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POLICY INSIGHTS

May 2018

The view from our global fixed income portfolio managers.

GLOBAL INVESTMENT TEAM


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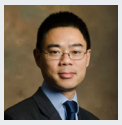
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Once a month, our fixed income portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This monthly article series examines one of the predominant themes highlighted during their discussions.

How Far Can U.S. Fixed Income Decouple From European Bond Markets?

The gap between yields on U.S. and German 10-year government bonds has reached its widest level in almost three decades. During our latest investment policy meetings, the global investment team took a deep dive into the underlying dynamics to determine whether this trend is at an inflection point or whether further decoupling between the U.S. and other developed markets should be expected.

Markets expect the Federal Reserve to deliver at least two additional interest rate hikes in 2018. Beyond that, U.S. interest rate futures indicate markets are priced for one interest rate rise in 2019 and none the following year. Reflecting these expectations, the Treasury market has flattened considerably, with the short end selling off aggressively while the long end has been anchored by expectations that the Fed's terminal rate will be lower in this cycle. However, the investment team believes that it may be too soon for markets to discount the end of the tightening cycle and that the risk still remains for rates to go higher.

"Pressure is likely to remain on U.S. Treasuries, particularly in the medium part of the curve," said Quentin Fitzsimmons, portfolio manager and member of the fixed income global investment team. "But given the magnitude of the moves experienced already, it will be important to trade duration positioning tactically as it is unlikely that interest rates will rise in a straight line."

Key to this will be how the overall macro environment evolves, the investment team noted. The story so far this year has been of the U.S. economy outperforming peers as momentum in several developed countries slowed. The UK, in particular, stands out in this regard after a string of weak data releases led to the markets pricing out rate hikes, which provided a boost for local bonds.

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>
> –Quentin Fitzsimmons, Portfolio Manager and Member of the Global Fixed Income Investment Team

In the eurozone, the slow pickup in inflation and the deceleration in economic growth have been supportive for government bonds versus the U.S. But it is important to note that the eurozone economy is still growing above potential, and it is possible that the European Central Bank (ECB) will end its

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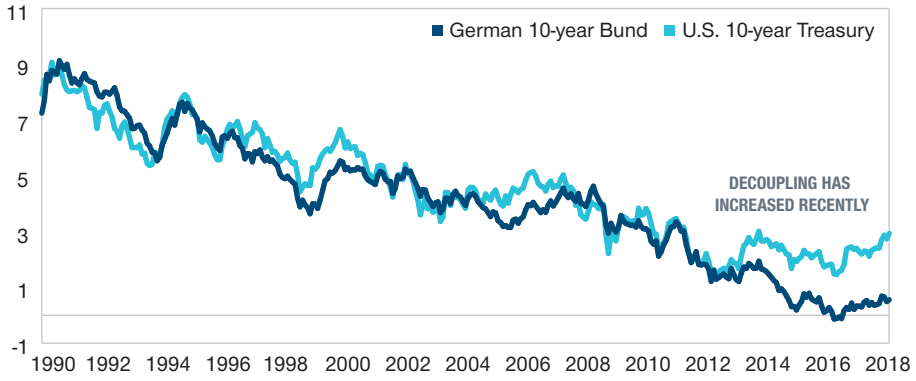
"The time may be coming for the market to show the euro a bit more love."

–Quentin Fitzsimmons, Portfolio Manager and Member of the Global Fixed Income Investment Team

FIGURE 1: **Relationship between U.S. and Germany 10-year interest rates (%)**

As of April 30, 2018



Source: Reuters.

bond-buying program sooner rather than later, a development that markets have yet to fully factor in.

"European bonds will have to play catch-up with U.S. Treasuries at some point," said Mr. Fitzsimmons. "I am not sure how long real yields in Europe can remain in negative territory if domestic growth steadily delivers above 2% for the next two years."

Technical factors will also be important, the investment team noted. The rapid rise of U.S. Libor has been a headwind for U.S. Treasuries, while international investors have bought more European bonds and have reduced their Treasury holdings due to the expensive cost of hedging dollars.

Supply considerations must also be taken into account. During the first quarter, the Treasury announced that net borrowing totaled a record USD $488 billion, over USD $40 billion more than expected. With tax cuts and increased government spending, U.S. deficits are expected to continue widening. To fund this, more Treasuries will need to be issued, raising an additional question mark over their value.

The team also surveyed currency markets for signs of whether the decoupling is also influencing foreign exchange. Until recently, the interest rate differential had not led to specific U.S. dollar appreciation. The recent trend reversal has been met with some degree of skepticism among the investment team, which believes the market has been too focused on short-term data. "The backdrop of steady growth and a large current account surplus should be supportive for the European currency. The time may be coming for the market to show the euro a bit more love" said Mr. Fitzsimmons.

The corporate sector is one market where the decoupling could come to an end, the investment team noted. U.S. investment-grade corporate bonds have struggled year-to-date, while their European counterparts have managed to hold better. However, it is possible that this divergence will end soon as the level of the ECB's Corporate Securities Purchase Program has dropped significantly in the past four weeks following a frontloading of buying earlier in the year to meet larger-than-expected bond supply. "European investment-grade corporate bonds could be vulnerable to a correction with the ECB potentially stepping away from markets at a time of heavy bond issuance," concluded Mr. Fitzsimmons.

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