



# Inflation-Linked Bond Review & Outlook

## March 2020 – For Professional Investors

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### United States

#### The coronavirus epidemic turns to pandemic

Since our last outlook piece written in early February, our negative scenario has come to pass, and the novel coronavirus (Covid-19) epidemic that appeared to be coming under control in China has spread to the rest of the world, and turned into a full pandemic. In February, evidence of the rapid spread of a new coronavirus strain that was associated with respiratory complications began to emerge from Wuhan province, China. In subsequent weeks, despite severe containment efforts by the Chinese authorities, cases linked to China began to emerge in other provinces, territories and countries. Since then, while China has been successful in bringing down new infections, the virus has taken hold elsewhere, and is now transmitting itself on a local basis at an accelerating rate.

The characteristics of the Covid-19 make it extremely difficult to contain. The virus has a relatively long incubation period, is easy to pass on, and there are indications that it can be transmitted while the infected person is still asymptomatic. The implication is that containment and eradication requires very strict quarantine procedures, which not all countries and communities have the capacity to implement. Importantly, indications are that the virus has a mortality rate many times higher than the seasonal flu, with the elderly and infirm particularly vulnerable. This combination of factors makes Covid-19 a particularly serious public health risk.

At time of writing, the World Health Organization (WHO) reports over 1.44 million confirmed infections, and 83,000 deaths. Given the shortage of testing, these numbers are without doubt far lower than the true numbers. Until the widespread imposition of public health measures in mid-March, the virus appeared to be spreading at an exponential pace. However, in recent days the public health measures appear to be finally attenuating the pace of new infections. Regardless, the impact has been to quickly strain healthcare systems in many countries.

Given the absence of a vaccine or cure, the public health response has been focused on suppressing the spread of the virus by (i) initiating isolation measures for the infected and those they have been in contact with, and (ii) implementing social distancing measures to slow further infections. The objective has been twofold: to buy time for scientific research and development of a vaccine and treatment, and to slow the pace of admissions at hospitals, such that health systems are not overwhelmed and additional capacity can be built. For some countries, testing has also been key: South Korea and Germany have had relative success with a mass-testing strategy focused on identifying the infected and tracing all known contacts, while encouraging social distancing. Other countries without testing resources have simply implemented blanket restrictions on movement, effectively confining much of the population to their homes, with only limited exceptions. What has become evident from cross-country experience is that the virulence of the coronavirus requires an aggressive public health response, based on isolation and social distancing.



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## **Economic impact of the coronavirus outbreak**

The strictness of the required public health measures means that the coronavirus outbreak has been as damaging to economic well-being as it can be to human health. Schools, restaurants, bars, cinemas, hotels, non-essential retail have all been closed. Non-essential workers have been urged to work from home where possible, and have otherwise been furloughed or made redundant. By limiting opportunities for physical proximity, a large proportion of economic activity has essentially ground to a halt. Perhaps as much as half of economic activity has stopped. Many businesses have either temporarily or permanently closed their doors. In the United States, around 17 million workers filed for unemployment benefits in the first three weeks of the shutdowns. PMI surveys across geographic regions have plummeted.

The cost to the economy of suppressing the virus will depend ultimately on the breadth and duration of the shutdowns. China's experience with the Wuhan province, where it had implemented extremely restrictive confinement measures, suggests that it could take over two months before a partial lifting of restrictions is possible.

Our base case is for public health considerations to require more than one shutdown. The modelling suggests that a confinement stage of 6 weeks or longer will be needed in the spring / early summer, and that an additional confinement will be required in the fall as the virus reemerges. This will be required to prevent infection numbers from again exceeding the health system's ability to cope. Hence, we may have a W-shaped growth trajectory.

Calibrating the economic impact is difficult, given the lack of historical precedent. The OECD estimated that sectors affected by the shutdowns account for between 30 to 40% of the total output in most economies, and depending on the extent of the shutdowns, the overall direct initial hit to the level of GDP is typically estimated to be around 20 to 25% in advanced economies. The impact on annual GDP growth would depend on how long the containment measures remain in place. Despite policymakers' efforts to protect jobs and businesses, we do not believe the economy will avoid hysteresis effects – meaning that we will not get a V-shaped recovery, and that this recession will leave deep, lasting scars that will impact its future productive capacity. Many businesses will simply choose to fold (temporarily or permanently), despite the availability of loans for some. Some sectors may never fully recover.

Workers are already losing their jobs by the millions, and unemployment benefits will not fully replace lost incomes or meet medical insurance costs. Businesses and consumers are turning extremely precautionary, and the Keynesian spending multipliers will then kick in. The government's efforts to inject fiscal stimulus, provide employment subsidies, guarantee and subsidize loans and encourage creditor forbearance will help, but these tools will still be too blunt to repair the damage fully.

In the credit markets, residential and commercial mortgage defaults will rise, many corporate bonds will default, and bank loan books will sour. Ultimately, many of private-sector losses will have to be transferred onto the government's balance sheet, and effectively be socialized.

The Fed will maintain rates at zero for several years, and have no choice but to fund the deficits and bail-outs that the federal government will have to administer. In effect, the US will monetize a large part of a quickly expending national debt, much as Japan has done.

## **Coronavirus impacts on inflation**

The immediate impact on CPI indices across geographies from the coronavirus crisis is likely to be negative overall.

- Energy prices have clearly collapsed, and this will pass through into gasoline and heating oil prices.
- Food prices are likely to rise, as the cost of manufacture and distributions will increase given public health restrictions.
- Prices of most core goods categories will soften, as retailers mark-down prices to maintain sales and reduce inventories. In other categories, prices could rise if there are supply shortages due to manufacturing and distribution shutdowns (electronic equipment for example).
- There could be CPI collection difficulties for many categories and services. The statistic authorities may therefore be unable to update prices for certain categories, where they cannot collect sufficient data, in which case the index for that category will be left unchanged, or rely more on internet-based prices, as well as imputed methods. For some categories, an unchanged CPI index will actually overestimate the true rate of inflation.

Over the next few quarters, the impact of a severe recession is also likely to be disinflationary. The economic impact of public health measures and uncertainty is to throttle both aggregate demand (workers lose income if they don't go to work, and opportunities to consume if they are confined), and aggregate supply (businesses cannot and will not produce without workers or orders). Overall, however, we would expect the slump in aggregate demand to dominate the decline in supply, and for inflation to fall. Core goods prices will likely drive further into negative territory, while core services prices will soften, but be robust enough to keep overall core CPI inflation positive.

In the longer term, however, as aggregate demand recovers, we could see the economy push up against capacity constraints given the damage done to potential output. Furthermore, it seems highly likely that pre-existing international trade tensions, as well as concerns over the resilience of highly connected global supply chains in an age of pandemics and great-power rivalries, will result in a lurch towards protectionism. A striking example of this is the current push for each developed country to produce its own respirators, with different designs. One can imagine that after the crisis, many industries and products will be designated as critical for national security, with governments supporting domestic producers. Ultimately, this reversal of globalization should be inflationary, limiting competition as it does. Politically, it is also highly likely that electorates whose financial fragility will have been exposed by a mandated lock-down will demand changes to the current economic structure in which wealth and incomes have become so concentrated. Higher wages and more generous healthcare benefits are inflationary. On the other hand, we cannot deny the potential for automation, technology and price transparency in the age of the internet to continue to limit inflationary pressures.

### **US TIPS market developments and portfolio strategy in the first quarter:**

Once it became evident in mid-February that Covid-19 could go pandemic (global), we anticipated that:

- Breakeven inflation rates (BEIs) would narrow;
- Nominal yields would fall;
- Energy prices would likely fall, taking CPI negative for a month or two.

TIPS already had only a limited bid in mid-February, so a meaningful exit from our TIPS overweight positions would have been very difficult without paying large transaction costs. Furthermore, we were not yet sure whether Covid-19 would be contained by testing and tracing measures, as countries had not yet conceded the need for widespread shut-downs. Correspondingly, we opted for the following strategy:

- We hedged our long real yield and breakeven inflation positions by buying additional nominal duration via futures. As a result we took overall duration to ~6 months overweight, and effectively reduced the BEI overweight to around 2 months (concentrated in 30-year sector).
- We maintained our 5s / 30s BEI steepener to (partially) protect against energy declines.
- We reduced our overweights to off-the-run securities, which had richened up versus benchmarks in January and February, rotating back into benchmark issues. We managed to do some of this in the 10-year sector before liquidity dried up.

Our strategy of buying nominal duration worked well until early March. Portfolio alpha was positive, as the duration hedge made significant returns. However, in early March, the Treasury and TIPS markets witnessed massive liquidation flows and both real and nominal yields moved quickly higher. The selling appeared to come from a number of sources:

- Risk Parity strategies having to reduce holdings across assets due to the volatility shock and pricing and reduced availability of repo, leverage and balance sheet;
- Stop-outs in TIPS by macro hedge funds who had bought BEIs at historically cheap levels, only to see oil prices collapse and sellers emerge;
- Selling by retail investors looking to increase precautionary cash holdings;
- Selling by central banks looking to liquidate reserves to support their domestic currencies and banking systems;
- Selling by sovereign wealth funds looking to either raise cash to support their domestic economies, or rebalance out of fixed income back into equities;

As a result, we saw both real yields rise and BEIs narrow significantly. The Treasury hedge, at this point, failed to protect the portfolio, and both absolute and relative returns (alpha) suffered sharply intra-month. However, as the seriousness of the economic shock became appreciated by policymakers, the Federal Reserve initiated a massive

stimulus program. In mid-March the Fed took rates back down to the 0 – 25 bps lower bound and announced \$700bn of new QE, of which \$500bn will be Treasury purchases.

These buybacks serve several purposes:

- (i) To provide much-needed cash and liquidity to the broader financial system
- (ii) To reduce Treasury yields across the maturity structure, thereby lowering the cost of funding for all economic agents (bolstering debt sustainability), and prompting a portfolio rebalancing effect out of safe-haven assets back into risk assets (i.e. supporting equities)
- (iii) To provide an exit for central banks and sovereign wealth funds who need to liquidate USD reserves held in Treasuries. (This is important, as the attractiveness of the Treasury market as a place to park reserves is precisely that there will be an exit window in times of stress. Treasuries' status as the safe-haven asset of choice depends on this feature, and therefore so does the Treasury's ability to raise funds at lower yields)

The Fed announced an extremely aggressive buyback calendar:

- \$375bn of Treasury purchases over 23 – 27 March (of which up to \$35bn TIPS)
- \$345bn of Treasury purchases over 30 March - 03 April (of which up to \$31bn TIPS)
- \$200bn of Treasury purchases over 06 - 09 April (of which \$20bn in TIPS)

The rate cuts and QE announcement helped to stabilize Treasuries and TIPS markets where prices had collapsed and liquidity had evaporated. 10-year TIPS yields fell back from 0.60% to -0.43%, and 10-year BEIs widened back from 0.56% to 1.18%, at time of writing. Our duration hedge made back losses and alpha recovered strongly.

### So what now for the TIPS market?

**Near-term market dynamics.** It is evident that some TIPS investors are continuing to liquidate positions. Sovereign wealth funds are likely to be significant sellers of TIPS holdings, as they seek either to raise cash or rotate into traditional risk-assets that have suffered meaningful valuation markdowns. In the near term, TIPS yields and BEIs will be driven largely by the balance of these liquidation flows and the Fed's purchases. We do not anticipate that new money will be willing to enter the asset class until this dynamic is complete, and prices have stabilized. However, it is evident that the Fed's asset purchases have already whittled down the supply overhang, and that liquidity has materially improved. TIPS are no longer trading as distressed assets.

**In the longer term,** valuations will be determined by macroeconomic and policy fundamentals. **On the growth side,** we anticipate a severe recession with a lasting impact on prospects for recovery. The Covid-19 crisis is a serious economic shock to a highly levered economy already suffering from relatively low trend growth. The negative impact on corporate and household balance sheets will be severe, and the reality is that a large proportion of private sector losses will need to be transferred to the government balance sheet. Accordingly, we anticipate that the Fed will need to maintain real yields at negative levels for years, in order to help reduce the national debt. This will only be possible if the Fed effectively finances government deficits through Treasury debt purchases, in order to prevent higher issuance from crowding out private sector borrowing. The appropriate historical parallel is the accord between the Fed and the Treasury in the 1950s, in which the Fed capped Treasury yields at a level well below the trend GDP growth rate in order to gradually reduce the national debt as a proportion of GDP. The implication is that the Treasury and the Fed are likely to coordinate the maturity profiles of issuance and purchases, in order to engineer low real yields over the coming years. This argues for a structural long position, or at least a strategy to buy duration on any meaningful back-ups.

### So where do we think TIPS should trade in 6 months' time?

Market timing is extremely difficult. Liquidations are likely to keep the asset class under pressure for some time. At the same time, once the Fed's purchases have whittled down the supply overhang, valuations could improve quickly. However, the Fed has frontloaded its \$500bn asset purchase program, and has already completed more than half in just two weeks. Tactically, the market may question what happens to TIPS when Fed purchases slow. We could well see a pullback. Of course, the answer is that the Fed will have to announce another tranche of QE – the deficits require it. Indeed, with the federal deficit over the next year likely to come in at around \$3trn, that will require \$60bn of net Treasury purchases per week (with the gross number being far higher, once we account for rollover of debt).

**Looking at real yields**, the Fed's medium objective is clear: drive them as low and as negative as possible. The economy will need negative real yields for a very long time to help work off the debt burden. The nominal yield curve will be anchored by the policy rate at 0 to 25 bps, and we anticipate that nominal 10-year yields will trade between 0.50% and 1.00%. If 10-year BEIs were to return to 1.40%, that would imply real yields should eventually trade between -0.90% and -0.40%. Is this realistic? Well, if the economy slowed in 2018 when 10-year real yields reached 1%, it seems plausible that over the next couple of years the 10-year TIPS yield will need to be held well below zero. **On the breakeven inflation (BEI) front**, a sustained widening of BEIs driven by buyers other than the Fed will likely require some indication that the country is through the worst of the coronavirus epidemic, and that the public health strategy is working. In other words, investors need to see some light at the end of the tunnel, with the prospect of an economic recovery becoming established. That evidence is beginning to emerge after 3 weeks of confinement, as the new infection and mortality statistics show evidence of slowdown, and indeed we have seen BEIs widen from a low of 0.55% in early March to 1.18% at time of writing.

Over the next 6 months, we think 10-year BEIs should return to 1.40%, perhaps 1.50%. In order to return to 2.0% or higher, we probably need to see the immediate disinflationary impulses of the recession fade, and for concern over longer term inflation risks to build. That will take some time.

### **How do we position the TIPS portfolio?**

The medium term outlook warrants both an overweight in 10-year BEIs and an overweight in real yields. At the moment, the weight of Fed TIPS purchases is dominating the liquidation flows, and TIPS are outperforming Treasuries both on real yield and BEI. Investors' confidence has also been supported by evidence that Covid-19 deaths are levelling off in countries that implemented social distancing measures 3 weeks ago.

However, we have to be mindful for pullbacks in prices if TIPS liquidations are seen to be overwhelming Fed purchases on any particular week. In addition, we have to recognize that TIPS BEIs will likely trade with risk assets, which will in turn be driven by the economic and Covid-19 data. Our concern is that the current improvement in sentiment could reverse once it becomes clear that virus containment measures will not be simply lifted in 2 weeks' time. Hence we leave room to add on pullbacks.

At the same time, there have been some interesting dislocations within the TIPS curve. In February and March the 10s / 30s BEI curve blew out to over 50 bps as investors sought safety against falling energy prices in longer maturities. As the Fed began its buybacks, the BEI slope began to correct. We were overweight in the 30-year sector and took profit, buying back our underweight in the 10-year sector. Unfortunately it is impossible to overweight 5 and 10-year TIPS against 30-year TIPS on a BEI-neutral basis given cash limitations, but at least we booked profits.

On the security selection front, we anticipate that the Fed's purchases will further normalize the pricing of off-the-run securities, since the Fed uses a fitted spline to choose which securities to buy. As the discount for off-the-run securities narrows, however, we have been switching back into on-the-run securities with better liquidity and deflation floors.

## Eurozone

### Eurozone inflation-linked bond market first quarter performance review:

Our active positions detracted from performance in the first quarter, with the bulk of the losses coming from our overweight position in Italy.

At the beginning of the year, we held an overweight in Italian versus core inflation-linked bonds. The position was motivated by our view that despite rising tensions between the two coalition parties of the Italian government, a new election was unlikely and the government would survive at least through the end of 2020. We also believed that too much political risk was priced in Italy relative to other Eurozone peripheral countries, and that Italian bonds should outperform in a “search for yield” environment. The position initially did well in January. Yield spreads between Italian and German government bonds tightened from 160 to 137 bps over the month as the ruling coalition Democratic Party won the local election in Emilia Romagna, fending off the challenge by the opposition party Lega.

However, Italian bonds were under significant pressure since a cluster of Covid-19 cases was detected on February 16th in northern Italy and 11 municipalities were locked down as authorities tried to contain the outbreak. Against this backdrop, Italian versus German government bond (BTP-Bund) spreads in the 10-year sector widened from about 130 bps mid-February to 170 bps by the end of February.

We initially decided to keep the position in February as we reassessed our trade thesis. On the one hand, Italy's GDP would suffer as tourism slows and economic activities are disrupted by containment efforts. A deterioration in GDP growth would highlight Italy's long-term debt sustainability problems. On the other hand, a health crisis could unite the government to focus on the problem at hand. Increases in fiscal spending to cope with the virus outbreak was unlikely to turn into a fiscal fight with the EU given the exceptional circumstances. Additionally, as the economic impacts became more widespread across the Eurozone, likely responses from the ECB, such as an extension of QE purchases, or rate cuts, or liquidity provisions, should reinforce the “search for yield” theme. We anticipated the ECB to announce easing measures in the March 12 meeting, and believed an easing announcement would provide better price levels and liquidity to reduce our Italy overweight.

In early March, the risk-reward profile of our overweight in Italy turned increasingly unfavorable given with rising market volatility and deteriorating liquidity conditions. In addition, ECB President Lagarde's misguided statement that the ECB's responsibility was “not to close spreads” was also not reassuring. In fact, 10-year BTP-Bund spreads shot up 60 bps on the back of her communication gaffe. Since then, the ECB's efforts to walk back the communication error and to skew asset purchases in favor of Italian bonds helped suppress volatility in peripheral spreads. Yet, as the political bickering regarding mutual funding assistance among Eurozone member states to fight the virus outbreak continued, our conviction on the position has declined. Since the beginning of March, we have started to scale out of the position, which unfortunately has crystalized losses.

The portfolio also held a short position in BEI and a real yield curve flattener, which did well amid the dramatic fall in energy prices and a decline in inflation expectations brought by the severe economic shock.

### Eurozone market outlook

**In the near term**, we expect the €120 billion envelope in addition to the €20 billion monthly Public Sector Asset Purchases (PSPP) and the €750 billion Pandemic Emergency Purchase Program (PEPP) will continue to keep Eurozone government bond yields low and suppress volatility in peripheral spreads.

During the liquidity crunch in March, we saw bid-offer spreads for core linkers widen to between 5 to 10 bps. Bid-offer spreads on a regular clip size of Italian or Spanish linkers widened as much as 25 bps. More recently, we observed that liquidation flows in Eurozone inflation-linked bond market have slowed. Optimism about a potential reduction in lockdown measures to reopen the economy cheapened linkers' valuations, and easing measures provided by the ECB have also generated more two way interests in the market, as well as a partial normalization of liquidity.

The return to a more normal functioning of the sovereign bond market, and continued purchases from the ECB's PSPP and PEPP facilities should keep fiscal financing costs low for Eurozone member states, including the southern countries with lower sovereign credit rating and higher debt levels.

More pertinent **in the medium term**, however, decisions regarding mutual funding assistance among Eurozone member states to fight the virus outbreak could have important political consequences.

The coronavirus is a symmetric exogenous shock. The loss in economic activities is not the fault of the countries who suffer from it. Member states will have to act with sufficient strength and speed to prevent the economic disruption morphing into a prolonged recession, and thereby preventing a permanent destruction of productive capacity and therefore the fiscal base. However, not all Eurozone members have the fiscal space to fight the current crisis. And the virus, at least for now, is hitting hardest the countries which had already been weakened by the previous financial and sovereign debt crises. Italy, for example, is forecasted to see its debt-to-GDP ratio rising to 160%. In contrast, Germany's rise in debt would be relatively contained at 80%, and the Netherlands will rise to near 70%. The vulnerable southern European countries whose debt levels would raise questions about their fiscal sustainability would have less capacity to deploy fiscal measures. Having given up their monetary policy independence, these countries will have to rely on a common fiscal response and massive coordinated support at the Eurozone level. Without the coordinated common support and access to equal level of cheap financing, divergences within the Eurozone are going to widen, and the economic inequity could deepen the divide within the Eurozone.

Indeed, as Italy faces its most severe crisis since WWII, there is a rising feeling among even its pro-European elite that the country is being abandoned by its neighbors. Some may conclude that the membership of the single currency brings no benefits, and Eurosceptic sentiment can rise. This could lead to resurgence of political support to radical party Lega, and/or fan the flames of "Italexit". A group of countries, led by Italy and Spain, are proposing debt mutualization through joint debt issuance dubbed as "coronabonds", but the idea of jointly issued debt is anathema to some member states, including the Netherlands.

At the time of writing, Eurogroup finance ministers have agreed to an emergency rescue package after days of marathon talks. The plan announced on April 9 is intended to combat the consequences of the pandemic, and discussions on a recovery plan will come later. The main measures (for a total of nearly €550 billion) are as follows:

- €100 billion to finance partial unemployment and avoid job losses (also known as the SURE program)
- An additional €200 billion of financing for companies with a focus on SMEs by the European Investment Bank (EIB)
- €240 billion loans via the European Stability Mechanism (ESM) with mild conditionality: the only requirement to access the credit line will be that euro area member states requesting support would commit to use this credit line to support domestic financing of direct and indirect healthcare, cure and prevention related costs. Access granted will amount to 2% of the respective member's GDP as of end-2019
- It has also been decided to work on a Recovery Fund which will be temporary and targeted

While the breakthrough on immediate economic measures should support businesses, workers and sovereigns to recover from the coronavirus, the questions on how the Eurozone would pay for later economic recovery plan for the bloc still remain unanswered. The announcement makes no mention of creating coronabonds, as the decision on whether to issue debt jointly and move towards budgetary integration is primarily political. The Eurogroup therefore passed the parcel back to the heads of state to decide whether or not "innovative financial instruments" should be employed.

The Eurozone has shied away from the fact that the currency union cannot succeed without a fiscal union. Today, the rising risks to debt sustainability and the associated political consequences have put the topic of fiscal risk-sharing front and center. There remains profound divisions on how large and how urgently it needs to be, and how the costs will be shared across member states. Politicians will need to overcome these divisions in order to preserve the euro.

### **How do we position in Eurozone inflation-linked bonds?**

The market will remain nervous about the impact of Covid-19 on public finances, issuance, debt-sustainability and sovereign credit ratings.

In an optimistic scenario, economic shutdowns end and growth rebounds faster than anticipated, EU leaders enact a coordinated response to mutualize fiscal costs, and the ECB looks through immediate rebound and continue their purchase programs. If this scenario materializes, we should see core government bond yields rise as market prices in the better inflation and growth outlook. Peripheral bond spreads tightened as the harder hit southern European countries

benefit from the improved political cohesion in the Eurozone and the liquidity support coming from the ECB. Inflation will likely bound back faster from the sub-zero levels as disinflationary impacts of the coronavirus crisis fade away, driving BEI rates higher.

At the other end of the spectrum, in a pessimistic scenario where a deepening recession is not met by decisive solidarity financing to help the more vulnerable countries to fight the crisis, the weaker member states could face sovereign credit downgrades. The political division within the Eurozone could grow, and nationalism could return. Investors will become increasingly concerned about a re-emergence of Euro breakup risk. Core government bonds, particularly German Bunds, will likely rally as investors flock to safety amid higher risks of debt redenomination. Peripheral bond yields will skyrocket, especially if Italian debt is downgraded to below investment grade. Inflation-linked bonds will likely underperform, as questions regarding what the bonds' linkage to Euro HICP inflation really means will find no immediate answers.

We expect what will materialize in the coming months to lie somewhere between the two extremes. Concerns about a second wave of infections and still limited testing, surveillance capacity and insufficient medical supply suggest that governments would be careful to relax containment measures. Some degree of social lockdowns will likely persist. A V-shape recovery is therefore unlikely. Member states will continue their marathon discussions to search for a compromise on how to finance the economic reconstruction. The poor economic and inflation outlook, combined with the ECB's asset purchase programs will keep government bond yields low, and peripheral spreads contained.

With peripheral spreads still relatively tight on a historical basis, and the risk of redenomination fears reemerging not insignificant, the risk-reward of owning peripheral bonds for carry purposes is unattractive. As such, we will continue to look for opportunities to exist our peripheral positions. We maintain a short bias in Eurozone BEI, as we expect deflationary impacts from demand destruction to overwhelm supply-side inflationary effects in the near to medium term.



## UK

### UK index-linked Gilts first quarter performance review:

Our active positions in UK index-linked Gilts added to performance in the first quarter.

Throughout the quarter, we maintained a short BEI bias, as we believed weaker growth outlook, slowing labour market, peaking wage growth and lingering retail price index (RPI) reform uncertainty did not bode well for BEI. We also saw asymmetric risks regarding potential RPI reform developments. The market had not fully priced the scenario of a full alignment between RPI and Consumer Prices Index including owner occupiers' housing cost (CPIH) as suggested by the UK Statistics Authority (UKSA). And even if the consultation was broadened to include considerations of unfair wealth transfer associated with RPI changes, we expected uncertainty during the consultation period to keep liability-driven demand for linkers on the sideline, with pension hedging activities favoring conventional Gilts instead. In March, inflation expectations declined rapidly as the economic toll associated with the coronavirus outbreak became increasingly significant. In addition, index-linked Gilts are also excluded from the Bank of England's QE purchases. While there was no evidence that such exclusion weighed on BEI rates in previous QE programs, the directionality of BEI relative to the rally in conventional Gilts and the accelerated pace of the current rounds of QE helped pressure BEI lower this time. BEI rates in the 30-year sector descended to as low as 2.6% in March, prompting us to take partial profit on the position.

In yield curve, we maintained a 20s30s real yield curve steepening bias in the first quarter, motivated by our view that the detrimental effects resulting from the potential RPI changes would be mostly borne by longer-dated index-linked Gilts. Monetary and fiscal policies were also supportive to a yield curve steepening bias. The UK government's plan to fulfill their election promises of ending austerity and increase public spending points to higher issuance and perhaps more supply pressure at the longer-end of the curve, while the dovish shift at the Bank of England suggests that shorter-dated yields would be better anchored. The real yield curve position benefited from strong pension demand in the 20-year sector and liquidation flows in the 30-year sector over the quarter.

In duration, we initially held an underweight position, with the view that a rebound in sentiment following the decisive December General Election and the anticipation of more fiscal easing to boost growth should reduce expectations of further policy rate cuts by the Bank of England (BoE). But as Covid-19 started to spread rapidly in several countries outside China in mid-February, we covered our duration underweight quickly at a modest loss. In early March, concerns about rising sovereign debt issuance and liquidation flows pushed government bond yields higher across regions. We took advantage of the market dislocation to establish a long duration position. An accelerated implementation of the BoE's QE program alleviated liquidity pressure in the Gilt market, helping 10-year conventional Gilt yields to rally from an intra-month high of 80 bps to around 36 bps by the end of March. Our long duration position added to returns, offsetting losses from the previous tactical duration underweight position.

### UK market outlook

The enormous economic threat brought by social distancing measures prompted the UK to pledge more fiscal stimulus than that during the global financial crisis a decade ago. The fiscal aid to fight the economic fallout includes the Job Retention Scheme, an unprecedented promise to pay up to 80% of furloughed workers' wages, which is estimated to cost the government up to 2.5% of the UK's annual GDP. The government also pledged to guarantee £330 billion of emergency loans, known as Coronavirus Business Interruption Loan Scheme (CBILS) to support struggling British SMEs. More recently, the government introduced the Coronavirus Large Business Interruption Loan Scheme (CLBILS) which will provide a government guarantee of 80% on loans of up to £25 million to middle-sized businesses with an annual turnover of between £45 million and £500 million.

The sizeable expansion in fiscal policy has been met by aggressive monetary accommodation. The Bank of England already cut the Bank Rate by a combined of 65 bps on two separate occasions, slashed the countercyclical capital buffer to 0% and announced an additional £200 billion Asset Purchase Facility (APF). The BoE and the HM Treasury also jointly introduced a £200 billion Covid Corporate Financing Facility (CCFF), which provides another means of lending to companies.

**In the near term**, the BoE will continue to play a central role in supporting the economy through maintaining easy financial conditions, as well as insulating the public finances from high interest rates.

Indeed, market dislocation seen in early March quickly corrected after the BoE committed to completing its APF in the secondary conventional Gilt market "as soon as operationally possible and consistent with improved market functioning". The speed of Gilt purchases has so far been twice as fast as any previous QE purchases conducted by the BoE since the policy was introduced in 2009. Perhaps it is part of the BoE's calculation to speed up Gilt purchases in order to outpace issuance from the Debt Management Office (DMO) as it attempts to ease monetary conditions. At this rate, even when the DMO borrowing needs are revised higher in the coming months, the BoE's APF should help to keep yields low.

In addition, the Bank of England and HM Treasury announced a temporary extension of the Ways and Means Facility. The facility works as the government's overdraft account with the BoE. If daily central government operations result in a cash shortfall, the gap is filled by overnight borrowing from the Bank. The announcement came against the backdrop of the government's Covid-19 fiscal package, which will require the DMO to raise a large sum of money in a very short timeframe through the usual Gilt market channel. If the DMO were to supply more debt than the market could readily absorb, it could result in market disruption, spikes higher in yields, and possibly uncovered auctions. In recognition of the highly uncertain government cash flows over the 2020/2021 fiscal year, the overdraft facility allows the DMO to manage the inevitable cash flow volatility.

Some may view the UK government tapping the Ways and Means overdraft facility as part of an inexorable move towards longer-term monetary financing of the UK's budget deficit. However, the BoE went to great lengths to stress the facility "will be repaid as soon as possible, and before the end of the year", and that "its response to Covid-19 will continue to be fully funded by additional borrowing through normal debt management operations". We see this as a temporary and short-term measure to spread the government's sharply higher borrowing needs over time to avoid market disruption.

**In the medium term**, the macroeconomic repercussions of the coronavirus outbreak remain dependent on the duration of social distancing measures. As in other countries, the reopening of the economy is contingent on the capacity to deploy large scale testing and surveillance measures, the medical capacity to treat patients requiring hospitalization, and evidence of sustained decline in new coronavirus cases and deaths. At the time of writing, it is reasonable to expect the lifting of the lockdown to be at least a few weeks away, if not longer.

Moreover, while it is still in the early days, the first round of data from the BoE's credit statistics suggest a limited pass-through of interest rate cuts to households and businesses. Despite the fact that the Bank Rate now sits at a historical low, mortgage rates have not yet adjusted meaningfully. There also seems to be an operational bottleneck as lending institutions are struggling to cope with increasing demand for credit among SMEs. Consumer credit products have also seen limited pass-through of March rate cuts. But of course, the transmission mechanism of rate cuts into the real economy may improve over time. It remains highly uncertain how effective the fiscal and monetary policies will be in softening the economic blow.

It is also worth highlighting that the February GDP print came weaker than expected at -0.1% month-over-month. While record amounts of rainfall and early signs of the effect of the virus have been a drag on activity, the combined January and February GDP data produced a meagre 0.1% growth carrying into the first quarter, falling short of the expectations of a post-election rebound. This also suggests that the UK economy headed into March's lockdown measures with little to no momentum, and raises the questions regarding the UK's capacity to recover from the initial hit to growth from the lockdown. After all, Brexit is not yet done, and the economic uncertainty associated with the trade deal negotiation with the EU is now further amplified by the coronavirus situation.

Regarding **RPI reform**, the UKSA and HM Treasury have launched a consultation on the Reform to Retail Prices Index Methodology. In line with previous indication, the consultation will be open for six weeks and will close on April 22. The government and UKSA will respond before the parliamentary summer recess (before July 22). The consultation contains eight questions:

1. Do you agree that this proposed approach is statistically rigorous?
2. What will be the impact on the interests of holders of 'relevant' index-linked gilts (i.e. 2½% IL 2020, 2½% IL 2024 and 4 1/8% IL 2030) of addressing the shortcomings of the RPI in a) 2025 b) 2030 or c) any year in between?
3. What will be the impact on the interests of holders of all other index-linked gilts of addressing the shortcomings of the RPI in a) 2025 b) 2030 or c) any year in between?
4. What will be the impact on the index-linked gilt market or those dependent on it of addressing the shortcomings of the RPI in a) 2025 b) 2030 or c) any year in between?

5. What other impacts might the proposed changes to address the shortcomings of the RPI have in areas or contracts where the RPI is used?
6. Are there any other issues relevant to the proposal that the Authority is minded to make of which the Authority or the Chancellor ought to be aware?
7. Which lower level or supplementary RPI indices are currently used, and what are they used for?
8. What guidance would users of lower level or supplementary RPI indices find most useful for the Office for National Statistics (ONS) to provide?

The set of questions appears to go beyond the timing of the proposed alignment of RPI with CPIH and the technical implementation of such an alignment. Some of the questions are even phrased from the perspective of the interest of linker holders. The consultation document also suggests that the detrimental effect of a RPI-CPIH alignment on linker holders is likely to be relevant to the Chancellor's upcoming decision.

In our previous write-up, we wrote that the probability of a full RPI-CPIH alignment was in excess of 75%. However, we also mentioned that the risk to our call was that the consultation could be further delayed, or morphed into a longer exercise to include discussion about designing a smoother transition, or to include compensation for RPI stakeholders in order to minimize unfair windfall losses and gains. The now broader scope of the consultation suggests that some of these risk scenarios will likely materialize.

### **How do we position in the UK index-linked Gilts market?**

As the government expands its fiscal spending to fight the economic fallout from the coronavirus, the explosion in fiscal deficit will likely continue to be supported by easy monetary policies from the Bank of England. The BoE can maintain the current pace of QE purchases, which is meaningfully faster than it had been in previous versions of APF, to complete the £200 billion program by early July. We believe the BoE has the firepower and the willingness to keep interest rates low in the face of rising government borrowing. We have recently taken profit on our long duration position, but we will be looking for pullbacks in Gilts to reestablish a duration overweight.

In terms of inflation, we believe the focus in the near term will be on all the many downside risks to the economy and the associated disinflationary impacts – unemployment is rising sharply, consumer spending intentions collapsing and signs of corporate distress increasing. Although the rising specter of debt monetization may lead to inflation upside surprises in the longer term, so far the BoE is successful in emphasizing the temporary nature of its aggressive unconventional policies, which are commensurate to the scale of the economic fallout from the coronavirus outbreak. On the other hand, the risk of a full RPI-CPIH alignment is diminishing – the government has more pressing priorities, and the RPI consultation questions also seem broader than expected. The wider scope of the consultation will give stakeholders more chances to express their opposition against a full RPI-CPIH alignment directly to the process, and perhaps more influence over the final decision as well. The end results of the RPI reform may not be as detrimental to index-linked Gilt holders as suggested by the UKSA recommendations. At the same time, RPI reform uncertainty has led to a temporary halt in long-dated index-linked Gilts issuance, at a time when linkers are already a smaller portion of the DMO's gross issuance. The supply drought makes long-dated real yields and BEIs susceptible to a squeeze to richer levels if pension hedging demand emerges in the near term. As such, while the economic fundamentals remain supportive to a short bias in UK BEI, we have reduced our short BEI position in the 30-year sector.

Similarly, we have reduced our 20s30s real yield curve steepener, as the aforementioned supply-demand dynamics are not favorable to being underweight in the 30-year sector. In addition, despite an extraordinary fiscal expansion in the UK, a curve steepening exposure can no longer be justified by increased Gilt issuance alone. In fact, the realignment of the BoE buyback maturity baskets suggests that the current APF purchases could be more concentrated at the back-end of the conventional curve. A pattern of relatively low offer to cover ratios in long-dated Gilt purchases is already emerging in recent BoE buybacks, making the nominal UK curve more susceptible to a flattening move. Having said that, the dynamics along the real yield curve is different. The “preferred habitat” for pension liability hedging activities has been in the 15 to 20-year sector of the real yield curve, while the selling of linkers from pension buy-out deals has been focused on linkers with maturities at around or longer than 30 years. We expect these trends to continue, offsetting the spillover flattening pressure from the nominal curve. But our conviction level in the 20s30s real yield curve steepener has definitely declined, and we will continue to look for opportunities to scale out of the position.

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