Global bonds update: On a steep slope

With Fed on hold and prospects of improvement in incoming data, US yield curve is likely to steepen

- The "long duration" bet has been a successful strategy, but has lower room for further run
- We expect that the UST yield curve is likely to steepen broadly on three reasons
    - Fed pause to keep short-end rates anchored lower
    - Growth concerns look overdone and pick-up in manufacturing activity should lift long-term rates
    - Too low, too negative term premium is under-pricing volatility in the Treasury market
- Subdued inflation expectations will act as a ceiling to the long-term rates, putting a limit to the steepening trend
- With the Fed moving to pause mode, emerging market bonds are unlikely to post massive returns
- *We take profit on our tactical overweight call on emerging market dollar sovereign bonds*

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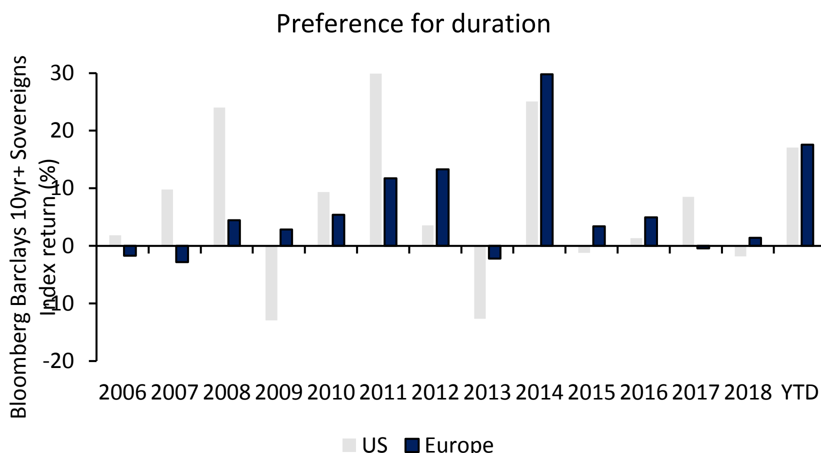
Long duration has been successful this year

2019 has been the long duration year so far. Long-dated bonds have significantly rallied with fears of synchronized global slowdown, signs of a global manufacturing recession and US-China trade tensions worrying the markets. These concerns had pushed the Fed to take a complete U-turn in its monetary policy- from hiking rates in December 2018 to pivoting to a pause in the first quarter of 2019 and then hinting at insurance cuts to ensure longevity of the current business cycle against the headwinds of US-China trade uncertainty. In addition to lower growth concerns and Fed's accommodative policy, the 'safe-haven' characteristics of US Treasuries has also proved quite supportive in pushing more inflows into long-dated US treasuries, especially during times of spike in volatility and increased geopolitical risks. The long-duration bet has also proved successful in the Europe with the ECB providing support in the form of additional monetary stimulus.



Source: Bloomberg and ADCB Asset Management

Steeper curve

With the preference for long-duration, curve flattening (also inversion in the case of US) has been the main highlight in fixed income markets. The inversion of the 10yr-3month yield curve had spurred recessionary fears in the market. This was also followed by a brief inversion of 10-2yr UST yield curve in the month of August when trade tensions between US and China were escalated. However, Fed's accommodative policy and other central banks globally moving to an expansionary policy has stabilised the yield curve, pushing the spread between long-dated and short-dated bonds into the non-negative territory.

In the first quarter of the year, we pointed out that the curve inversion triggering recession worries were overdone. Now that the yield curve has un-inverted, we expect the yield curve to run a normal trajectory in the coming months. We believe that the yield curve is likely to steepen henceforth and do not expect another round of inversion taking place unless there is a significant deterioration in growth outlook and the Fed fails to do anything about it.

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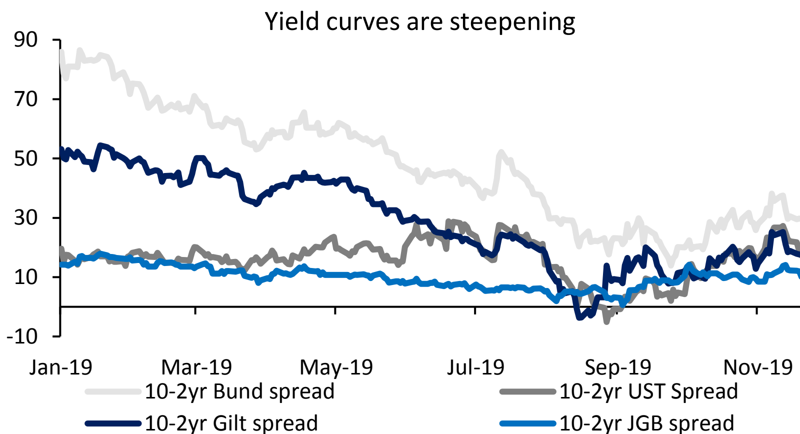


Source: Bloomberg and ADCB Asset Management

Below, we enlist the various underlying reasons why we expect a change in yield trajectory

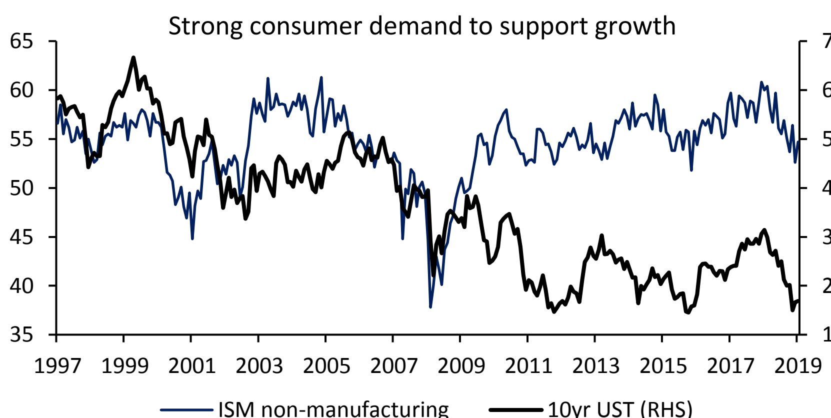
I. Fed has been proactive

The Fed has hinted at a pause to its insurance rate cuts at the recent MPC meeting. But at the same time, the central bank still holds a dovish stance on interest rates. In addition, the central bank has been proactive before there was any evidence of marked slowdown in the economy and conducted three insurance cuts. At the same time, the Fed also acted quickly by providing liquidity in the interbank market when there was a sharp spike in repo rates. The central bank plans to keep purchasing short-term money market instruments to ensure that there is not another incident of liquidity crunch in the repo market. The buying of short-dated paper is in a way reversal of the quantitative tightening that the central conducted earlier in 2018. As a result, short-dated rates should largely remain pressed lower. In addition, the Fed's proactive stance this year sends a clear signal that the central bank will be prepared to take charge and not avoid any delay in easing policy rates in case the growth outlook deteriorates further.

II. Recession or no recession, curve should steepen

Trade uncertainty and recession concerns should begin to fade away as economic indicators have been indicating that economic slowdown is likely to be moderate in nature. While manufacturing contraction still remains a concern, there have been signs of the manufacturing recession bottoming out lately. More importantly, historical evidence shows that manufacturing recession has not technically resulted into actual economic recession as service industry continues to remain a larger contributor to overall growth. The non-manufacturing numbers still look robust. In spite of slight decline in outlook, the service industry remains in expansionary mode. At the same time, growth numbers have indicated that consumer spending remains upbeat. Looking at the chart below, there is a positive correlation between the non-manufacturing ISM and the 10yr US Treasury yields. With manufacturing outlook stabilising and strength in consumer spending sustainable, long-term bond yields are likely to undergo a correction.

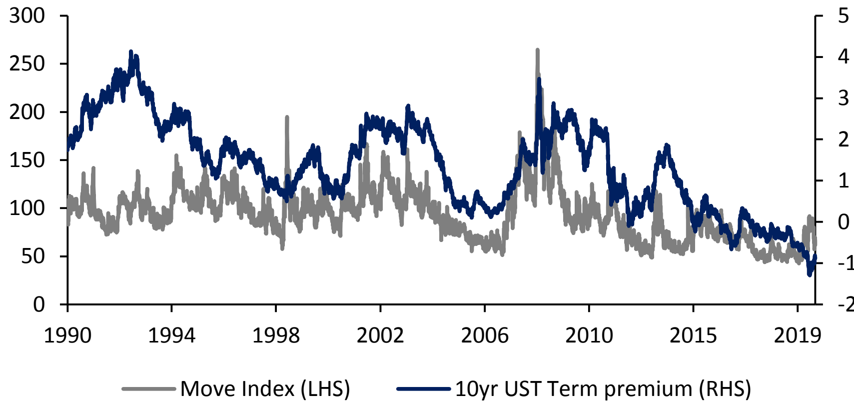
Even if the next downturn is around the corner, the curve is still likely to steepen. This is because, markets will be quick in pricing in more rate cut expectations. Currently, the fed fund futures are pricing the possibility of only one rate cut in 2020. The Fed's response to growth concerns this year clearly points out the central bank's willingness to employ tools to avoid recession. The Fed is also expected to respond by easing policy rates in the event of sharp slowdown in growth. In such a scenario, both long-term and short-term rates will move lower, but the latter will be decline more than the former, thus leading to further steepness. We would also like to add that yield curve flattening occurs roughly 18 months before recession hits, but the curve typically steepens going into and during the downturn.



Source: Bloomberg and ADCB Asset Management

III. Term premium has started rising

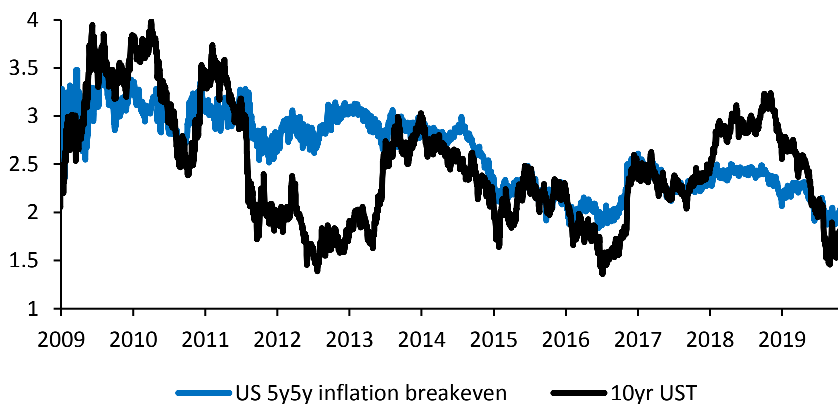
Term premium- the extra premium for holding long-term securities over short-term has been further depressed owing to the trade uncertainty, global economic slowdown concerns and geopolitical risks including Brexit risks. However, after the massive bond rally in August, term premium-which moved deeper into the negative territory in the first half of August- has started rising again. The term premium is still negative which implies investors are still underestimating volatility in the bond market. Historically, there has been a strong correlation between term premium and bond market volatility as indicated in the chart below. With the Fed remaining on hold for a while, we expect that term premium will continue to rebuild.



Source: Bloomberg and ADCB Asset Management

Inflation could pose risks to our steepening view

We believe that the main risk for our steepening view is the depressed inflation backdrop. For the long-dated bonds to underperform short-dated bonds, growth and inflation prospects should improve with the Fed remaining on dovish mode. While there is possibility of growth picking up, a similar pick-up in inflation is likely to remain a challenge. As such, inflation expectations are still key in driving Treasury yields and they have remained low over past few years. The core personal consumption expenditure has averaged only 1.6% over the past decade and the recent numbers have not breached the average trend. These subdued inflation expectations should put a ceiling to the long-dated bond yields. Given that we are currently experiencing unprecedented low inflation environment, it is possible that the upcoming steepening trend may not be as aggressive as we have seen during the Fed pause period post the rate cuts.



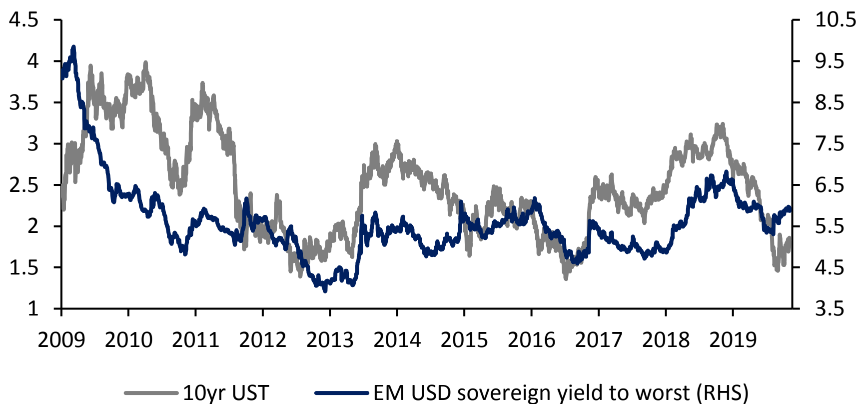
Source: Bloomberg and ADCB Asset Management

Emerging market dollar bonds: taking profit on our tactical overweight call

We went overweight on *emerging market sovereign dollar bonds in March,* mainly to take advantage of the Fed's policy pivot and support of China stimulus. The Fed easing combined with other global central banks dovish bias has been the main catalyst for the emerging market bond rally. In addition, investments into emerging market bonds increased as the market participants searched for higher yielding assets with the bulk of negative yielding debt shooting after the ECB announced another round of massive stimulus. Emerging market dollar sovereign bonds remained resilient even when other risky asset classes including emerging market equities and emerging market currencies came under heavy selling pressure in August.

In terms of valuations when compared to other risky assets within the fixed income space, emerging market dollar sovereign spreads are still trading at attractive levels. However, we believe that scope for further rally is slowly diminishing with the main catalyst of Fed rate cuts fading away. The Fed hinted at a pause over next year has already started dialing back market expectations of future rate cuts. There are also doubts emerging within the ECB committee members on the introduction and sustainability of their new additional stimulus. With both the Fed and ECB not signaling more rate cuts in the future, the outstanding size of negative yielding debt has also stabilized to USD12trn, after breaking the USD17trn level in August. As such, with the main drivers of global central bank rate cuts and growth of negative yielding debt now slowly dwindling, it is not surprising that the total returns on the Bloomberg Barclays EM USD sovereign bond index have been mostly flat over past two months. This is in contrast with the performance of other emerging market asset classes including equities and currency that have done reasonably well, mainly supported by the dollar weakness and hopes of US-China trade deal.

While introducing our overweight call on *emerging market dollar sovereign bonds in March 2019*, we had stressed on the tactical nature of the call, mainly on our expectation that the Fed may not easing aggressively and China will be unable to stimulate their economy like before. With these two risks coming to the forefront, it now makes sense to <u>take profit on our overweight stance on emerging market dollar sovereign bonds</u>. However, we believe that ***a selective approach on emerging market dollar sovereign debt*** still makes sense. We continue to stress our preference for ***high-quality GCC sovereign dollar bonds, Brazil, Russia and Indonesia dollar sovereign bonds.***



Source: Bloomberg and ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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