

## Central bank watcher

- ECB: how long will it remain on this tightening path?
- Fed: in denial
- PBoC: more stimulus needed
- BoJ: no changes priced in

### In denial, but for how long?

‘Tightening in tougher conditions’ was the title of our last ‘Central bank watcher’, and conditions have been tough, even tougher than we expected. Momentum has declined somewhat in the real economy, but market sentiment has been hurt badly. By focusing primarily on economic data and less on the weakness of equity and credit markets, and the resulting tightening of financial conditions, in our view, the Fed runs a serious risk of overtightening. As pressure continues to mount, we expect to see a stronger dovish response from central banks. This is reflected in our outlook for official rates.

We expect the Fed, ECB and PBoC to opt for a lower rate trajectory than is currently being priced in. This should lead to continued support for bonds, with longer-maturity bonds standing to gain the most, provided that central banks continue to ignore the warning signals from equity and credit markets. A greater acknowledgement of the downside risks of the current economic conditions on the part of central banks should be a signal for curves to steepen.

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‘This is a case of pausing, or being forced to do so’

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## ECB: how long will it remain on this tightening path?

- ECB unlikely to hike rates in the next year, if not longer

ECB in for a reality check

The market is pricing in a 50% chance of a 15bps rate hike by December 2019 and another 20bps hike in 2020 (see table below and Chart 1 on next page). We think the ECB will not be able to hike rates in 2019, which seems about fairly priced. 2020 is more interesting, as the market is still pricing in an additional 20 bps in rate hikes taking place by December 2020, but we expect this to be challenged further. As a framework we looked at what was priced in in early 2017 when hikes were still not expected anytime soon (see Chart 1). The corresponding five-year rate levels were approximately 10bps below the current levels.

What is priced in for the ECB Deposit Facility Rate, versus our expectations					
Deposit rate	-0.40	Mar-19	Jun-19	Sep-19	Dec-19
Implied in futures (bps)		1	1	4	8
Our expectation (bp)		0	0	0	0

Draghi still only marginally more dovish so far

The ECB is moving in a dovish direction, but at a gradual pace. While it is true that the ECB has lowered its outlook for growth and inflation in 2019 somewhat and acknowledged some downside risk, it has ended APP purchases as planned and will continue forward guidance (with rates to remain unchanged "at least through the summer") as before. In our opinion, the discussion on forward guidance will become more serious in the spring, as the summer draws near. Economic data recently disappointed across a broad range of euro area countries, with leading producer data in particular edging lower (see economic barometer chart on the next page). Weaker exports are probably to blame for this. Upward pressure on wages is noticeable, but these developments have been slow to translate into higher inflation. Consumer spending momentum has also weakened. Overall, the recovery looks fragile. In this environment, hiking rates is risky, especially because the ECB would hardly have room for stimulus if growth fell back. Apart from Germany, the Eurozone has limited fiscal room, too. We expect rates to be on hold for the next year, if not longer.

Forward path	Spot yield	12m Fw	Carry (bps)
2y	-0.60	-0.49	8
5y	-0.30	-0.10	19
10y	0.23	0.42	20
30y	0.85	0.90	7

\* for a 1pd position over 12 months

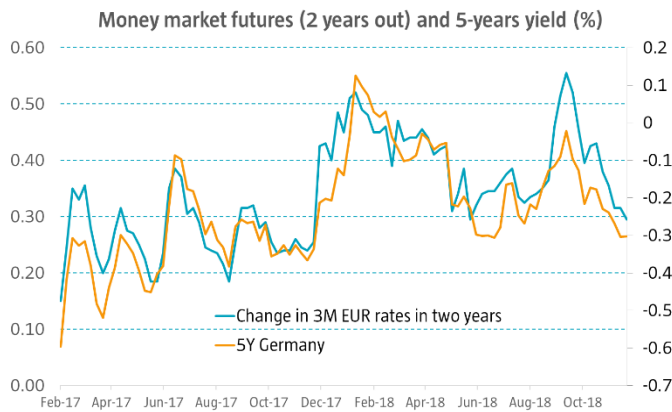
Level to buy Bunds is not far from current

Yields are low, but a modest inflation outlook, limited free float of Bunds, modest net supply and positive carry should keep yields contained. We favor buying Bunds at around 0.4%.

Central bank expectations to remain a key driver of Bund yields

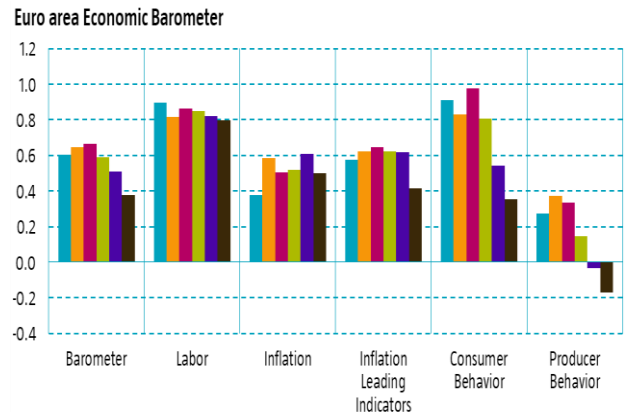
- Of the three main drivers of yields (central bank rate expectations, inflation expectations and term premium), we expect central bank and inflation expectations to remain the most important. While there is room for inflation expectations to recover a bit, we believe that room for an upward adjustment on expectations for central bank rates and inflation is limited.
- We see yields remaining in a range close to current levels and given the attractive carry, we see opportunities to buy 10-year Bunds at around 0.4%.

Chart 1. 30bps in rate hikes priced in for the next two years (RHS)



Source: Bloomberg

Chart 2. Weakening economic barometer for the euro area



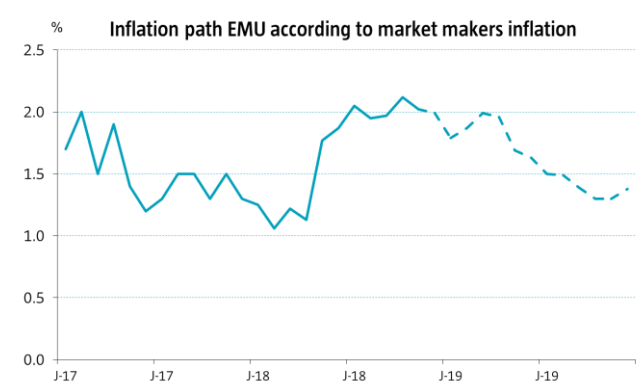
Source: Bloomberg

Chart 3. Inflation expectations have come down



Source: Bloomberg

Chart 4. Inflation outlook still modest



Source: Bloomberg

## Fed: in denial

- Economic momentum past its peak
- Fed will be forced to pause soon – we do not expect any hikes in 2019

### Fed hikes priced out to a large extent

We have adjusted our view from expecting a pause after the March meeting, to not expecting any rate hikes at all in 2019. Market expectations have come down a lot. Investors are only pricing in a 60% chance of a 25bps hike by December 2019. This is above our expectations, but not by much.

What is priced in for the Fed, versus our expectation					
		Mar-19	Jun-19	Sep-19	Dec-19
Fed funds rate	2.38				
Implied rise (FF Futures)		0.09	0.13	0.16	0.16
Our expectation		0.00	0.00	0.00	0.00

### Market says stop, Fed looks the other way

The Fed runs a serious risk of overtightening. That is the message that the markets have clearly sent over the past weeks. Speeches by the most influential Fed policymakers (Powell, Williams and Clarida), indeed suggested a policy shift towards a pragmatic, data dependent stance. In its December meeting, the Fed did shift a bit, but not as much as the market had hoped. FOMC members changed the dot plot to two rather than three hikes in 2019, but Chair Powell still gave the impression that the Fed is quite model-oriented and bent on reaching a neutral yield above 2.5%. In addition, Powell indicated he was comfortable allowing the balance sheet reduction to run on autopilot, defying market signals that USD liquidity is getting scarce. In our view, by focusing primarily on economic data and giving less weight to the weakness of equity and credit markets and the resulting tightening of financial conditions, the Fed runs a serious risk of overtightening. While we share the Fed's view that economic data have remained strong, leading growth indicators have lost some momentum since August. By not acknowledging the deterioration in market sentiment, the chances that sentiment in the real economy will lose momentum are increasing. We believe that not pausing now is a case of postponing the inevitable and expect the Fed to signal a pause.

Forward path	Spot yield	12m Fw	Carry*	Hedged to EUR
2y	2.66	2.65	138	-34
5y	2.63	2.69	56	-15
10y	2.75	2.82	33	-5
30y	2.97	3.00	16	-1

\* for a 1pd position over 12 months

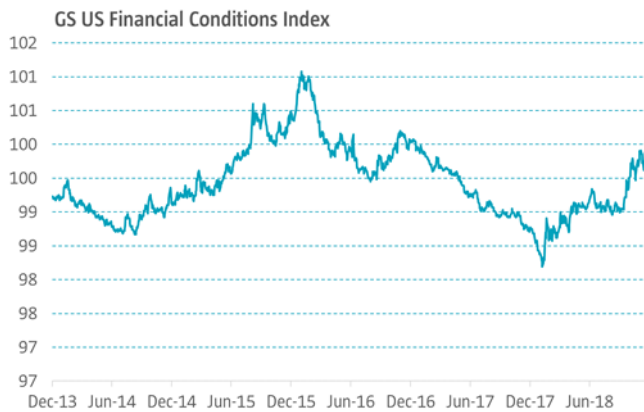
### Long-term yields to decline until the Fed gives in

In spite of the negative carry after hedging, we favor long positions in 10-year US Treasuries. Yields are moving closer to a lower terminal Fed funds rate. Long-term yields may fall further until the Fed's tone is more dovish. That would cause the curve to steepen again.

A more dovish tone would cause the curve to steepen again

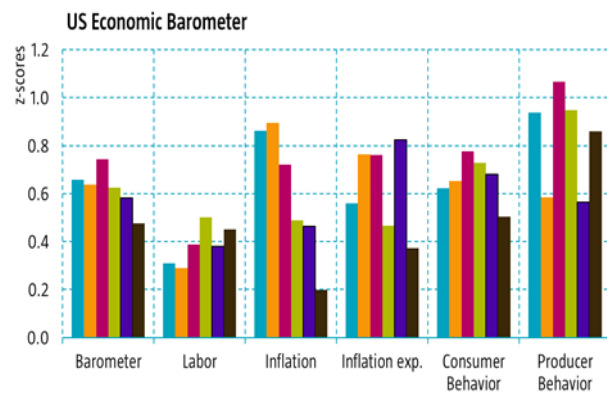
- All three drivers of yields (central bank rate expectations, inflation expectations and term premium) have contributed to the recent decline in yields. Further out we expect the term premium to push the long end up, but only after the Fed's tone turns more dovish. For now, we favor long positions in 10-year US Treasuries.

Chart 1. Financial conditions tightening rapidly



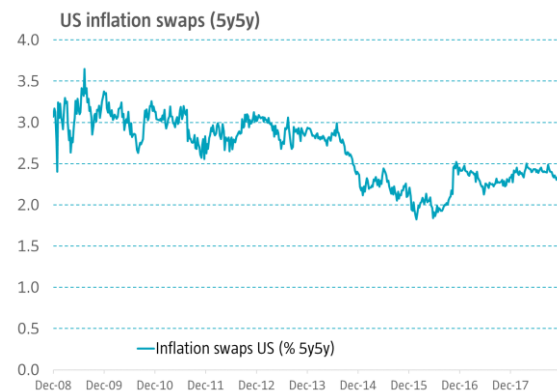
Source: Bloomberg, Goldman Sachs

Chart 2. Economic barometer losing some momentum



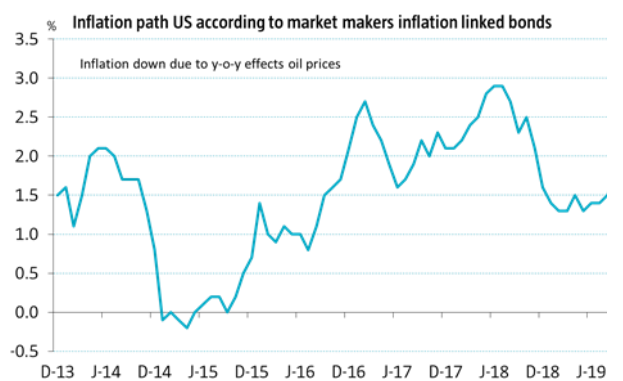
Source: Bloomberg

Chart 3. Inflation expectations have come down



Source: Bloomberg

Chart 4. Inflation to remain modest in 2019



Source: Bloomberg

## PBoC: more stimulus needed

- Both official data and external data on China are still pointing down
- All rate hikes priced out now – time to price in a cut

Market not expecting a hike, we expect a cut to be priced in

Stable rates are being priced in for the PBoC. That is the message being sent by front-end CNY forward rates. We think the market will start to price in a 25-bps rate cut for 2019.

Over the past weeks, the PBoC kept liquidity ample and the 7 day repo rate declined another 10 bps to 2.6%. The repo rate has remained within a 2.3-2.9% corridor since July 2017 and we expect it to continue declining towards the bottom of this range. The 2.3% level was also reached during the 2015 downturn. We expect it to hold steady at that level, as the government's desire to limit the growth in leverage has remained intact.

What is priced in for the PBoC versus our expectations						
7day repo rate	2.60	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Implied rise (bp)		-3	-4	-4	1	3
Our expectation MT		0	0	0	0	0

### Further policy easing likely

In his 13 December speech, PBoC Governor Yi Gang signaled the intention to keep monetary policy at a neutral level and to focus more on "guiding expectations" in policy. In this same speech, he expressed concerns about the global tightening of financial conditions, signaling the need for proactive adjustment and fine-tuning in the monetary stance. It did not take the PBoC long to follow up on this message. On 19 December, a new targeted medium-term lending facility (TMLF) was introduced, aimed at loans to "small and private firms". The TMLF came with a 15bps reduction in rate (one-year rate of 3.15%). We expect the PBoC to pursue more targeted stimulus, maintain ample bank liquidity and implement further RRR cuts. In our opinion, this stimulus is still needed. Consumer spending was supposed to gently pave the way to sustainable growth, but recent spending data suggest a quicker slowdown. External data on trade with China is confirming a weaker growth picture. Producer prices and industrial metals prices also point to weakness.

Forward path	Spot	12m Fw
2y	2.72	3.07
5y	3.04	3.31
10y	3.35	3.50

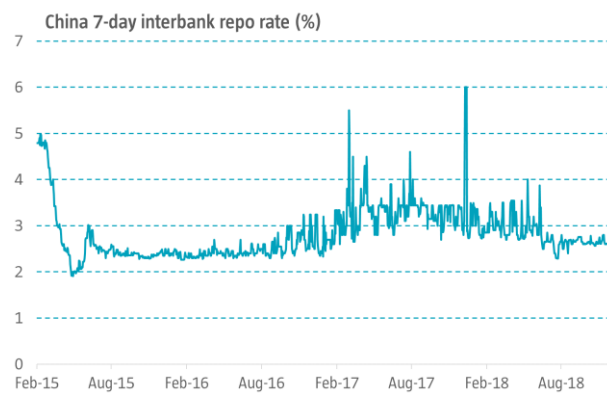
### Low Chinese yields are a bad sign for the RMB

Chinese yields have collapsed to US levels (see Chart 3). Financial account data suggest Chinese banks use this opportunity to reduce USD debt. This trend, together with continued efforts to increase RMB liquidity, will probably lead to further depreciation of the currency.

Prices not yet showing signs of a Chinese recovery

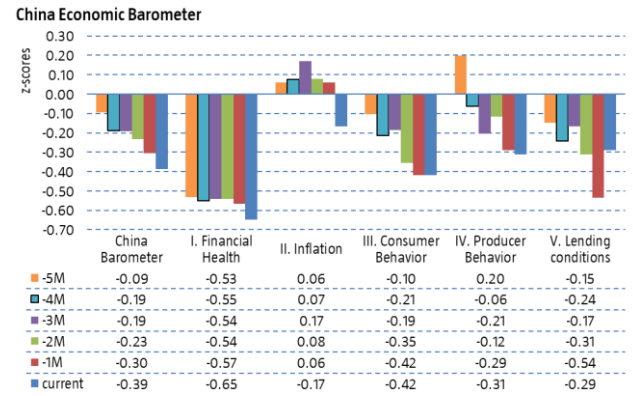
- Early indicators such as industrial metals prices have remained at low levels. This suggests downward pressure on CGB yields is likely to continue.
- Liquidity has remained ample, suggesting continued downward pressure on RMB.

Chart 1. Liquidity has remained ample and pushed rates lower



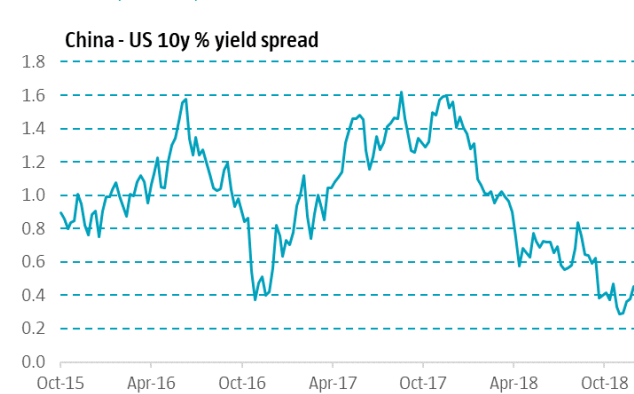
Source: Bloomberg

Chart 2. Chinese economic barometer values lower overall



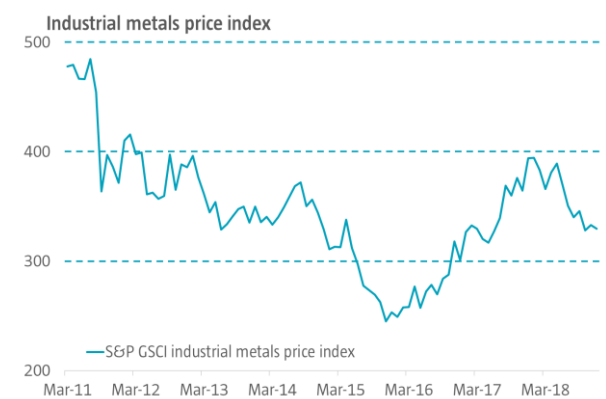
Source: Bloomberg

Chart 3. 10y Yield spread vs US stabilizes at level of around 0.4%



Source: Bloomberg

Chart 4. No recovery so far in industrial metals prices



Source: Bloomberg

## BoJ: Nothing is priced in, no reason to own JGBs below 10-years

Market no longer expects the BoJ to adjust rates

The market is back to pricing in a 0% chance of a hike in 2019, even for 2020 only 4bps are priced in. We do not expect any change in rates in 2019, either. However, the odds of a rate cut are also slim, if for no other reason than because that would hurt the banking sector. Therefore, risks for pricing in any BoJ yield changes are now skewed to the upside.

What is priced in for the BoJ, versus our expectation						
Policy balance rate	-0.10	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Implied rise (bps)		-1	0	1	0	1
Our expectation		0	0	0	0	0

BoJ rhetoric suggests no change for now

The BoJ will not risk ending the recovery by tightening policy. That much was clear from Kuroda's recent speeches before Parliament on 6 and 7 December. He indicated that risks for the economy were skewed to the downside, "particularly regarding developments in overseas economies". On inflation, the BoJ thinks the effects of the current developments will be "relatively weak", given economic conditions. The risks for the outlook were reiterated in the 20 December monetary policy statement. With this kind of rhetoric, it does not look as if there are plans to hike rates in the next year. Widening the current +/- 0.2% target range is still a possibility. Kuroda has recently stressed that this should not be regarded as tightening, but as a means to improve market functioning. Still, we expect the BoJ to have little appetite to widen the range in H1, as yields are far enough below the upper level and BoJ will probably want to avoid any misinterpretation of its measures.

Moderate growth and inflation

We expect growth to come down to a modest level. Growth of exports to China has slowed materially and the momentum of leading indicators, such as the Economy Watchers Survey, show signs of fatigue. Jobs growth is still strong, which will support consumer growth. The inflation outlook is more positive, in spite of lower oil prices. Momentum in wage growth has picked up from a dip in Q3. In addition, hiking the VAT is still on the agenda for October.

Forward path	Spot yield	12m Fw	Carry*	Hedged to EUR
2y	-0.14	-0.13	-6.1	-6.1
5y	-0.12	-0.11	-2.2	-2.2
10y	0.05	0.18	7.1	7.1
30y	0.79	0.86	5.3	5.3

\* for a 1pd position over 12 months

Little reason to own JGBs with maturity of less than ten years

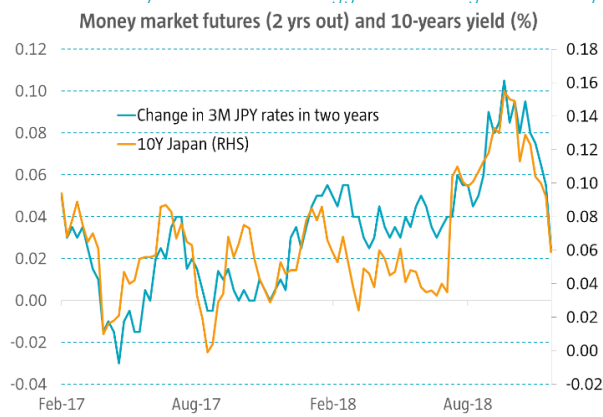
The BoJ hiking risk is fully priced out, yields are at the low of the past years and carry and roll down are zero for maturities below 10-years. We favor underweight positions in JGBs.



After the recent correction, room for somewhat higher yields

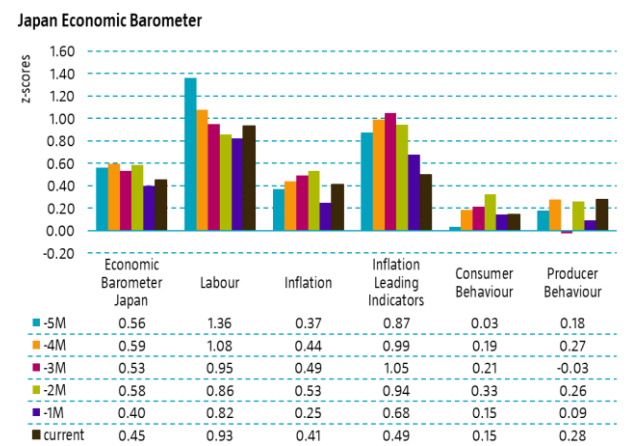
- With regard to the three main drivers of yields (central bank rate expectations, inflation expectations and the term premium) we expect some upward pressure on yields from the term premium, stable inflation expectations and stable to higher central bank expectations.

Chart 1. Money market futures suggest no change next two years



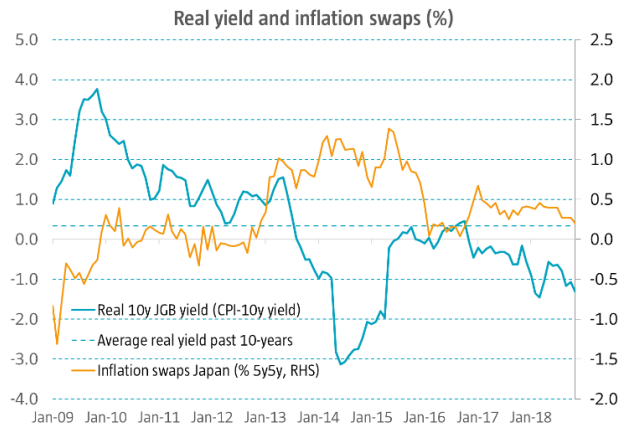
Source: Bloomberg

Chart 2. Economic barometer shows weaker inflation expectations



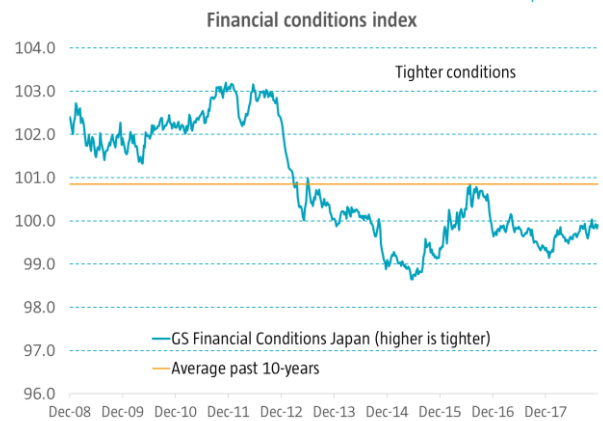
Source: Bloomberg

Chart 3. 10-year real rates are the lowest since the VAT hike in 2014



Source: Bloomberg

Chart 4. Financial conditions more or less stable in Japan



Source: Bloomberg, Goldman Sachs

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This document is exclusively distributed in Switzerland to qualified investors as defined in the Swiss Collective Investment Schemes Act (CISA) by Robeco Switzerland AG which is authorized by the Swiss Financial Market Supervisory Authority FINMA as Swiss representative of foreign collective investment schemes, and UBS Switzerland AG, Bahnhofstrasse 45, 8001 Zurich, postal address: Europastrasse 2, P.O. Box, CH-8152 Opfikon, as Swiss paying agent. The prospectus, the Key Investor Information Documents (KIIDs), the articles of association, the annual and semi-annual reports of the Fund(s), as well as the list of the purchases and sales which the Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, at the office of the Swiss representative Robeco Switzerland AG, Josefstrasse 218, CH-8005 Zurich. The prospectuses are also available via the website [www.robeco.ch](http://www.robeco.ch).

## Additional Information for investors with residence or seat in the United Arab Emirates

Some Funds referred to in this marketing material have been registered with the UAE Securities and Commodities Authority (the Authority). Details of all Registered Funds can be found on the Authority's website. The Authority assumes no liability for the accuracy of the information set out in this material/document, nor for the failure of any persons engaged in the investment Fund in performing their duties and responsibilities.

## Additional Information for investors with residence or seat in the United Kingdom

Robeco is subject to limited regulation in the UK by the Financial Conduct Authority. Details about the extent of our regulation by the Financial Conduct Authority are available from us on request.

## Additional Information for investors with residence or seat in Uruguay

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.

## Additional Information concerning RobecoSAM Collective Investment Schemes

The RobecoSAM collective investment schemes ("RobecoSAM Funds") in scope are sub funds under the Undertakings for Collective Investment in Transferable Securities (UCITS) of MULTIPARTNER SICAV, managed by GAM (Luxembourg) S.A., ("Multipartner"). Multipartner SICAV is incorporated as a Société d'Investissement à Capital Variable which is governed by Luxembourg law. The custodian is State Street Bank Luxembourg S.C.A., 49, Avenue J. F. Kennedy, L-1855 Luxembourg. The prospectus, the Key Investor Information Documents (KIIDs), the articles of association, the annual and semi-annual reports of the RobecoSAM Funds, as well as the list of the purchases and sales which the RobecoSAM Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, via the website [www.robecosam.com](http://www.robecosam.com) or [www.funds.gam.com](http://www.funds.gam.com).