

# On second thought...rates lower for longer

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In a very short period, the Eurozone rate outlook has changed in a rather visible fashion. As Q3 2018 was drawing to a close, investors seemed to be preparing their fixed income portfolios for an imminent rise in bond yields, but only three to four months later, the narrative has shifted to where positioning appears to be centered more towards rates being 'lower for longer'.

The natural question that comes to mind is: what has changed? In a nutshell, the economic and central bank policy outlook. I first broached this possibility in a 10 December 2018 blog, "Rates going up...maybe not so fast", where a changing economic backdrop had certainly caught my attention. At that time, disappointing data for Eurozone Purchasing Managers Indices (PMI), as well as outright GDP figures, stood out, and raised the question of any potential impact on the European Central Bank's (ECB) decision-making process.

### Figure 1: 10-Year German Bund yield levels

Source: Bloomberg, as of 28 January 2018.

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Well, here we are only about a month or so later, and it appears as if fixed income investors have received more clarity. The Eurozone PMI fell further in January to a reading of 50.7. This is not only the lowest reading since August 2013, but it is also getting perilously close to the 50.0 level, or the threshold that is considered to be the arbiter between contraction and expansion. In addition, recent data on industrial production were weak while the ECB's Bank Lending Survey pointed towards softening demand for credit from both the consumer and business sectors. Adding more fuel to the 'slowdown fire' was the decline in the German Ifo Business Climate Index in January.

At this point, we do not envision an outright recession for the Eurozone in 2019, but the 'stars appear to be aligning' for a visible drop-off in growth for the year, with GDP estimates falling in the +1.0% - +1.5% range. Needless to say, the ECB has also looked at the same data points, and apparently has drawn a similar conclusion. In fact, at last policy meeting, the ECB acknowledged that growth would likely be "weaker than previously anticipated." While the policymakers have yet to formally alter their forward guidance, it seems increasingly apparent that there may be no rate hike in 2019, a sentiment echoed in the futures market. Against this backdrop, we could foresee the 10-year German bund yield trade in a 0.30% to 0.65% range. Interestingly, as the enclosed graph illustrates the trendline over the last two years places the level a little over 0.40%.

### **Conclusion**

Given this outlook, fixed income investors may consider yield enhanced strategies, but we expect they will remain within guardrails that do not stretch overall risk parameters.

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