Central Banks Are Not Out of Ammunition Yet

How the prospect of further monetary easing could impact bond markets.

November 2020

KEY INSIGHTS

- Developed market central banks ready to take new action to support struggling economies.
- Positioning on the yield curve is important as bond-buying programs vary across central banks.
- Emerging market central banks expected to stay on hold, benefiting local debt.

Central banks are not done yet. With economic recoveries under threat, several developed market central banks, including the European Central Bank (ECB) and the Bank of England (BoE), look set to unveil new supportive measures over the coming weeks and months. What we should expect from these measures and their implications for bond markets in particular were the key discussion points during our latest investment policy meetings.

New Monetary Policy Fire Power Expected to Be Unleashed

Although there may have been welcome progress recently on a vaccine for the coronavirus, it does not change the current state of play—cases have risen rapidly across the world, leading to the reintroduction of lockdowns and restrictions in several countries. This has left economies struggling, particularly those with dominant service sectors.

"In the summer, it looked like we had seen all there was to see from central banks in 2020," said Quentin Fitzsimmons, a portfolio manager and member of the fixed income global investment team. "Fast-forward to today, and it's a very different picture—several economies remain under huge strain, and central banks are looking into their toolkits to see what firepower they have left to provide support," he said.

Among high-quality countries, potential candidates for further monetary easing include Sweden, South Korea, and Israel. The BoE is another contender given that it has made no secret of the fact that it is considering negative rates. Similarly, the ECB has said that with economic risks titled to the downside, all tools are being reexamined—which we anticipate could result in the expansion of its bond-buying program and possibly a cut to the deposit rate in early 2021.

Global Fixed Income Team

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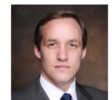

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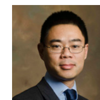

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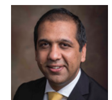

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Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

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Portfolio Manager

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"Let's not forget that the Federal Reserve's rhetoric has been even more dovish lately, raising the possibility that the world's largest central bank could also provide additional accommodation," said Mr. Fitzsimmons. "The current negative impact of surging coronavirus cases on the U.S. economy far outweighs the positive news about a possible vaccine."

Where to Find Duration Value

In government bond markets, the prospect of further monetary easing provides a broad supportive anchor. But with bond-buying programs varying from country to country, we believe it is important to assess each on an individual basis. "A key decision as we head into 2021 is not simply how much duration[1] is needed in fixed income portfolios, but rather which part of the yield curve is potentially best to overweight because of a specific country's central bank behavior," said Mr. Fitzsimmons.

In the U.S., we favor the short end of the Treasury curve as this area is likely to remain well anchored, thanks to the Fed's support. The long end, meanwhile, could continue to face volatility as there is the potential for new fiscal stimulus and the possibility of growth rebounding in 2021 when vaccines are rolled out.

By contrast, we prefer the long end of curves in eurozone government bond markets. "The ECB's bond-buying program is relentless and looks set to be expanded again soon," said Mr. Fitzsimmons. "Against this backdrop, we feel there's more value in the long end of curves in the eurozone, where additional issuance will likely be more than compensated by the regular central bank purchases."

Keeping some flexibility around yield curve management is important, however. Yield curve valuations have been heavily impacted this year by how markets have discounted fiscal easing across different economic regions. With that in mind, any signs of fiscal retrenchment in 2021 may lead to significant readjustments in yield curve shapes.

Emerging Markets Expected to Buck the Easing Trend

Contrary to developed markets, we anticipate that the majority of central banks in emerging markets (EM) will keep monetary policy broadly stable.

"EM central banks have done as much as they can when it comes to monetary easing. While further modest cuts in places can't be ruled out, largely we expect a pause in 2021," said Mr. Fitzsimmons. That said, it is possible that many of the EM central banks will decide to retain an easing bias in their communication in the early part of next year because they will want to avoid seeing their currencies appreciating too much against the U.S. dollar. This backdrop makes EM local currency bonds an interesting asset class.

Indeed, the steepness of local government bond curves in select EM countries, such as Indonesia, Israel, and Peru, is likely to remain attractive in the current environment, where interest rate volatility remains shackled by the Fed and the ECB's ultra-easy policy stances.

"EM stands out in the current environment with interesting opportunities in both currencies and local bonds," said Mr. Fitzsimmons, noting that the team has been increasing exposure recently in select countries, such as Brazil and Serbia.

[1] Duration measures a bond's sensitivity to changes in interest rates.

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