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Fixed Income markets: what will be key?

Eurozone and US sovereign bond markets have partially reversed the decline recorded over the summer. The decline in yields was driven by global growth concerns and abundant liquidity. How can fixed-income investors position themselves today?

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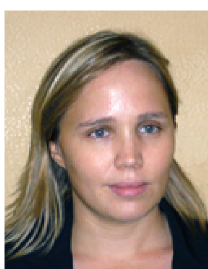

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Long-term yields have declined despite the ongoing strong recovery from the crisis, high inflation data and expectations among market participants that central banks globally may gradually slow their asset purchases in the near future. The decline in yields was driven by global growth concerns and abundant liquidity. Indeed, the United States and China have shown signs of slowing, which have prompted investors to revise their growth forecasts downwards. We have identified three important questions for fixed-income investors:

1. The global economy has passed the peak of the pandemic recovery and a slowdown after this V-shaped recovery is, of course, inevitable. How smooth will the slowdown be?
2. Inflation data surprised investors on the upside. What is key to the inflation debate? Should we consider the current inflationary surge as transitory?
3. What will this crisis's impact be on potential growth?

The shape of the global slowdown after the recovery peaks will be key. Global growth is projected at 6% in 2021, before moderating to 4.1% in 2022. Three factors to watch: the Covid-19 pandemic, the slowdown in the Chinese economy, and the post-Covid deleveraging of economies.

- **The pandemic will continue to weigh on growth and keep the level of uncertainty high.** The vaccination rate remains low in emerging countries. The Asia-Pacific region has taken a zero-tolerance approach to new Covid cases and has been willing to impose new lockdowns. China's services activity has 'plunged' after coronavirus flare-ups. In North America and Europe, the Delta variant has had less impact on mobility and business conditions. However, the Delta variant is likely to prolong supply bottlenecks. Bottlenecks are weighing on the recovery by limiting supply, replenishment and investment. More companies in more sectors are subject to supply constraints. Transportation costs from China to Europe and the US have increased seven- to 10-fold over the past year. Delivery times have lengthened to rather extreme levels.
- **The slowdown of the Chinese economy needs to be monitored.** Besides the impact of the pandemic, Chinese economic activity could be affected by the government's willingness to implement structural changes. China's growth over the past decade came at a price, in the form of rising debt and social inequalities. Thereupon, the pandemic led to a 30% surge in debt and a heightening of social inequalities
  - Delivering "common prosperity" has emerged in recent months as an underlying theme of Chinese political discussion. The Chinese government is not prioritising growth as it once did, but instead is trying to curb unbridled capitalism, whether the power of big tech companies or rising economic inequality. These structural changes are positive for medium-term growth, but will they could come at the expense of short-term growth. Indeed, China has already made the debt-reduction campaign a 2021 priority, and this slower credit growth is contributing directly to lower activity.
  - Evergrande is a consequence of these political changes. The tightening of real estate regulations and the terms for granting loans have exacerbated the difficulties of the country's second-largest developer. In China, the real-estate sector in the broad sense accounts for almost 30% of gross domestic product. For Beijing, the stakes are high: to limit the excesses of an over-indebted sector without causing a general collapse.
- **After the surge in debt to fight the pandemic, certain deleveraging trends are also emerging in developed economies.** (1) Governments are reducing their support, with the expiry of unemployment benefits and business aid; (2) companies are using their profits massively to reduce their indebtedness; and (3) pandemic household savings are being used to buy assets and pay down or pay off credit card debt, rather than for consumption.

After the surge in deb to fight the pandemic, certain deleveraging trends are emerging

The surge in inflation will last longer than expected. Labour markets hold the key.

- **The surge in inflation is so far a Covid and a growth story that will last longer than expected.** Much of the increase in inflation results from the distortions caused by Covid, as a small group of items such as used cars and holiday accommodations explain most of the price increases seen in recent months. However, we expect current supply chain disruptions to last until the end of 2022 and the historically low level of industrial inventories will also drive demand next year.
- **In the medium term, climate-change battle and the huge economic transformation underway will also play a key role in the inflation trajectory.**
- The risk is, if prices continue to rise, that consumers will adjust their expectations, causing them to demand larger wage

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increases. This mechanism could potentially create a self-sustaining price-wage loop. This vicious circle would destabilise the economy and require the intervention of central bankers.

For the Fed, the way is narrow: it has to normalise its monetary policy so as not to appear too far behind the curve and fuel financial imbalances, but without causing a sell-off in risky assets and a solvency crisis, given the economy's level of debt.

Labour markets hold key to inflation debate

- Staying too long behind the curve could be a risk for the inflation trajectory with a risk of loss of credibility. Powell recognized that inflation is elevated but the spike in inflation continued to be viewed as temporary. According to FOMC members, inflation should remain above the Fed's 2% target across the forecast horizon (at 2.1% for 2024).
- These historically low real interest rates are contributing to the build-up of financial imbalances. Record low real interest rates are contributing to the build-up of financial imbalances, including record levels of M&A and share buybacks, huge activity on the US primary market, soaring US real estate prices, increased inequalities, etc. A too abrupt normalisation of monetary policy poses a risk of an asset sell-off and a rise in delinquency rates, given record asset prices and debt levels. Indeed, the net worth of US households as a percentage of disposable personal income has climbed to new heights.

Fixed-income market: liquidity and technicals have also been major drivers. Real yields are at historical lows despite the recovery.

Liquidity played a key role in the recent decline in yields

Concerns about global growth explain part of the decline in US rates, but technical factors (liquidity, flows and positioning) have also played an important role in the sharp drop of yields in since Q2.

Since February, the US Treasury department has used a huge amount of its cash deposited with the Fed at the Treasury General Account (TGA) to finance the deficit. The Treasury cash balance has declined significantly, from $1,568bn mid-February to below $100bn! When the US Treasury uses the TGA cash, it transfers its liquidity to the banking system. Banks reserves have soared, with QE and TGA liquidity leading to a renewed surge in global liquidity and a broad-based reach for yields underpinning a strong rally in risk assets, as well as US government bonds.

Strong demand for US bonds

Real yields are at historical lows despite a record supply of bonds in a striking illustration of the strong demand for US bonds. The net bond supply to the market (i.e., net of Fed purchase) has reached a historical record of $1,700bn. Meanwhile, real yields have stayed stubbornly low despite the recovery, even reaching an historical low of -1.20% at the end of July.

US banks have, of course, been a strong source of demand. Banks deposits have increased sharply, but their customers on the other hand are taking out fewer loans. As companies and households have plenty of cash, their willingness to borrow has weakened, and the Delta variant is complicating reopening plans. As a result, banks have had little choice but to buy government debt rather than keeping all their excess deposits in cash. In the past few months, banks have bought a record amount of Treasuries. On the other hand, the Fed is managing the cash flood through the RRP facility, which has reached record levels recently.

Another important source of demand has been the increase in net inflows into US bond mutual funds and exchange traded funds. A significant part of household savings – which increased during the pandemic – has been used to buy financials assets. Despite expectations that inflation fears would erode the appeal of fixed-income funds, bond mutual funds and exchange traded funds added $372bn in the first half of the year (vs. $446bn of inflows for the whole 2020 and $459bn for 2019).

The rise in long term yields will be limited by the high level of debt

Low term premiums

Following the recent rally in bonds, term premiums have reached very depressed levels. Financial markets seem to believe that the neutral real interest rate is extremely low. The 5Y5Y real which is a proxy of the market's estimate of the neutral rate currently stands at -0.40%. This is an unsustainably low level that indicates a strong overvaluation.

We expect a moderate rise in yields over the coming months

We expect the impact of liquidity on the bond market to diminish in the coming months with the Fed's tapering and the end of the Treasury Department's cash drawdown. As a result, yields are expected to rise, driven by the correction of a valuation overshoot above-trend growth. The Fed is preparing the ground for a withdrawal of stimulus, and if the economy progresses as expected it can start a tightening cycle without hurting the economy. Fiscal policy should also pay a role, as we expect additional fiscal plans to be approved by the end of the year. This inflection point in monetary policy should also contribute to a rise in long yields. The rise in long yields will be limited by the post-Covid deleveraging of economies and the high level of debt.

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