Central Banks change their tone

Paul Brain

In the second half of 2016, the bond markets were spooked by the political shift away from austerity and towards talk of fiscal expansion. At the time Central Bankers were hinting that they had done enough and that any further deflationary concerns would need to be offset by government action rather than further QE or moves into negative rates. To be fair there had been a significant monetary boost coming from the ECB, the Bank of Japan and the Chinese authorities so they were probably right to switch the debate.

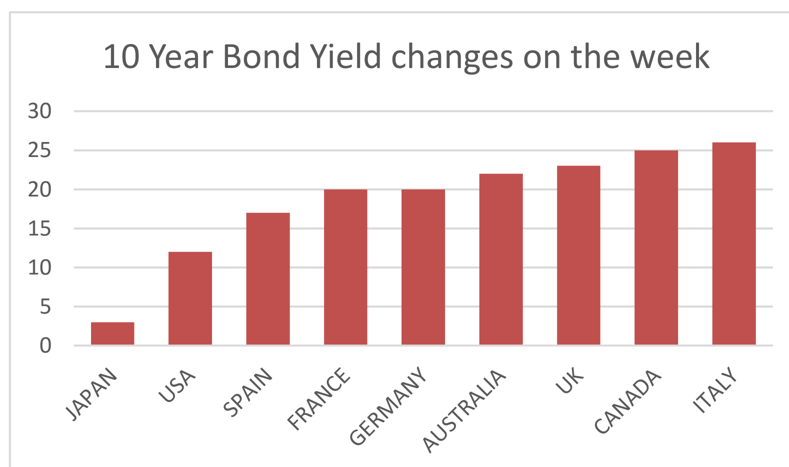
The Global economy has been expanding for several years and the brief slip towards slower growth in 2015 early 2016 was arrested by the last splurge of monetary stimulus. See chart on the left.

Collectively the Central Bankers seem to have shifted the debate a little further over the last couple of weeks.

With the Federal Reserve on a gradual path of rising rates, their attention has shifted to how they will unwind their large balance sheet by not re-investing the proceeds of coupons and redemptions. Meanwhile some members of the Bank of England MPC have voted to raise rates and comments over the last two weeks have pointed towards higher rates if the data continues to improve. ECB members have changed their tone, subtly, suggesting they can look through any temporary moves in inflation and focus on the broadening European economic recovery. We have highlighted for some time that the pick-up in European lending is likely to aid the recovery and as a result, the ECB will have to talk about removing their monetary stimulus before the end of the year. Other economies where the authorities may be inclined to have a 'hawkish tone' are Canada, Sweden and Norway.

We remain sceptical that there can be aggressive tightening of monetary policy in the face of some significant deflationary headwinds. 20 years of over-investment in emerging markets have led to chronic overcapacity globally, and their remains a bias towards savings in the west, and financial repression globally. That said, there are a few bond markets where the change in tone of central banks needs to be further priced in. (European, UK and Canadian bond markets for example). We expect the central banks to only tighten from here in areas where the economic data justifies it.

However bond markets have responded to this change in tone by selling off. As you can see from the chart on the right the European, Canadian and UK markets have suffered the most. In the US, the central bank's message has only subtly changed, and the Bank of Japan is committed to its QE programme for the foreseeable future.



NEWTON
Investment Management

Currency markets have also changed direction. The currencies of those central banks who have changed their stance the most (hawkishly) have benefitted over the last 2 weeks.

Strategy

To avoid losing money in European bond markets the Global Dynamic strategy has most of its Euro interest rate risk hedged by shorting the Bund market through futures. It also has a short Gilt futures position to hedge against rising Gilt yields. We added to the Gilt short position last week. Overall duration is around 2.7 years, with the majority of that duration biased towards USD bonds. The US bonds are partially hedged using put options on the US 10 year, which we have also increased.

We have changed the currency profile to move towards currencies that can benefit from this central bank shift. We have increased our European currency positions by owning SEK and NOK and we have increased our JPY short position in favour of the MXN.

Going forward, with the US economy likely to slow modestly from here and the Fed unlikely to want to spook the market, we expect 10 year yields to stay within the range on the left. The possibility of some form of tax change, that could prove positive for growth, will keep the bias upwards for now (the put options will limit the downside for the strategy), whilst the gradual decline in US inflation towards the end of the year will send yields back towards the bottom of the range.

European bond yields, on the other hand, need to rise further and the underperformance of Bunds vs US Treasuries since the beginning of the year, as shown by this chart, will continue.