Global Interest Rates: A Race to the Bottom

The sharp fall in bond yields represents a challenge to fixed income investors.

July 2019

KEY INSIGHTS

- Expectations for rate cuts has led to a significant repricing of global government bonds.
- Further easing from the European Central Bank could potentially benefit Eastern European debt indirectly.
- While valuations in investment-grade credit look stretched, Europe is finding support from expectations for more quantitative easing.

Global interest rates are engaged in a race to the bottom as major central banks look set to ease monetary policy to stimulate growth. During our latest policy meetings, the investment team discussed the implications for fixed income markets.

What began as a hiking pause by the Federal Reserve has evolved into a situation in which almost every major central bank has become cautious over growth concerns. "This dovish shift has triggered the start of a new regime in fixed income, with several central banks now expected to ease monetary policy in the months ahead, including the European Central Bank (ECB)," said Quentin Fitzsimmons, a portfolio manager and member of the global fixed income investment team.

In fact, some countries have already taken action. Australia, for example, has cut rates at two consecutive meetings for the first time since 2012. "Countries such as Australia and Chile have shown a willingness to act early, which has attracted a wave of international investors into their local bond markets and driven prices meaningfully higher," said Mr. Fitzsimmons. "Given how far the rally has gone, it may be time to take some profit in these markets."

There has been a significant repricing across global fixed income markets in response to heightened expectations of a more accommodative stance from central banks. In some countries, such as the U.S., multiple rate cuts are now anticipated—to the extent that there is now a debate over whether the market pricing has become too extreme. "While a lot has been priced into the short end of the U.S. curve, it still offers value, especially on a duration-hedged basis versus longer-maturity bonds," noted Mr. Fitzsimmons.

Turning attention to the eurozone, anticipation is building over what the ECB may deliver given its history of

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Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

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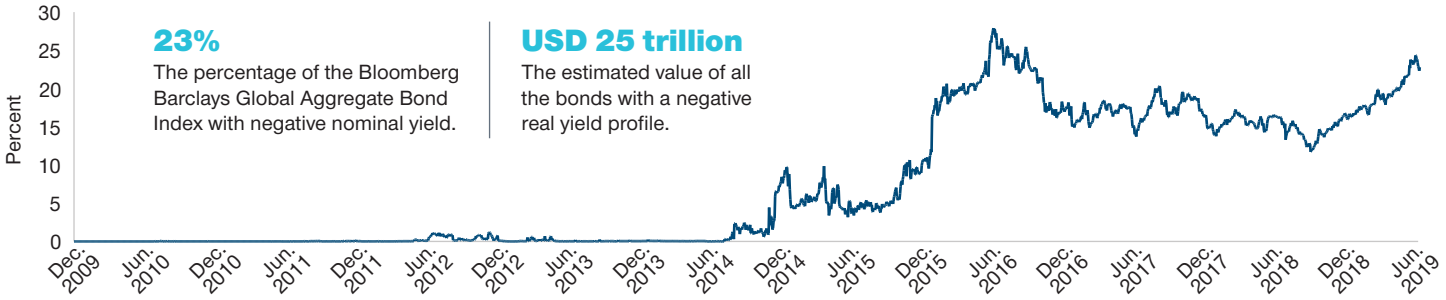
>
> — **Quentin Fitzsimmons**
> *Portfolio Manager*

(Fig. 1) A World of Absolute Zero Yield

Percent of securities with negative yield in the Bloomberg Barclays Global Aggregate Bond Index

As of July 12, 2019



Source: Bloomberg Index Services Limited (see Additional Disclosures).

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>
> — **Quentin Fitzsimmons**
> *Portfolio Manager*

springing surprises during President Mario Draghi's tenure, which is due to end on October 31. "With inflation around its lowest level since inception of the euro, Mr. Draghi's parting gift could be a cut in the deposit rate this September. The door could also be opened for his successor to extend monetary easing even further."

Indeed, markets are pricing in both interest rate cuts and the potential for more quantitative easing, which is pushing rates across eurozone periphery markets lower regardless of fundamentals. "The market is only focusing on the positive technical aspect from further quantitative easing," said Mr. Fitzsimmons. "Italy's weakening fiscal situation, for example, is currently being overlooked. The upcoming 2020 budget discussions may refocus investor minds on Italy's deteriorating fundamentals, which could put its bonds back in the firing line."

In Eastern Europe, bond markets are expected to benefit indirectly from looser monetary conditions from the ECB. Countries such as Serbia and Romania, stand out as those where interest rates could move lower over the medium term. The search for yield could also support euro-denominated sovereign bonds of countries like Lithuania, Latvia, and the Czech Republic should the ECB turn more accommodative.

Credit markets have also enjoyed a strong rally, making them one of the best-performing fixed income asset classes so far in 2019. This does not tell the full story, however, as the performance of corporate bonds has been driven by the search for yield rather than an improvement in fundamentals, which makes valuations look expensive given current economic conditions. For example, the average premium offered by U.S. investment-grade corporate bonds is similar to levels 12 months ago—despite weaker growth and earnings. In some cases, company ratings quality has also declined.

Against this backdrop, it is tempting to be pessimistic about the outlook for corporate bonds. However, it is possible that the current favorable environment might persist for a while yet, especially in Europe. Mr. Fitzsimmons said, "European corporate bonds could become even more expensive if the market continues to believe that the ECB could pull a new bond-buying program out of its hat."

After spending the last two to three years thinking about how far interest rates could rise, the question on all bond investors' minds right now is: how low can interest rates go?

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