THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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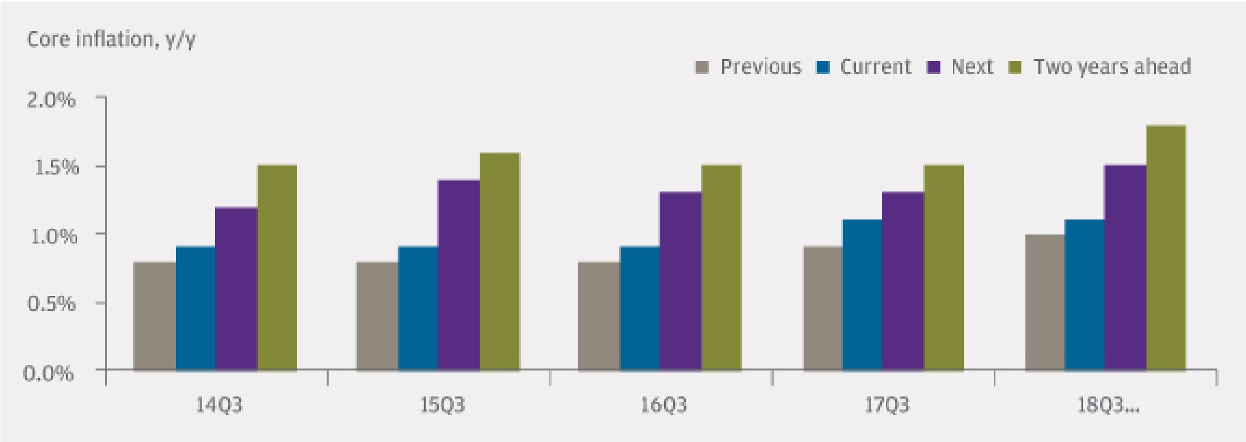
A breakthrough for Bunds

The 10-year German Bund yield broke the 0.50% threshold for the first time since May. Does this reflect a shift in the eurozone inflation regime? Keep watching the data.

Fundamentals:

European growth remains above trend, although recent data prints suggest a softening in momentum. The eurozone manufacturing purchasing managers' index weakened in September, as did consumer confidence, though the German Ifo was more encouraging, suggesting improved business sentiment. However, recent moves in the European government bond space have been driven more by the inflation narrative—in particular, European Central Bank (ECB) president Mario Draghi's comment that he expects a "relatively vigorous" pickup in underlying inflation, which has caused the market to question the central bank's future path of rate hikes. The ECB has long expected an increase in inflation, but these forecasts have previously seemed optimistic. This time, there is more reason to believe that they could be right. First, slack has diminished in the economy, with eurozone unemployment at the lowest level since 2008. This has begun to feed through into wages: an average of eurozone wage measures registers at the highest point in nine years. And finally, base effects are likely to bias inflation upwards over the next few months. While the ECB's forward guidance has been extremely clear, making a rate rise very unlikely before September 2019, we could see a more hawkish path of rate hikes if inflation picks up—and more specifically, if wage inflation feeds through into core inflation.

Historically, ECB inflation forecasts have seemed optimistic—but this time could be different



Source: European Central Bank; data as of September 2018. y/y=year on year.

Quantitative valuations:

German 10-year Bund yields closed at 0.54% on 25 September, breaking through the key technical level of 0.50% for the first time since 23 May. While a meaningful upward move from current levels is contingent on inflation data, it's worth noting that fair value models suggest the 10-year Bund yield should be materially higher. Currency markets have reacted on the back of the rates move, with the euro 0.9% stronger vs. the US dollar over the past week, to close at 1.18—the highest level since mid-June (data to 25 September).

Technicals:

The ECB's quantitative easing programme has been running for well over three years, providing unprecedented support to the European bond market. Year to date, these asset purchases have absorbed essentially all of the total net sovereign issuance across the eurozone. With a step down in purchases due on 3 October—from EUR 30 billion per month to EUR 15 billion—before a complete cessation by the end of the year, a key structural driver of the market will disappear. While this process has been clearly telegraphed by the ECB and is therefore priced into markets, it is nevertheless supportive of higher government bond yields across the region.

What does this mean for fixed income investors?

We believe the grind higher in German Bund yields could persist, though a meaningful break out of the recent range will require clear evidence that inflation is trending upwards. As a result, we remain cautious on core government bonds—though we note that any pickup in political risk could see them resume their safe haven status. History tells us that credit sectors could have the ability to absorb any move higher in rates, so long as the higher yield environment is not driven by a monetary policy shock.

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