THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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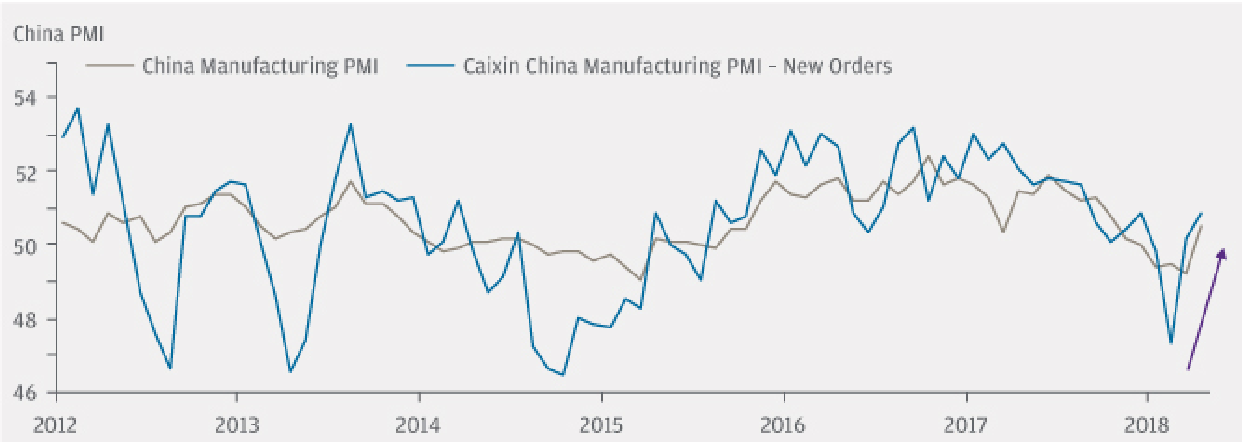
Momentum in manufacturing?

Weakness in the global economy has been almost entirely driven by the manufacturing sector. With recent data showing tentative signs of a recovery, what could be the implications for bond markets?

Fundamentals:

The manufacturing sector, outside the US, is arguably experiencing an industrial recession, while services have been more resilient. The eurozone manufacturing purchasing mangers' index (PMI) peaked in December 2017 at 60.6 and has declined every month since then except for one, to the current reading of 47.5 (signalling contractionary territory). Primary drivers of this downturn are twofold: first, the slowdown in China and threat of tariffs on supply chains, which has weighed on economies globally; and second, Brexit uncertainty, which has hit Europe specifically. Although these issues have yet to be fully resolved, recent data prints show tentative signs of bottoming and a potential turn in the global manufacturing cycle. In China, the March manufacturing PMI print, at 50.5, was better than expected (even adjusted for seasonal factors such as Chinese New Year), supported by infrastructure. Leading components such as new orders also had a meaningful rebound. This improvement has been further verified by data releases in Korea and the US.

Recent Chinese data was better than expected, possibly indicating a turn in the global manufacturing cycle



Source: Bloomberg, Markit, China Federation of Logistics and Purchasing; data as of 31 March 2019.

Quantitative valuations:

Momentum in the manufacturing sector could drive global yields higher—if we see more concrete signs of a recovery. Although the US economy has been more resilient than other regions, global weakness has influenced the Federal Reserve's shift to a more dovish policy stance and the subsequent rally in Treasuries. As such, further evidence of improvement in the manufacturing cycle may push US yields higher. There may also be scope for core European rates to reverse much of the rally we've seen since the start of March, which has taken German 10-year Bund yields from 0.18% at 28 February to -0.05% at 2 April. However, a more sustained sell-off in Europe would require a significant pickup in inflation, which continues to be very subdued.

Technicals:

Investor positioning in US Treasuries has been moving longer since the fourth quarter last year, though this shift appears to have peaked. While the market is still far from being short duration, positioning is certainly cleaner, potentially allowing fundamental factors to have more of an influence on market moves. Our daily fund flow monitor also indicates a shift in risk bias: US equity funds have registered more than USD 37 billion of outflows year to date (to 1 April), while core fixed income funds have seen USD 41 billion of inflows.

What does this mean for fixed income investors?

A rebound in the manufacturing sector could have a meaningfully positive knock-on effect to global economies. However, it will be key to monitor upcoming prints for more concrete evidence. Given that the data improvement alone is unlikely to spur a significant sell-off in core rates, we continue to favour high-quality carry, especially in Europe given the persistent search for yield in a negative rate environment. We also see exposure to commodity-linked currencies as a way to capitalise on the better Chinese data.