The “High-Pressure Economy” experiment has begun

Fixed income quarterly outlook - fourth quarter 2018

FOR PROFESSIONAL INVESTORS - October 2018

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Key points

- The recent repricing of expectations for monetary policy has once again caused a wobble in risk assets. But the move higher in real Treasury yields may reflect greater investor confidence in the medium-term growth outlook.

- Indications that the new Federal Reserve leadership remains unconvinced that monetary policy will need to turn restrictive may be underpinning this confidence in the outlook. With inflation expectations well-anchored, the core of the FOMC appears comfortable running a “high-pressured economy” that provides incentives for stronger business investment, which could ultimately boost trend growth and relieve inflationary pressures.

- As markets are now closer to fully discounting the terminal policy rate for this cycle, the environment favors carry in many fixed income markets. We feel particularly comfortable owning risk assets at the front of the curve.

Full commentary

We have been fairly consistent in previous quarters in our view that there are many reasons to be concerned about the macro outlook. This quarter, and despite recent equity market developments, we take a pause from our doom and gloom and pay tribute to a truly remarkable economic run that appears poised to become the longest in history. First, some background. The ability of the United States economy to weather higher interest rates remains one of the enduring questions of an expansion that is entering its tenth year. Over recent years, investors have periodically fretted that continued monetary policy tightening will eventually throw the economy into a recession. To some, risks of a monetary policy error have been heightened by the fact that inflationary pressures have remained muted, as well as the belief that cyclical and structural factors have suppressed the neutral policy rate.

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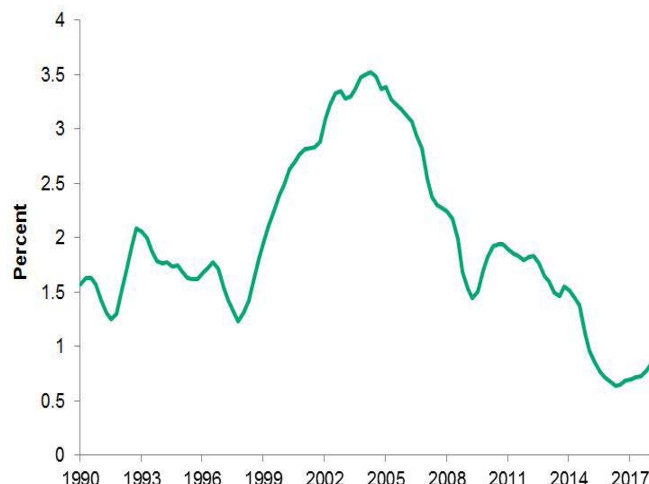
Recent developments have put this narrative to the test. Markets are currently pricing a higher terminal policy rate for this cycle than at any other point in time since the FOMC began raising rates in 2015, while consensus forecasts are for growth to remain solidly above trend at least through the end of next year. However, similar to the spring, the recent discounting of higher policy rates has contributed to a decline in equity prices. As we write this update, the S&P 500 index has fallen about six percent from its September peak as the 10yr US Treasury yield jumped as much as 25 basis points.

Figure 1. US Stock Performance and Forward Policy Rate Expectations

Source: Bloomberg

We caution against over-interpreting the recent declines in US equity indices as signifying new and significant concerns about the US outlook. The higher interest rates that initially prompted equity market losses might reflect a growing view that trend growth will pick up in the years ahead, and that recession risks will remain contained under new Federal Reserve leadership that continues to signal that any move of monetary policy to restrictive territory will likely be modest. As for trend growth prospects, there are already some encouraging signs in the productivity data. In addition, strong investment spending in recent quarters, should it continue over the medium term, suggests even better days ahead for productivity growth.

Figure 2. Productivity Growth (Y.o.Y.)



Source: Bureau of Labor Statistics, as of Q2 2018, 20-quarter moving average shown

One remarkable feature of this possible shift in investor perceptions of the growth outlook is that it has not been accompanied by a change in views at the central bank. With some minor variations along the way, Federal Reserve policymakers' outlook of growth decelerating to trend against a shallow path of rising policy rates has not shifted materially over the course of this year. And the new leadership has downplayed the need to take policy into restrictive territory, which may be buoying investors' confidence in the durability of the expansion. Indeed, the FOMC's most recent projections make clear that the Committee is engaging in a strategy aimed at prolonging the expansion indefinitely, at the risk of above-objective inflation. In practice, Chairman Powell seems comfortable running an experiment that his predecessor hinted at only in theory, namely, running a "high-pressure economy" in an attempt to boost investment spending and trend growth. Amidst the sell-off, there may be signs that bond market investors are validating the experiment – as of writing, the real 10-year Treasury yield recently reached its highest level since early 2011, but the market-based measure of 10-year inflation compensation still remains close to its expansion average.

Figure 3. Ten-Year US Treasury Real Yield

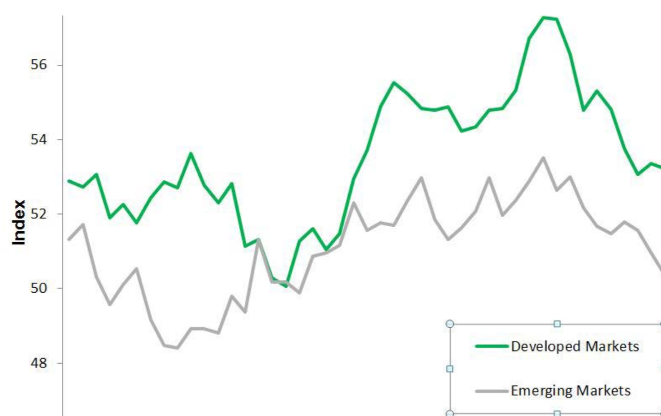
Source: Bloomberg

While investor confidence in the medium-term outlook may ultimately provide support for risk assets, we are less than convinced that financial markets are in for a period of uninterrupted smooth sailing. First, despite the recent rise in Treasury yields, markets still appear to be underpricing how much the Federal Reserve will raise rates in the years ahead, so a further adjustment to higher rates cannot be ruled out. Chair Powell even noted that the policy stance remains "a long way from neutral," and recently for the first time conceded that interest rates may eventually need to move into restrictive territory. We also cannot ignore the reality that Treasury supply dynamics are becoming increasingly challenging for fixed income investors. The Federal Reserve's portfolio has only just entered into its phase of maximum allowable run-off, and Treasury issuance still needs to head higher to fund larger deficits in the years ahead. If an adjustment to these supply pressures coincides with an increase in inflation pressures, the subsequent yield spike could leave equities and credit instruments vulnerable to a correction.

Markets also remain complacent about risks related to US trade policy. The impact of the latest escalation in the US-China trade dispute will only begin to appear in the data over the next month or so. In addition, we see little prospect for a resolution of the dispute before year-end, and hence expect the rate on the recently-announced set of US tariffs on Chinese imports to ratchet up to 25 percent, from 10 percent currently, in the New Year. It is also quite possible that the Trump administration will begin the process of implementing tariffs on all remaining Chinese imports, and China may find increasingly creative ways to retaliate once it has placed tariffs on all US imports. Beyond this specific dispute, we remain concerned that US trade policy is aimed at de-globalizing supply chains in an attempt to bolster US manufacturing production. Indeed, tariffs or quotas on European and Japanese auto imports remain a very real possibility. If we are correct on this broader aim of US trade policy, we are hard pressed to imagine that the adjustment will be a smooth one.

Risks to the outlook are far from limited to the United States. In particular, emerging markets remain vulnerable to higher US interest rates at a time when growth momentum is already on shakier ground. Trade frictions between the US and China also have the potential to adversely impact Asian exporters that are currently integrated into global supply chains. In addition, Chinese policy makers appear less willing to act aggressively to support growth than in the past. There is no less resolve or capability to provide stimulus. Rather, at least for the time being authorities appear to be taking a balanced approach, providing targeted stimulus to avoid a sharp slowdown while also preventing a further buildup of financial leverage in the system. This more limited response compared to past periods of softer growth suggests less support for other economies in the region from Chinese demand.

Figure 4. Manufacturing PMI Surveys: New Orders



Source: Markit

We start with a backdrop of caution by developed market central banks in the normalization of policy. In addition, we highlight historically low default rates and resilient earnings strength. In the US, the market has priced in approximately three more rate hikes. This suggests that we are getting closer to pricing in the terminal policy rate for this cycle. The curve may begin to retreat from its march toward a flat or inverted shape. Indeed, we see a number of reasons to begin the debate about the possibility of a steeper curve, including the approaching end of global quantitative easing (QE), an increase in higher duration government bond issuance due to unprecedented funding needs, and the potential for pension fund demand for long dated government bonds to ease due to an end to tax incentives.

This environment continues to favor carry in many fixed income asset classes. Given the above arguments, we feel particularly safe owning risk assets in the front end of the curve.

The emerging market debt space is arguably the only sector that has gone through a meaningful correction. The market looks to have fully priced in potential trade wars and a strong dollar. We look to finally build selective positions within the sector. We initiated a preference for local currency relative to hard currency for the first time since January. We have been constructive on local currency debt since August but now see favorable technicals, stabilizing global growth and a benign Federal Reserve as key signals for potential outperformance of the asset class through the rest of the year. Importantly, we note that the significant increase in emerging markets interest rates this year re-injects carry to the asset class and helps support currency valuations. We also note that a likely gradual slowdown in US growth coupled with inflation stable around two percent will open the door for a second-round carry trade regime.

We are well aware that there is a debt crisis brewing in emerging markets that will continue to simmer, and we expect more emerging markets sovereign defaults in small, frontier countries going forward. However, the market has begun to differentiate between emerging markets stories rather than treating it as a single homogeneous market, and we suspect the contagion period has peaked. These frontier countries are not in the local market index and will only affect a minute percentage of the hard currency universe.

In the Eurozone, the European Central Bank (ECB) has announced the end of its QE program by December, with a reduction in assets from EUR 30 billion to EUR 15 billion during the last quarter. With such long forward guidance, monetary policy will stay on automatic pilot for the coming months. Therefore, the short end of the yield curve now looks well protected here as well. While we are expecting an overall rise in long yields across the Eurozone, short rates should remain low for some time yet. As indicated by the ECB, the first increase in the deposit rate is unlikely to happen before September 2019 at the earliest and banks still have plenty of short-term cash. Our forecasts for 10-year German yields are 0.75% to 1% for the end of the year, assuming there is no contagion from emerging market and/or Italian stresses.

In the periphery, Italy is likely to remain a special case, and we expect risk premia to increase before a solution is achieved. We remain both underweight and poised for higher volatility via option straddle packages. Spain may see further tightening of its spreads over those in Germany and France so we remain long duration there. The sovereign debt of countries rated single A and above has become scarcer due to the ECB's massive purchases. A one-notch improvement in Spain's credit rating by Moody's (from Baa1 to A3) would anchor Spain firmly among the 'safe' bets for the market. Spanish spreads could then follow a similar path to those in Ireland. Portuguese government bond yields should remain somewhere between those of Spain and Italy and should also narrow.

Lastly, over the next few months, we expect the US dollar to remain well supported by strong US data and US monetary policy normalization that is not likely to change course. The interest rate differential between EUR and USD is at an all-time high and should continue to support USD. Furthermore, the euro faces political issues over the Italian budget that may continue to flare up. However, early on in 2019 we would expect the euro to start recovering against the US dollar due to monetary policy convergence – the ECB will start hiking rates late in 2019 while the Fed may be approaching the end of the hiking cycle.

Biography

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Dominick is Chief Investment Officer of Fixed Income for BNP Paribas Asset Management. His responsibilities include global and regional fixed income (Europe, US, Asia), including money market funds, and global emerging market debt. He has oversight responsibility for all activities relating to the management and performance of the organization's fixed income investment teams, products and portfolios. He is responsible for challenging the strategies and processes of the various investment teams. Dominick joined FFTW, a predecessor of BNP Paribas Asset Management, in 2013 and is based in New York.

Prior to joining us, Dominick was Managing Director – Head of Product Management and Development (Americas) for Deutsche Asset Management where he served in a senior portfolio management capacity as Head of Fixed Income Asset Allocation. Prior to Deutsche Asset Management, Dominick held the position of Head of Fixed Income (Americas) for Robeco, Weiss Peck & Greer Investment Management where he oversaw the management of US and global fixed income assets. At Robeco, Dominick managed numerous fixed income multi-sector portfolios, with a focus on fixed income asset allocation. Prior to Robeco, Dominick held various fixed income portfolio management positions including fixed income portfolio manager for Chase Asset Management, a predecessor of J.P. Morgan Asset Management. Dominick began his career as a credit analyst at Chase Securities Inc. after graduating from their industry leading credit training program.

Dominick has over 28 years of investment experience. He earned his BS in Economics from State University of New York, SUNY – Oneonta. He is a member of the New York Society of Securities Analysts and the CFA Institute.

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