MARKETS

Outlook 2019: Global bonds

The storm clouds are gathering for fixed income investors who may soon have to leave behind the quiet life which they have become accustomed to since 2008.

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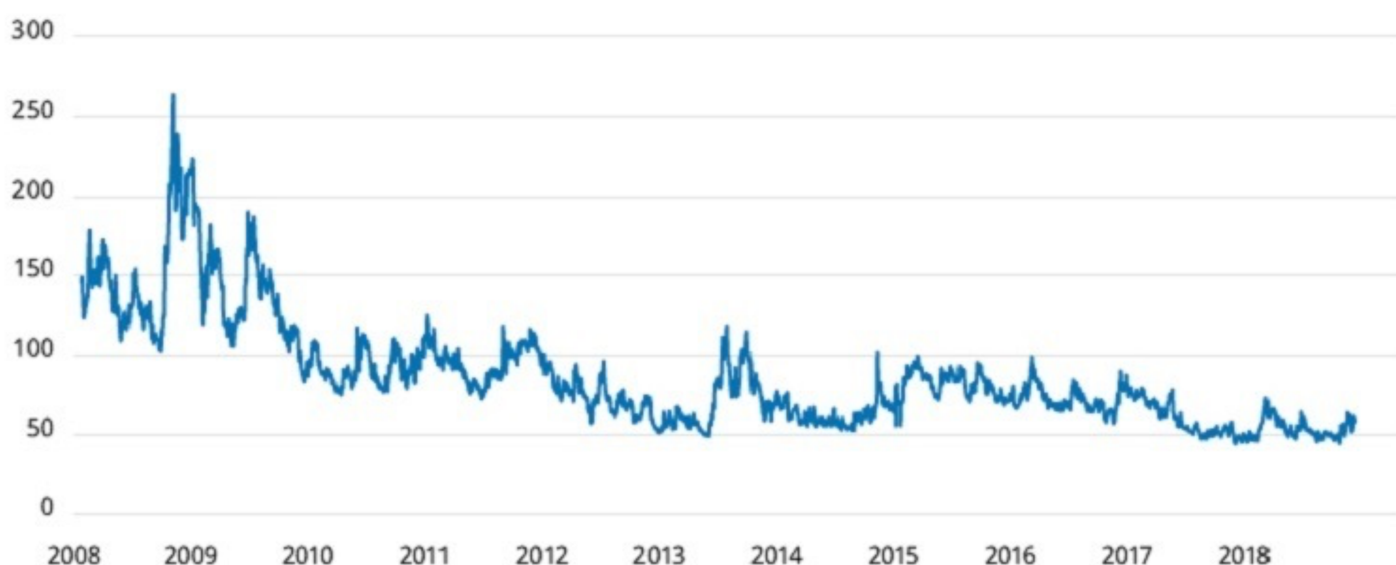
- *The post-2008 low volatility sea of tranquillity is being disrupted by monetary policy adjustments and geopolitical factors*

- *We see a mixed picture: the US expansion has further to run (good), red flags such as excessive consumer borrowing remain absent (neutral), but market gains are likely to moderate (negative)*
- *Countries and companies with a lot of debt may be vulnerable and we see the shifting environment resulting in opportunities for active investment approaches*

For most of the post financial crisis period, fixed income markets have been a relative sea of tranquillity, with volatility (the degree to which prices fluctuate) declining at first precipitously before stabilising at a historically low level (see chart).

Post-crisis sea of tranquility in US Treasury yields



Source: Bloomberg. Merrill Lynch Option Volatility Estimate (MOVE) Index as at 21/11/2018 (measuring the volatility of US Treasury yields, the level of fluctuation in yields, using one month options contracts).

Past performance is not a guide to future performance and may not be repeated.

How to explain this? Central banks have been extremely influential in driving down volatility and until now, suppressing any periodic upticks in market fears. Interest rates have been lowered to unprecedented levels, with central banks adding to the stimulus by expanding their balance sheets with quantitative easing (QE), where money is printed in order to buy bonds in the open market.

Money has been freely available and central banks have been offering apparently unlimited economic support through the printing presses. It is perhaps then no surprise that any political or economic shocks have failed to generate any real escalation of concern you would normally associate with a pick-up in market volatility.

However, enough of history, time to dust off the crystal ball for 2019.

First, what has changed?

1. **What was, post the Global Financial Crisis, a problem of meaningful underemployment of labour is now verging on a global shortage.** US unemployment is now around 50 year lows, in Japan the job vacancies to applicants ratio is at 45 year highs and even with the ongoing Brexit fears UK unemployment is the lowest since 1975.
2. **Central banks seem increasingly convinced QE has had its day and interest rates need to rise**. Having fretted over the potential for inflation to fall into deflation (falling prices), central bankers are willing to say such risks have receded enough to take away some of the QE punchbowl. Even in Europe, which lags the rest of the world's economic recovery, the central bank has announced the probable end of its QE programme.
3. **Governments are loosening the purse strings**. Whether it be the more spectacular fiscal splurge of Donald Trump, in the form of substantial tax cuts, or the more measured 2018 budget announcement from the UK government, billed as marking the end of several years of austerity, governments are taking steps to make life easier for their electorates, pretty much globally. Whether it be caused by a rise in populism or improved government finances, fiscal policy is more of a global economic tailwind.
4. **The rise in protectionist tendencies.** US President Donald Trump characterises his administration as "America first". His decision to impose tariffs on imports from China has had a detrimental impact on economic sentiment in Asia. The region, together with the majority of emerging markets, has suffered for the majority of 2018. The outlook for global trade remains uncertain. President Trump's stance towards China and trade more generally will remain a key factor in determining the future path of the global economy and markets.

Where from here?

After a decade of extreme monetary policy accommodation, it's hardly surprising there is a degree of market turbulence as central banks begin the gradual removal of these policies. Markets are acclimatising to the shift and some of the more inflated riskier assets, equities notably, have recently suffered. From here we see a mix of both good, neutral but also some negative developments.

The good news: the US expansion looks more durable than most commentators suggest. Our analysis suggests productivity (often measured as amount of economic output, or GDP, per amount of input, usually hours worked) could rise going forward. While this may involve interest rates ultimately settling at a higher level, it also suggests a stronger level of growth. The positive developments in terms of higher productivity could also extend beyond the borders of the US.

The more neutral news: domestic economic activity in most parts of the world is moving ahead nicely, consumers are mostly living sensibly within budgets and many of the excesses which can often appear after a long period of economic expansion and as the economic cycle starts to mature, are still largely absent. For the most part, employment and average wage earnings growth are reasonable rather than excessive.

Inflation, while nudging higher, is again not flashing any real warning signals of excess. While monetary policy accommodation (QE, low interest rates) may be removed, should the above backdrop continue, central banks can continue to remove it gradually without risking choking-off economic activity.

The bad news: asset prices are unlikely to continue to rise at the speed and consistency they have been for much of the last five to 10 years. As monetary policy returns to a more normal level, many assets will need to be priced without the meaningful support provided by the world's central banks. For some this could mean significant adjustments.

Markets are likely to be more volatile going forward. We may see higher levels of company defaults (companies missing interest payment on bonds) as a result. Risk will need to be stringently and realistically priced, which means it could be time to throw away the rose tinted spectacles, especially in parts of the world where debt has quietly been increasing to record levels.

While this doesn't have to be disastrous for asset prices, it could suggest the days are numbered for buy and hold type tactics, holding stocks and bonds and riding a fairly smooth upward trajectory. We envisage substantive opportunities arising for more active approaches, not just in fixed income, but potentially across asset classes.

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We cover many of the issues discussed above in our recent paper: inescapable investment truths for the decade ahead (/nl/insights/economics/Inescapable-investment-truths-for-the-decade-ahead/).

Please check back for further articles in our Outlook 2019 series over the coming days and weeks.

You can find out more about our Credit strategic capability here. (/nl/strategic-capabilities/credit/)

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