THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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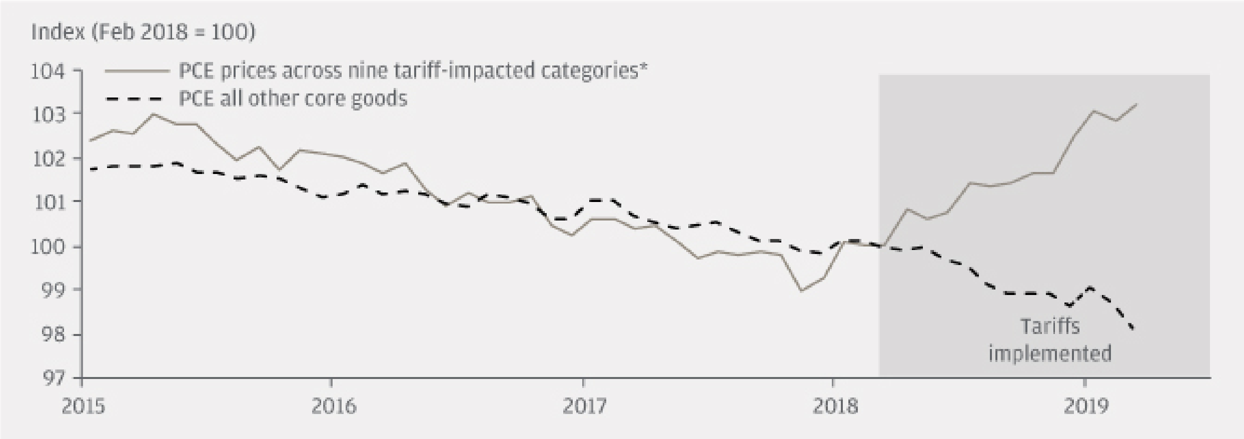
Trading on trade wars

Trade rhetoric is dominating news flow, weighing on risk assets. What could be the implications for US growth and inflation, and how is the outlook reflected in valuations?

Fundamentals:

The US has raised tariffs on USD 200 billion of imports from China from 10% to 25%, with additional tariffs still being threatened on a wider range of imports. The costs are set to be borne by consumers, as US companies competing with China on tariff-impacted products have hiked their prices correspondingly, putting upward pressure on inflation. The direct effect on growth may be relatively limited given the size of the US economy: the USD 74 billion of tariffs announced so far amount to 0.35% of US GDP. However, there will also be potentially meaningful indirect effects, through financial conditions and business confidence. We continue to expect some form of resolution, though the timing has likely been pushed back. With some fourth-quarter headwinds, notably central bank policy, having been addressed, trade wars now appear to be the key driver of risk sentiment.

Higher tariffs are feeding through to higher consumer inflation



Source: Goldman Sachs; data as of 31 March 2019. PCE: Personal consumption expenditure. *Includes laundry equipment and other appliances, furniture, bedding, floor coverings, auto parts, motorcycles, sport vehicles, housekeeping supplies, and sewing equipment and materials.

Quantitative valuations:

Markets have proved increasingly sensitive to trade rhetoric over the past month. Ten-year US Treasury yields have continued to rally from their recent peak of 2.6% on 17 April, to a current level of 2.41%. Meanwhile, high yield and investment grade spreads have widened 36 basis points (bps) and 7 bps respectively since the end of April. In the context of this year's rally, these moves are not large, but should the sell-off persist, it may create buying opportunities. (Data as at 14 May).

Technicals:

Recent supportive technical factors for fixed income have softened somewhat. Fund flows have turned negative for both high yield and emerging market debt, although not to an extent that would cause us concern, while investment grade funds have continued to attract inflows. On the supply front, we are coming out of the earnings blackout period for most corporates, so we expect primary market activity to be elevated for a short while. In the busiest week of issuance so far this year, US investment grade markets had to absorb about USD 46 billion in new supply in the week to 10 May, including two of the 10 largest bond deals on record (Bristol Myers Squibb and IBM). In the high yield market, supply has picked up too, but not quite to the same extent, and plenty of cash is expected to come back to investors through bonds being called. Although supply has picked up in credit markets on the whole, we retain our long-term outlook of low net supply.

What does this mean for fixed income investors?

We do not expect a repeat of the risk asset rout experienced in the fourth quarter of last year, given that some of the growth worries have been addressed and central bank policy looks set to remain accommodative for the foreseeable future. Trade wars therefore continue to be one of our main concerns, especially now that the tail risk has likely increased. We believe a significant determinant of the future direction of trade policy will be market reaction. Should risk assets sell off substantially, the US administration may strike a more conciliatory tone, providing investors with a buying opportunity. However, if the recent risk-off move proves to be just a wobble, Washington may be emboldened to put further pressure on China by following through on tariffs that have been threatened but not yet enacted.

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