2 The sustained low bond yields environment: what are the critical factors?

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The year started off with a further decline in long bond yields (as of 11 February) to 0.19% in Germany and 1.67% in the United States. Nothing seems to be preventing long bond yields from falling further or, at the very least, keeping them at continued low levels. Is this environment permanent… and is it supportive? This is the question that must be asked, as lower long-term interest rates can result from increasing risk or favourable monetary and financial conditions… two diametrically opposed scenarios as far as asset allocation is concerned. We would also add that it has been nearly four years since market forecasts have been wrong about long rates, when everyone – or nearly everyone – underestimated the forces keeping long rates at historically ultra-low levels. The purpose of this article is to analyse the factors likely to propel rates higher (or to keep them low).

Six key factors are likely to change – or reinforce – current conditions. For long-term interest rates to move up, we need:

1 An increase in potential growth

The world is facing a reduction in potential growth and an excess of savings worldwide. In other words, the global equilibrium interest rate has fallen sharply over the last few years. It is hard to believe that current interest rates are excessive, just like it is hard to believe that that the bond bubble will pop. Whether we are talking about China (where it has definitely fallen by 50% in 10 to 15 years), Japan, Europe or even the United States, potential growth has plunged. We have therefore entered a new growth trajectory, where the pace of expansion is much weaker than in the past. For potential growth to climb back up, we must reverse demographic trends (by birth rates over the long term, and by immigration over the short term) and greater gains in productivity. Nothing can be done in the very short term.

The macrofinancial stability of this new trajectory calls for lower interest rates for a longer period of time, because these are structural modifications, not cyclical ones. Added to all this are accumulated debt levels that "prohibit" a sharp increase in interest rates.

2 A renewal of inflation

Given falling oil prices and the absence of wage inflation in most advanced economies, a speedy return of inflation to central bank target rates is out of the question for 2016. Monetary policy is likely to remain highly accommodative. All in all, no one, or almost no one, believes that inflation will return, partly because economic indicators do not suggest it, but also because the central banks that are trying to bring it back (especially the Bank of Japan) are not succeeding. Deflationary trends (wages, China, commodities prices, industrial goods prices, global trade, etc.) remain powerful and inflation expectations are still low, sometimes excessively so.

3 A radical change in the attitudes of the major central banks

In order for short-term and long-term interest rates to rise, central banks must hike their key interest rates. Of course, the Fed just started its monetary tightening policy. However, this does not represent a "normalisation of monetary policy", nor is it a real tightening cycle. We prefer to call it a tightening "mini-cycle". In fact, it should be noted that the Federal Reserve is conducting its first interest-rate hike at a time when the economic cycle is already well underway. The Fed took its time because of risks to the major financial balances and the (overly) strong appreciation of the dollar. At present, the situation cannot be described as one group of central banks in a tightening phase and another group of central banks that want to keep interest rates low or tighten later. Instead, there is one central bank that is raising its rates (the Fed) versus the

The essential

The level of interest rates -both short-term and long-term-, and their continuation at low levels are determining and critical factors in our scenario and asset allocation. The impact on corporate bonds and particularly on equities is especially significant. Be aware, however, that lower long-term rates can result from increasing risks or favourable monetary and financial conditions... two diametrically opposed situations for asset allocation.

The purpose of this article is to highlight the various factors likely to propel long-term interest rates higher and provide a way out of the low interest rate morass in which we have been living for several years. We will discuss six of these factors: higher growth potential, rising inflation and inflation expectations, tighter monetary policy, reduced central bank balance sheets (with the Fed at the top of the list), bigger budget deficits and the bursting of bond bubbles. Our conclusion is unequivocal: it is hard to identify the determining factors that might permanently propel long-term interest rates upwards. As long as this situation continues, and barring the onset of a crisis or risk aversion, a radical shift in our asset allocation is unlikely.

> "Lower long-term rates can result from increasing risks or from favourable monetary and financial conditions"

> "Nothing seems to be preventing long bond yields from falling further or, at the very least, keeping them at continued low levels"

rest of the world (or almost), which wants and will continue with monetary easing. This means that the Fed's room to manoeuvre is limited, as well as the potential for interest rates to rise.

4 A drastic reduction in the balance sheets of the major central banks

The major central banks all implemented a quantitative easing programme (QE). Some have interrupted theirs (the Fed and the Bank of England), others started theirs less than a year ago (ECB) and others have no choice but to keep going with theirs (the Bank of Japan and the Chinese central bank). In all of these cases, this has resulted in substantial bond purchases (sovereign and others) and a massive expansion of central bank balance sheets. It also seems clear that once the QE programmes ended, central banks did not begin shrinking their balance sheets and have reinvested assets as they mature. The risks to financial stability mean there is no other way. This will not change anytime soon.

5 A new willingness to resort to major budget deficits

A willingness to accept bigger budget deficits is another factor that could increase long-term interest rates. However, we must be careful: the relationship between such deficits and long-term interest rates is not universally accepted by economists. Far from it. According to those who believe in the crowding out effect, an increase in public spending will result in a decrease in investment and private consumption. To finance deficits, governments must obtain funding on financial markets, which will attract savings that would otherwise go to productive investment (volume effect). Deficits are therefore detrimental to growth (this is why Keynesian budgetary policies to stimulate overall demand are contested, and why neo-liberals prefer to decrease public spending). Consequently, government action increases demand for investment funds, thereby increasing the price for such funds (price effect). Overall, interest rates will go up, all else being equal. However, it has been amply demonstrated that the crowding out effect only occurs under very restrictive conditions (full employment, neutral monetary policy). In addition, if public investments are made when private investment is lacking, it is unlikely there will be an impact on interest rates. Overall, it is difficult to predict: other, much more powerful factors will determine interest rates, which are not the only factor affecting investment.

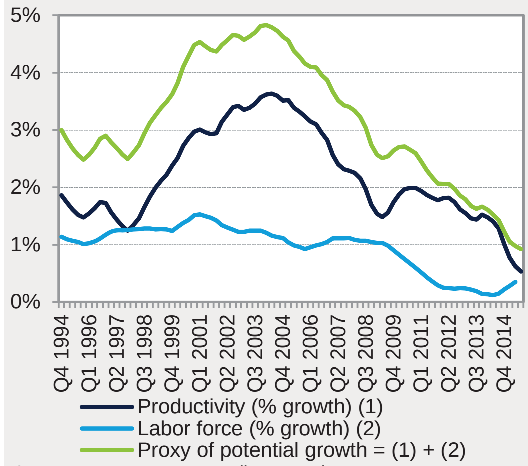
It is likely that the US will loosen its budgetary policy (maturity of the growth cycle, election year, etc.) while budget austerity in the eurozone is losing ground. However, this is not equivalent to budgetary stimulus. Overall, the impact on interest rates, if there is one, will be limited.

6 Bond bubbles that burst

Bubbles must exist before they can burst. Interest rates may seem excessively low compared to past data, but they are nevertheless logical in light of the current conditions mentioned above. A crash may occur without bubbles being identified, but we do not believe that the upcoming interest-rate hikes are sustainable, even though they are inevitable given the prevailing volatility and interest-rate levels.

In conclusion, long-term interest rates are low and are likely to remain that way. However, a sharp distinction should be drawn between falling interest rates brought on by risk aversion and falling interest rates brought on by monetary and financial conditions. **The movement seen last summer and early this year, coupled with rising volatility and a foreign exchange shock, is clearly due to the former and calls for caution.** We have repeatedly mentioned the macro-hedging strategies that must be instituted for portfolios and asset allocations: long on US bonds, long on USD, long on JPY, long on USD cash positions, long on volatility and long on gold.

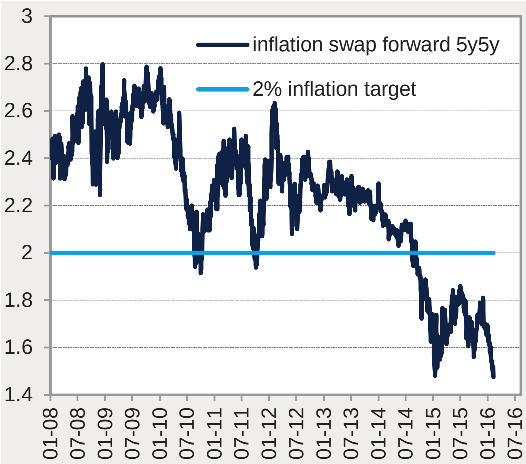
1 Eurozone: inflation swap forward 5y5y



Source: Datastream, Amundi Research

"The Fed's latitude for raising interest rates is limited"

2 United States: proxy of potential growth (5-year trend)



Source: Bloomberg, Amundi Research

"No reduction of central bank balance sheets in sight"

"Budget deficits are hardly the most powerful determining factor for interest rates"

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