

THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

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Forecasting the Fed

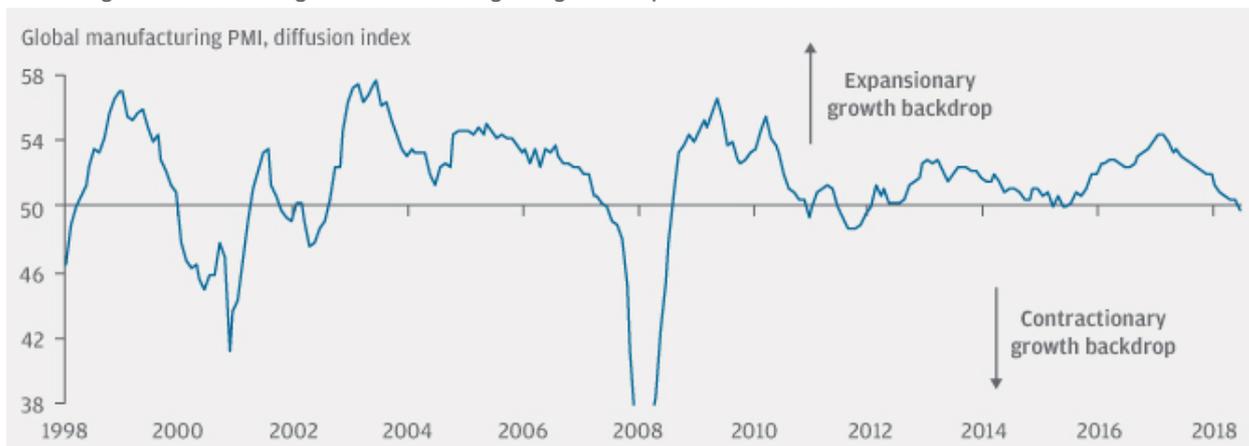
With Mexico the latest target of Washington's tariff tactics, trade tensions are clearly escalating, not subsiding. Could this be the final straw to push the Federal Reserve to cut rates?



Fundamentals:

The global manufacturing purchasing managers' index (PMI)—one of the best leading indicators of global growth—entered contractionary territory in May for the first time since 2012. Historically, this statistic has only fallen below the crucial 50 level in recession or rate cutting cycles. Digging below this headline number, responses to the survey included comments emphasising the negative impact of trade uncertainty on investment and confidence, suggesting that the outlook is also fairly bleak. Combined with the benign inflation backdrop, is this trade escalation—and its effect on growth—what was needed to drive the Federal Reserve (Fed) to cut rates this year? It's possible, though financial conditions have not yet weakened substantially and they remain easier than in December 2018, so there are still two sides to the story.

The weak global manufacturing PMI reflects the negative growth impact from trade wars



Source: Bloomberg, Markit, JPMorgan; data as of 3 June 2019.



Quantitative valuations:

The yield on the 10-year US Treasury has rallied more than 100 basis points from its peak of 3.24% in November 2018, to 2.13% on 5 June. Markets are now pricing in more than two rate cuts from the Fed between now and the end of the year, partially driven by Fed Chairman Jerome Powell's speech on 4 June where he stated that the central bank "will act as appropriate to sustain the expansion". Many interpreted his comments as an indication of imminent rate cuts, though we did not think he was universally dovish and there may have been some overreaction in financial markets, with equities posting their strongest single day performance since January.



Technical:

Investors are largely positioned long duration, and they have been for much of this year. While consensus positioning does pose a risk, it will likely only become an issue when there are no further catalysts for driving yields lower. On the flows side, recent activity has had a risk-off tone with equities, high yield and emerging market debt posting outflows in the week to 3 June. However, money continues to come into unconstrained fixed income and government bond strategies, suggesting that demand for bonds—and duration—is still there.

What does this mean for fixed income investors?

Developments over the week, both in terms of the further escalation of trade tensions and central banks' reaction function, point to an increased likelihood that the Fed will cut rates sooner rather than later. Regardless of the timing of any rate cut (which would be the Fed's first since 2008), it will be key to consider whether the reduction is a one-off "insurance cut" or the start of a rate cutting cycle. This difference could have important implications for risk assets and currency markets: an insurance cut could boost risk assets and weaken the US dollar as it signals that the Fed is willing to support markets and prolong the expansion; while the start of a rate cutting cycle would likely be negative for risk assets and positive for the US dollar as it suggests that we've reached the end of the economic cycle.

About the Bond Bulletin

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Our common research language based on **Fundamental, Quantitative Valuation and Technical** analysis provides a framework for comparing research across fixed income sectors and allows for the global integration of investment ideas.



Fundamental factors include macroeconomic data (such as growth and inflation) as well as corporate health figures (such as default rates, earnings and leverage metrics)



Quantitative valuations is a measure of the extent to which a sector or security is rich or cheap (on both an absolute basis as well as versus history and relative to other sectors)



Technical factors are primarily supply and demand dynamics (issuance and flows), as well as investor positioning and momentum



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