Global Policy Rates Stuck in Lockdown

How interest rates could remain at emergency levels for a sustained period.

June 2020

KEY INSIGHTS

- Central banks are likely to remain cautious for some time, keeping the short end of developed government bond curves anchored.
- Longer-dated government bonds could face greater volatility as they become the preferred instrument to express duration views.
- Volatility in long-dated government bonds is a risk for corporates.

Responding to one of the biggest economic shocks of the last 50 years, central banks and governments have pushed the boundaries of monetary and fiscal policy. The impact of this will be felt for some time in bond markets, even though the worst of the crisis appears to be behind us for now. During the latest policy meetings, the investment team discussed what the new fixed income environment will look like as the global economy slowly starts to rebuild.

Short-Term Rates Likely to Remain Anchored

The global recovery may be underway, but hopes of a swift rebound from the downturn have all but disappeared. "While a typical recession usually lasts from four to six quarters, fully recovering from this deep slump is likely to be bumpy and more drawn out than most currently anticipate," said Quentin Fitzsimmons, a portfolio manager and member of the global fixed income investment team.

Given this, central banks are likely to err on the side of caution before they lift emergency interest rates or rein in monetary easing programs. "Central banks will do whatever it takes to maintain stability during this uncertain time," Mr. Fitzsimmons said.

As usual, all eyes will firmly be on the Federal Reserve for direction. "It's doubtful that the likes of the European Central Bank, Reserve Bank of Australia, or Bank of England will take any action toward normalizing interest rates before the Fed does," said Mr. Fitzsimmons. "Central banks have a vested interest to see how the Fed navigates policy, and the indications so far suggest there will be no changes to U.S. interest rates for at least the next two years."

This dovish rhetoric sends a strong message to bond markets. "Shackles have essentially been put on global policy rates," Mr. Fitzsimmons said. "This will likely keep short-dated government bonds anchored for the foreseeable future."

Global Fixed Income Team

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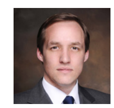

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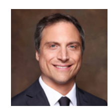

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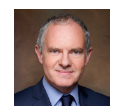

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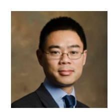

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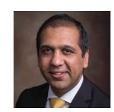

Saurabh Sud

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*

Countries where the short end of the curve offers modest positive roll-down look attractive in an environment of prolonged low interest rates, the investment team noted. The bond markets of countries such as India, China, and South Korea stand out as still offering appealing opportunities on this front.

Longer-Dated Bonds Expected to Exhibit Volatility

For long-dated government bonds, however, the performance pattern is likely to exhibit more volatility. Mr. Fitzsimmons said: "Even though global central banks are likely to remain on hold, the fiscal pressure is building as almost all governments launched large stimulus programs in response to the pandemic. This could drive massive issuance of longer-maturity bonds, with potential knock-on effects for the supply and demand dynamics in this part of the curve. This could lead to short-term price disruptions."

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

Growing expectations that the Fed may introduce a policy of yield curve control, like Japan did in 2016, could also cause longer-dated bonds to become more volatile. In Japan's experience, yield levels of specific short- and intermediate-dated maturities were targeted, while longer-dated Japanese government bonds, such as 30-year bonds, were given more freedom to move. Australia also adopted a similar policy recently. "Yield curve control is, for the most part, a statement of intent by a central bank to look away from traditional monetary policy. It should not be viewed as an automatic stabilizer for long-dated bonds," Mr. Fitzsimmons said.

Against this backdrop, 30-year bonds across a range of developed countries, including the U.S., UK, and Germany, could become more impacted by duration rebalancing going forward. That's because we expect investors to start using longer-dated bonds as their instrument of choice to express absolute yield views and amend duration profiles in their fixed income portfolios.

Volatility in Long-Dated Government Bonds a Risk for Corporates

Corporate bonds could also be impacted by greater volatility in long-dated government bonds. In the last two months, companies have rushed back to the primary bond market to raise new cash, with some opting to sell long-dated bonds to push out their refinancing needs.

While supply has been met by strong demand so far, there are risks involved with taking on more duration that might not have been fully understood by market participants. "Investing in long-maturity corporate bonds carries risks," Mr. Fitzsimmons said. "The moves in core government bonds at the end of May and in early June when curves steepened rapidly should serve as a reminder that the pricing of long-dated corporate bonds is not only determined by credit spreads, but also by its interest rates duration component."

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