# Bonds: not shaken, not stirred

*Peter De Coensel, CIO Fixed Income DPAM*

### ECB taking the baton from the Fed

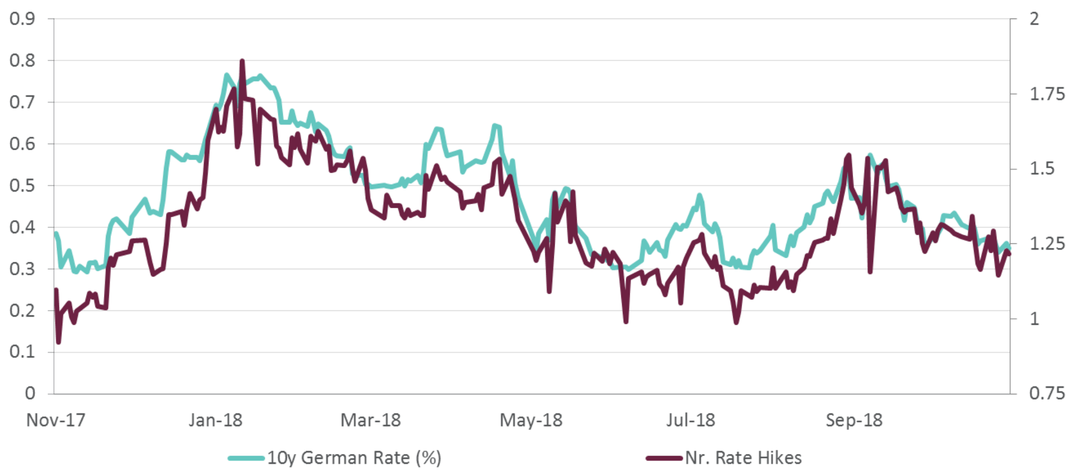
As 2018 is drawing to a close, Peter de Coensel, CIO Fixed Income at DPAM, shares his convictions on global fixed income markets.

Peter highlights that a modest global economic slowdown does not translate into a standstill or conditions of negative growth. Our base case scenario does not expect a recession over 2019. However DM and EM economies will not expand to the extent and in the synchronized manner as witnessed since 2016. On a background of contracting growth market participants will have to weather bouts of market volatility as too much risk leverage or financial leverage will take their toll.

We expect the US interest rate cycle to pause over H1 2019. With US policy rates stalling at 2.50%-2.75% our view centers around a consolidating US yield curve. The flat shape will prove resilient. We do not call for a pronounced inversion. Such stable conditions will be conducive for **stronger bond returns across sectors** in 2019.

### EU policy rates & yield curves

*Which type of ECB rate hike cycle is coming? - Current shallow path keeps bund yields in check*




Source: DPAM, Bloomberg, 26.11.2018

The pace of upside normalization for 10 year German reference rates is dependent on the day the ECB starts hiking policy rates as well as the expected path of the interest rate cycle i.e. at what angle will policy rates rise? Market participants currently expect a delay for the first rate hike into 2020 as well as a very protracted cycle of about 1 hike per year. Our base case calls **for ECB rate normalization to start in Q4 2019**. We also expect a steeper path. This view translates into a call for 10 year German bund rates to end 2019 above current forwards pointing to 50bp but below consensus that pencils 10y bund rates at 95bp at year end. Strong forward guidance and support for the EU banking system through additional TLTRO's will keep supportive financial conditions and banking union objectives intact.

**European core inflation** readings will receive support from sustained YoY wage inflation figures**. Headline inflation** figures will deal with higher volatility and face negative base effects on the back of the correction in energy prices since mid 2018.

## US policy rates & yield curves

US real yields backed up towards 1.00% reaching 2011 levels. Real and nominal US rates have gone through a beautiful normalization over the past 3 years. One-off tax cuts are not ingredients that increase productivity rates in a sustainable fashion nor impact trend growth in active labor population.

Yes, real yields are correlated with economic growth. A deceleration of US growth will translate into a **consolidation pattern for US real rates**. A push towards 2.00% would require sustained real growth rates between 2.5% and 3.5%. That is not in the cards with current YoY productivity growth at 1.3%* and active population growth figures at 0.47%*. The Fed's assessment that US long term potential growth rate evolves around 1.8% adds up nicely with above productivity and labor force growth.

***Real Yields are back at 2011 levels***


Source: "US Real Rates (10y)": historical yield of US inflation linked bonds with a maturity of 10 years), 22.11.2018, (*) BLS, Fred Economic data

Over November and December market participants turned from 2 to 3 Fed policy hikes over 2019 towards a mere ½ a rate hike over 2019. As such market expectation jumps over **our base case of 1 hike early 2019**. We stick to our base case scenario of 1 hike over 2019 followed by a pause. The market leans towards a 'No Inflation Scenario' that would see the US Treasury curve bull flatten into 2019. Time will tell. Irrespective of yield curve volatility we assess that value returned to the US Treasury curve.

## Investment grade bonds

The European IG corporate bond universe is maturing in style. Since the GFC of 2008 the universe has grown from € 800bn towards € 2000bn. The bond team was not surprised to see IG credit bump into a return air pocket over 2018. IG spreads started the year around 90bp to finish around 155bp. We called for prudence end of 2017.

With the ECB's Corporate Sector Purchase Programme (CSPP) coming to a stop we observe that the impact on spreads was temporary and tilted towards the short end of credit curves. A trend reversal towards decompression between BBB and single A spreads unfolded over the year. We expect this effect to taper out over 2019 as interest in the universe returns and flows provide technical support. End of 2018 the EUR IG universe provides a yield of approx. 1.40%. An adverse move of 30bp is able to wipe out a year's carry. **Investors should take measure over an average 5 year investment horizon**. Over that period, taking into account carry and average credit curve steepness the **expected return** builds towards a respectable **2.45%.**

## HY corporate bonds

High yield is a beta investment on economic growth. If economic growth slows down, HY spreads tend to widen. Throughout the past year the number of stressed HY credit events increased markedly. Credit selection makes or breaks HY performances. In the meantime leverage levels of European issuers remain close to historical lows, interest coverage numbers provide comfort. US HY names boast more leverage risk and carry higher sensitivity to tighter US financial conditions.

Overall, despite signs of rising company-specific credit risk, Moody's expect default rates remain anchored between 2% to 4% over the coming years. With spreads around 500bp , investors are well compensated to weather such a scenario. Excluding the extraordinary September 2008 till September 2009 when HY spreads exploded to the upside, we arrive at an average 425bp HY spread level over the past 15 years. Current valuations lead us towards **a neutral EUR HY recommendation.**

## Emerging Market Debt

We expect **increasing real growth differentials between emerging and developed economies** next to stable to decreasing inflation differentials. The negative performance drivers over 2018 might become tailwinds over 2019. The stronger USD, an upward shift in US Treasury rates and country specific stress events resulted in a subpar performance reading for the sector. However the damage was well contained and local currency EM bonds were far less exposed than hard currency EMD investments.

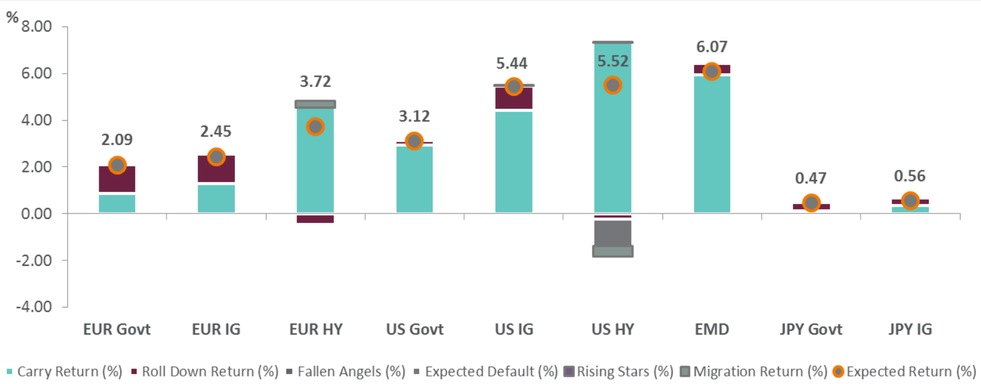
Our **outlook for 2019 is positive**. USD and US rates consolidation serve as a sound foundation. Many EM FX pairs have reached long term attractive levels. We prefer to select EM local currency bonds from governments that exhibit a high dose of 'real politik' as they tackle structural fiscal and social policy challenges.

## Expected returns: all about starting yields

2018 proved to be a transition year when looking at performances. It was the year that fixed income sectors said goodbye to doped calendar year performance charts. Central banks have been absorbing duration for about 10 years. That era is about to end and year over year **returns will fall back to expected return levels** as shown below.

Carry and roll-down returns will become the main components of performance. Investors fall back on the basics in fixed income where coupon income tells the whole story and periods of capital appreciation will be left behind.

***Expected returns across main bond sectors***
*Do not underestimate to power of roll down returns in low rate environment, carry starts dominating when we get closer to the end of the cycle*




Source: DPAM

**What happens to returns when we take normalization paths for long rates predicted by official institutions (US CBO and ECB)?**

Well first of all investors should not panic or try to avoid episodes of increasing long term reference rates.

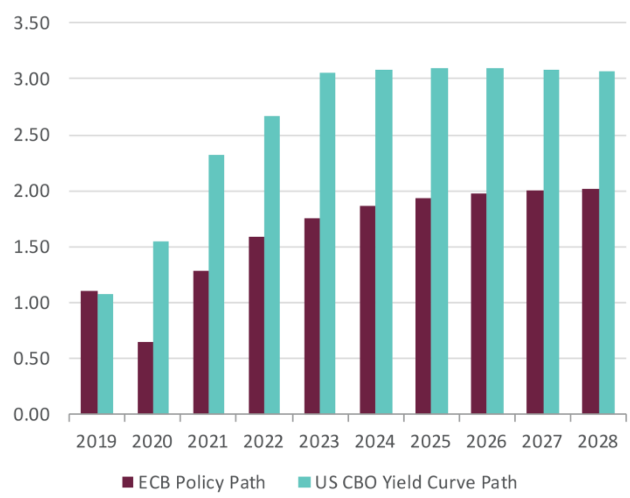
Rule of thumb: the higher the starting yield level, the lower the relative impact of a yield shock. That is the case for most of US bond sectors today. Given current levels of US rates, significant yield shocks have to arise before investors' returns get hurt. In the Eurozone the starting point, in below example 0.95%, provides less comfort.

| End-of-period Yield | Today | 2019 | 2020 | 2021 | 2022 | 2023 - 2028 |
|---|---|---|---|---|---|---|
| US Government | 3.04 | 3.44 | 3.94 | 4.54 | 5.24 | 6.04 |
| Euro Government | 0.95 | 1.10 | 1.30 | 1.50 | 1.75 | 2.05 |

The stacked chart below show the YoY expected returns on US and EMU government bonds.

The relative low change in projected yield increases over the next 5 years, generates no annualized negative results. Investors will need to adapt to a low for longer rates setting. Global diversification, carefull security selection and time will bring forward the **power of compounding returns**.

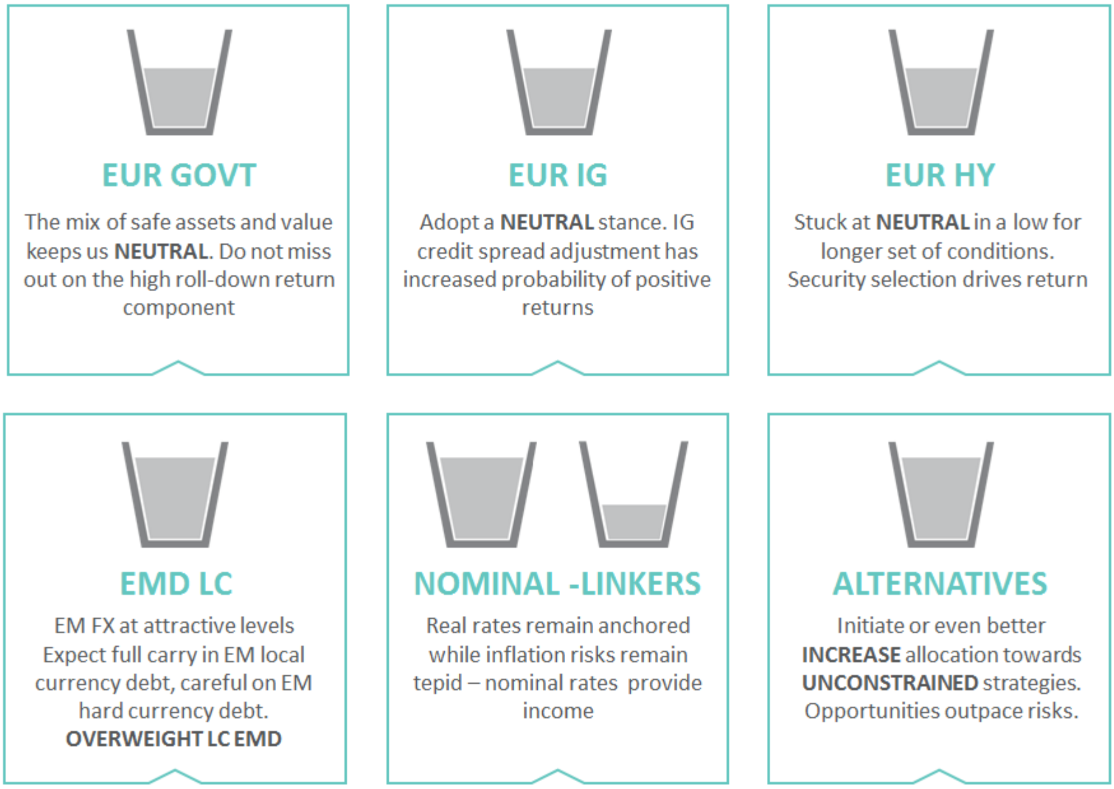
*Annualised Returns*




Source: Bloomberg, DPAM

**Key messages**
International diversification across bond sectors improved your 2018 risk/return equation over 2018. Expect this trend to be persistant. Our confidence in bond markets increased as the year draws to a close. Our current stance is summerized as follows:

- We diversify towards US Treasury curve given attractive carry value.
- We are neutral across € denominated EMU Govt Bonds, IG and HY Corporates.
- We are overweight EM LC Govt Bonds and Global Nominal Bonds (unhedged)
- We are underweight Global Inflation Linked Bonds (unhedged)




## Disclaimer



## Contact

**dpam@degroofpetercam.com ▪ www.dpamfunds.com**