

Higher rates? Don't rush to judgement

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A recurring theme for us in 2019 has been to consider the altered interest rate outlook for the euro area, namely rates staying lower for longer. I first blogged about this topic in early December of last year, and with the calendar now squarely in the middle of Q2 for 2019, I thought it would be a good idea to revisit the issue. So, have my thoughts changed? In a word: no. I'm in no rush to move into the higher rate camp.

Certainly, the markets as well as the European Central Bank (ECB) have seemingly moved into this territory as the year has progressed. With respect to the ECB, President Mario Draghi, once again, reiterated following their 10 April policy meeting that risks to the euro area outlook are still "tilted to the downside" and seemed open to the possibility of additional stimulus action if needed. The problem is that the ECB may have limited ammunition on this front. The TLTRO III program is the first step in the 'stimulus direction', but after this maneuver, one could certainly argue Draghi & Co. don't have that many arrows in the quiver, especially with rates already at zero, or in negative territory. Sure, they could jump start the Quantitative Easing (QE) program, but after recently announcing an end to new asset purchases, does the ECB really want to reverse course so quickly? The one tool at their disposal is forward guidance. If economic data continue to disappoint in the months ahead and show little in the way of improvement, it would appear likely the ECB could alter their rate guidance from keeping rates on hold "at least through 2019" to perhaps "at least through mid-2020."

Figure 1: Implied probabilities for 2019 rate action – European Central Bank

Source: Bloomberg as of 23 April 2019. Forecasts are not an indicator of future performance and any investments are subject to risks and uncertainties.

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Back to the markets, in mid-December prior to the US Federal Reserve's last rate hike implied probabilities for the ECB to follow suit and raise rates were pegged at 44.5%, with the odds of a rate cut placed at only 6.4%. Fast-forward to the end of April and the probabilities have changed dramatically: 4.0% for a hike and nearly 20.0% for a cut.

What has this shifting policy stance done to bond yields? Let's take a look at the graph for 10-year German bund yields. For the first time since 2016, the bund yield witnessed another move into negative territory, and as of this writing, continues to straddle the 'zero threshold'. In fact, the trendline has now clearly shifted into a descending pattern over a two-year time horizon.

Figure 2: 10-year German Bund yield levels

Source: Bloomberg as of 24 April 2019. Historical performance is not an indication of future performance and any investments may go down in value.

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From an economic standpoint, there does not appear to be anything on the horizon that would suggest a higher rate setting would need to be adopted either. Inflation continues to 'miss the mark' and recent Purchase Managers Index (PMI) data continued to reside barely above the 'expansion/contraction' threshold of 50.0. Manufacturing is acting as an albatross on overall activity, falling measurably below the 50.0 level, with Germany posting its fourth straight month in contraction territory.

Against this backdrop, investors should continue to consider enhanced yield (EY) strategies for their core fixed income portfolios, while maintaining familiar risk profiles. While investors should also be cognizant of moving too far out in duration, the current shape of the yield curve does highlight some extension within certain 'guardrails' could also be considered. Indeed, unlike some of the inverted/negative relationships in the US Treasury market, the spread between German 2-year and 10-year yields remains visibly in positive territory.

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