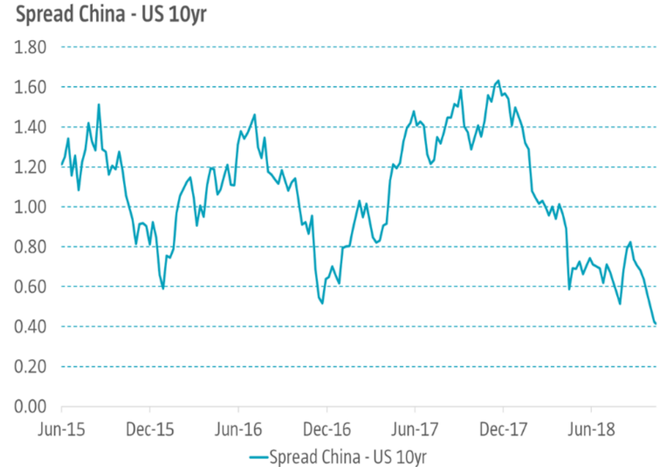
Source: Bloomberg

Chart 7. Inflation in narrow range



Source: Bloomberg

Chart 8. CGBs trading almost US yield levels



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BoJ: Time to change the 10-year JGB's target range?

- Yield curve control main BoJ tool
- Wage pressure could be dampened by plan to open labor market
- Tight range for 10-year JGB for the foreseeable future

From asset purchases to yield curve control (YCC)

In July, the BoJ surprised the market by announcing a change in the target range for the 10-year JGB yield from +/- 0.1% to +/-0.2% around its 0% yield target. Concerns that the bond market's pricing mechanism could have been impaired, motivated this policy shift. Kuroda recently confirmed that this range is the BoJ's main monetary policy instrument. He also made it clear that an exit from unconventional policy would be signaled by a further increase in the long-term yield target. Still, a necessary condition will be the 2% inflation target being met, or almost met.

When will the BoJ relax its yield curve control?

Although the current policy setting will remain in place for now, pushing up the range could come sooner than the market is currently pricing in. There are three main reasons. First, such an announcement is likely to trigger an appreciation of the yen and possibly a mild equity market correction too. To avoid moving markets again, the BoJ could communicate its policy shift when the US dollar is strengthening.

Second, Abe plans to raise the consumption tax in October 2019. To ensure this does not slow down the economy like it did in 2014, some stimulus measures are in the pipeline, which increases the probability of the 2% inflation target being met. Third, the increasing likelihood that the term premium will start to normalize worldwide as a result of shrinking global liquidity may exert substantial upward pressure on 10-year JGB yields. Although the BoJ may use bond purchases to adopt a more flexible monetary stance and ensure that the bond market functions more efficiently, it is unlikely to try to swim against the global tide.

Increasing flexibility in terms of asset purchases

In September the BoJ reduced its super-long rinban operations, which has contributed to a steepening of the long-end of the curve (10-30s). It did not renew this strategy in October, probably in order to offset the pressure of rising US rates and to avoid impacting equity prices. Looking ahead we think there is some potential for further steepening of the short-end of the curve, but that the BoJ is unlikely to surprise the market by hiking rates anytime soon. This means that the 2-year yield may remain relatively well anchored around its current level. However, it will become increasingly difficult for the BoJ to keep the 10-year yield insulated from forces relating to tighter net global monetary policy.

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Kuroda announced that any changes in the YCC target will depend on the 2% inflation target being close to being met. Despite the improving inflationary trend, there are factors that could limit the chances of this goal being reached. For example, downward pressure on wage growth may result from Prime Minister Abe's plan to open the domestic labor market to foreign workers in as early as April 2019.

Valuation

What is priced in for the BoJ, versus our expectation (bps)

17-Oct-18	Oct-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Implied rise (Futures)		2	4	5	4	8
Implied rise (OIS)	0	1	2	4	5	5
Our expectation	0	0	0	0	0	0

Main drivers of 10-year JGBs in the next quarter

We see the 10-year JGB yield moving in a 0.15-0.3% range by the end of the year.

1) Inflation expectations have not been responsive to the strong wage growth, pick up in the oil price or even the rising trend in headline inflation. They have actually been on a declining trend since March this year. We don't see any significant risk of inflation expectations surprising on the upside and pushing 10-yields up in the coming quarter.
2) Monetary stance: While the risk that the BoJ will surprise by hiking rates in the next three months is virtually zero, a higher long-term yield target is more likely, particularly if global long-term yields correct, as a result of term premium normalization in an environment of shrinking global liquidity.
3) Term premium: it is likely that term premium in developed economies will start to normalize in the coming quarter as the aggregate balance sheet of the three major central banks (Fed, ECB and BoJ) will decline. As this will cause international bond investors to adjust their portfolios, it will also impact the Japanese term premium.

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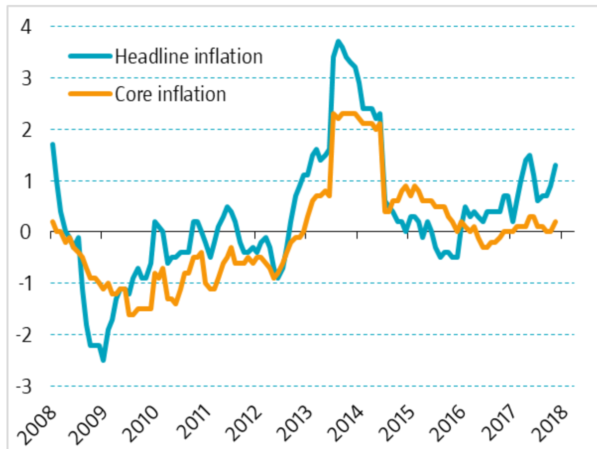
Stimulus measures may help Japan move closer to 2% inflation

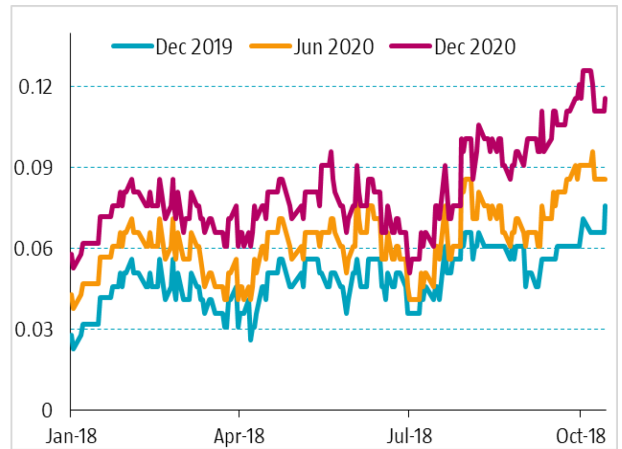
- Inflation is still well below target level and even headline inflation is only just above 1%.
- Risks of a rate hike in the short term (next three months) are virtually zero.
- The Japanese shadow interest rate (which includes unconvetional policy) is below -8%

Chart 1. Japan core and headline inflation



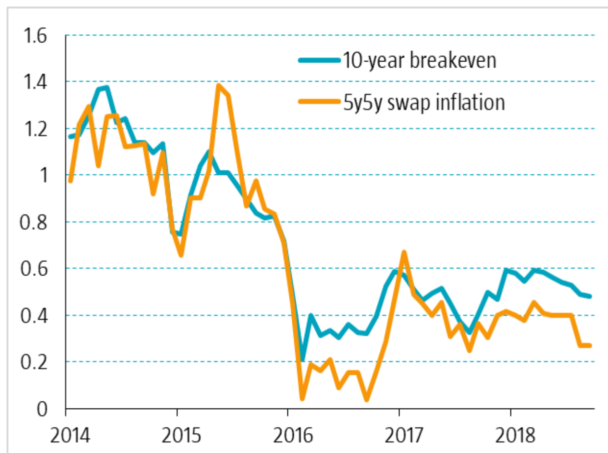
Source: Bloomberg

Chart 2. BoJ rate hikes: what is priced in? (implied in futures)



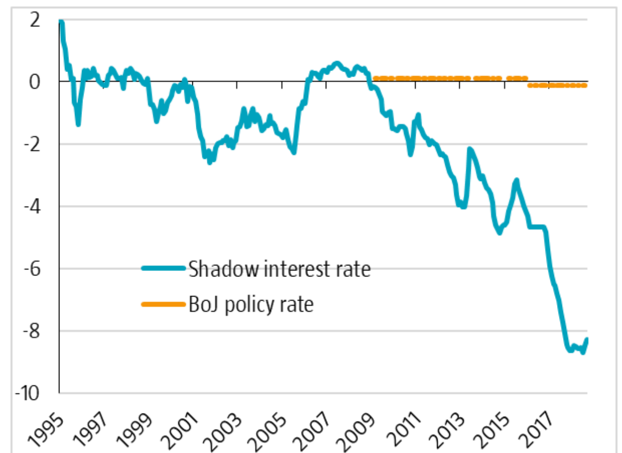
Source: Bloomberg

Chart 3. Market-based measures of inflation expectations



Source: Bloomberg

Chart 4. BoJ Policy rate and shadow interest rate



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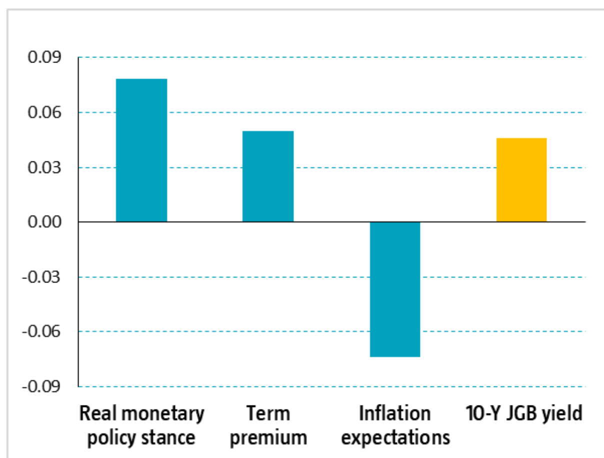
10-year yields range bound – at least in the short term

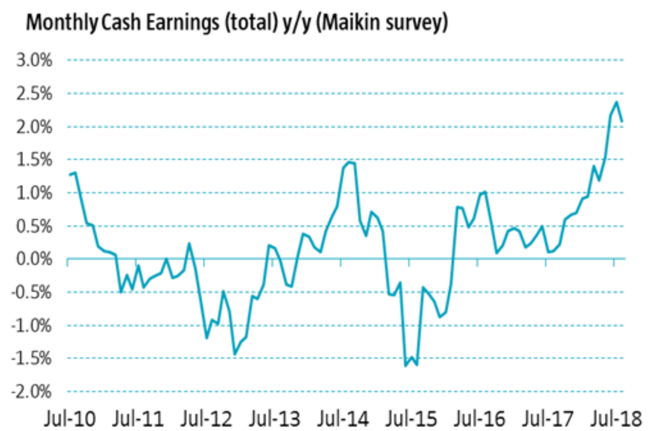
- Monetary policy expectations and the term premium have been the main upward drivers of 10-year JGB yields. Inflation is unlikely to become the reason for any rise in yields.
- Inflation yields have been responsive to changes in bank share prices.
- Real 10-year JGB yields remain well-below historical averages.

Chart 5. Drivers of change in 10-year JGB yield since end-July 2018



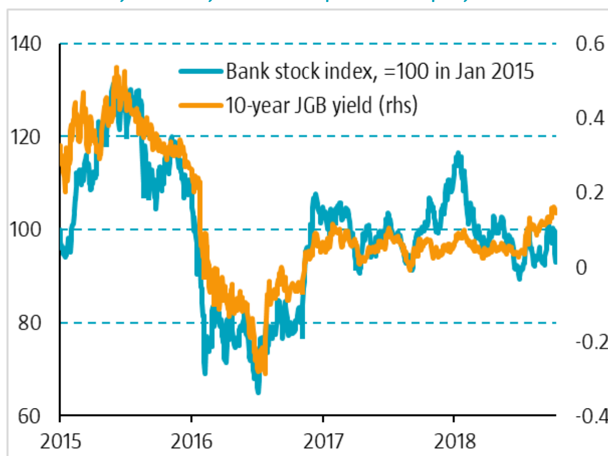
Source: Bloomberg

Chart 6. Wages are rising, but the trend remains fragile



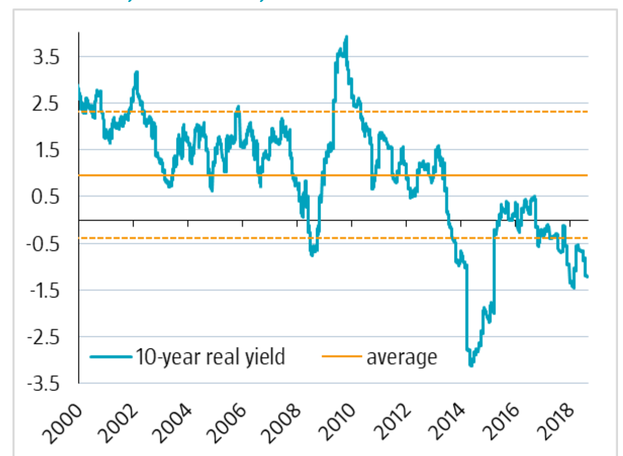
Source: Bloomberg

Chart 7. 10-year JGB yield and Topix bank equity index



Source: Bloomberg

Chart 8. 10-year real JGB yield



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