THE FUTURE OF FIXED INCOME

Weekly Bond Bulletin

9 August 2019

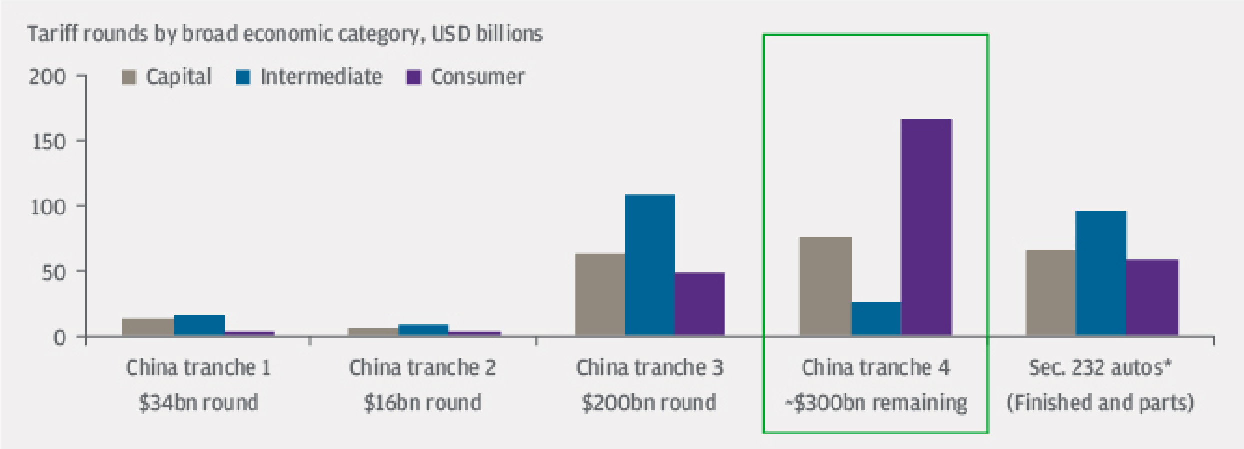
Trading on trade

A new trade announcement from the Trump administration has comprehensively overshadowed the Federal Reserve's first rate cut since the financial crisis. What impact will the most recent round of tariffs have on the economy and on markets?

Fundamentals:

The US decision to impose 10% tariffs on the remaining USD 300 billion of Chinese imports (effective 1 September) is momentous for two reasons. First, whereas the goods affected by the previously introduced tariffs could be substituted with equivalents purchased from other countries, production of the goods in question this time around (such as smartphone parts) is dominated by China, and therefore the impact of the tariffs is likely to be greater. Second, this final tranche of tariffs is focused on consumer goods, whereas previous rounds were more targeted on intermediate goods. Up until now, the consumer has been the bright spot of the US economy, but these tariffs could threaten that as companies are expected to pass through the higher costs to consumers. Beijing's retaliation—in the form of allowing the renminbi to weaken—led the US Treasury to label China a currency manipulator. While the validity of that label is questionable, it is important nevertheless, as the US may use it as justification for further escalation. What form might this escalation take, given that the US administration has now tariffed all Chinese imports? In theory, there is nothing stopping the US from increasing tariff rates beyond the current maximum of 25%.

The final tranche of tariffs on Chinese imports will hit consumer goods the most



Source: Goldman Sachs Global Investment Research; data as of 5 August 2019. *Proposed, not yet enacted.

Quantitative valuations:

Market reaction to the trade news was considerable, with risk assets selling off and safe havens rallying. Ten-year US Treasury yields fell 36 basis points (bps) to 1.70% in the week to 6 August—the lowest level since before President Trump was elected in November 2016. Meanwhile, US high yield spreads experienced the largest single-day widening move since the Brexit referendum in June 2016, rising 34 bps on 5 August. With the rally in core bonds, 90% of European covered bonds now have a negative yield, and a total of 15 countries have joined the negative 10-year bond yield club (as at 6 August). While 10-year US Treasury yields have already broken through the bottom end of our expected 1.75% to 2.25% range, we think rates could rally further as markets are being driven more by the trade newsflow than by valuations.

Technicals:

Technicals continue to be a powerful positive tailwind for fixed income markets. In particular, the prospect of quantitative easing from the European Central Bank is intensifying the search for yield and driving demand for any sort of positive-yielding fixed income security. Further support is coming from the seasonally low supply calendar and, particularly in the European high yield space, from cash returned to investors via corporate actions. Given a lack of incremental news on trade, these overpowering technical factors can continue to push fixed income returns higher—though we are mindful that technicals can reverse quickly.

What does this mean for fixed income investors?

As we look ahead to our Investment Quarterly meeting next month, the balance of risks is pointing firmly to an increasingly sub-trend growth environment. While central banks may be able to cushion the blow of tariffs by easing policy further, the likelihood of recession will ultimately be driven by trade and the extent to which it percolates through the economy. Strategically, we continue to favour a long duration stance, though there may be tactical opportunities to trade on trade newsflow, and we recognise that core bond yields could consolidate in the absence of new news.

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