Global Overview Of Bond Markets In 2016

XIII Russian Bond Congress

Chris Golden

St Petersburg – December 2015

Spoiler Alert : Summary Conclusion

- We are not out of the woods
  - Leverage still high, money velocity low + slowing
  - Deflation still possible
  - Global economy slowing
- ZIRP still rules
  - Though US may move soon: Dec is 50% chance
    - Depends most on NFP (today)
  - Rest of world still on hold
  - UK next, but probably not in 2016
  - Euro area maybe in late 2017
  - Japan ?????
  - China still cutting rates
- So Yield curves generally stable to LOWER (flatter / parallel)
- No bond market bloodbath

Bond Markets in 2016

- Where are we?
  - A Panorama
  - The Great Divergence
  - Is explained by :
- How did we get here?
  - “We” started from the same place
  - At the same time
  - But economies started to diverge
  - Almost from the beginning
- Where are we going?
  - Nowhere, slowly
    - (Actually…. Slightly lower yields)

Where are we?
The Panorama

- The global economy
  - And particularly “The West”
- Is STILL emerging from the Perfect storm of
  - Deregulation
  - Disinflationary pressures from Asia
  - Demographic alignment
  - And “The Computer Revolution” => Finance
    - i.e. quantification of risk
- The storm took some 30+ years to brew

Where are we?
The Panorama

- The Minsky irony of the Great Moderation:
  - The longer the moderation
    - Stable inflation
    - Stable growth
  - The longer and greater the lending
  - The greater the leverage
    - Of ALL Balance sheets
  - The lower the rates (absolute AND real)
- And thus the <u>greater</u> and more <u>traumatic</u> the shock

Where are we?
The Panorama

- The shock was
  - A financial crisis
  - With a bank crisis and so
  - A credit crisis leading to
  - A balance sheet (leverage) recession….
- I have always said that it would take AT LEAST 10 years to recover
  - And probably more……

- We are in year 8

Where are we going?
The Great Divergence

- Over the next two weeks
  - Starting yesterday!
- Markets are assuming
  - And “betting” on the fact
- That interest rates in the US and the Euro area
- Will start to move in opposite directions
- i.e. EBC will continue ZIRP and QE
- And the Fed will start to tighten

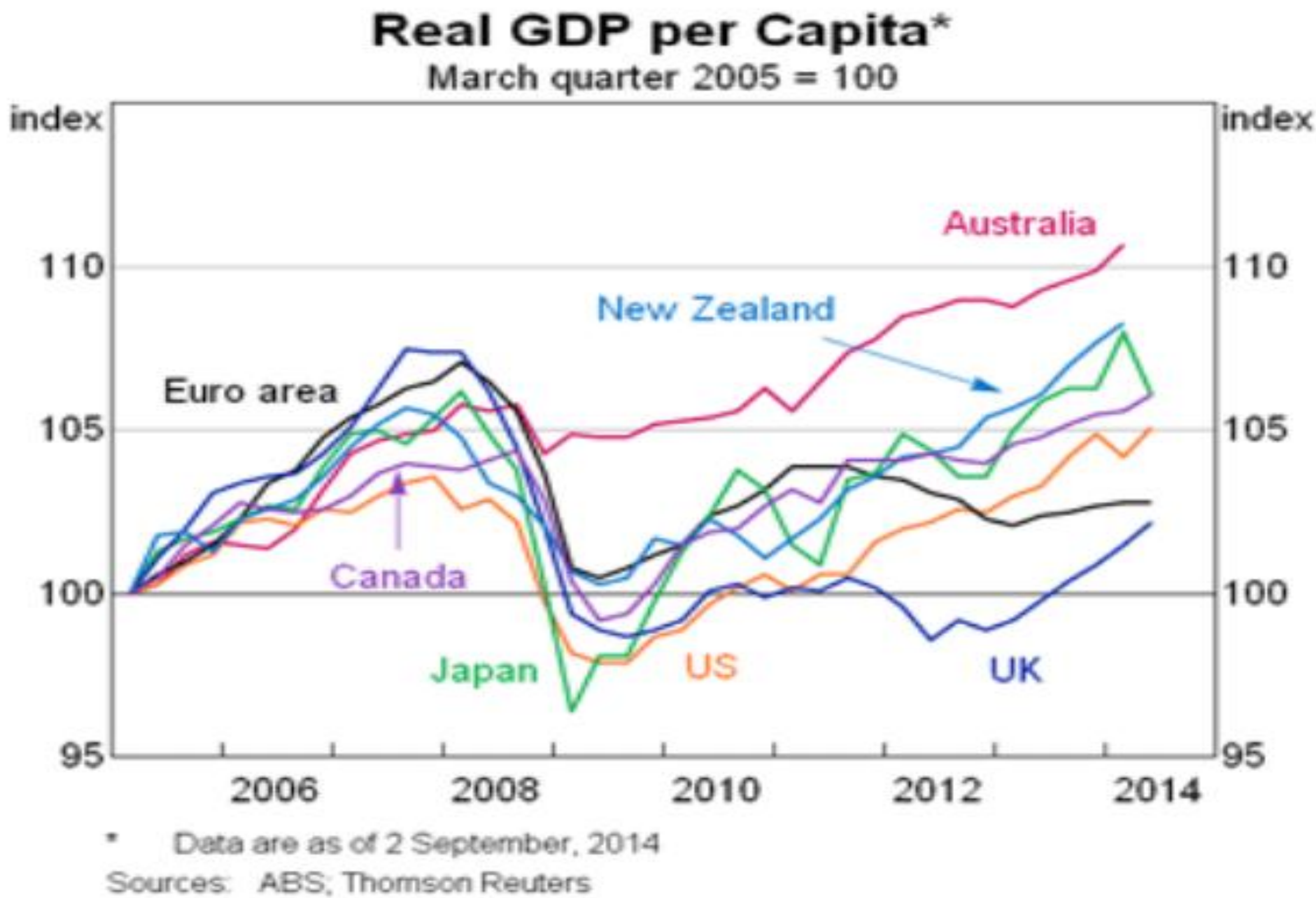
Where are we going? The Great Divergence

- Meaning that US & Euro yield curves will move in opposite directions
- And that the Euro will continue to weaken against the US Dollar
  - (with the Dollar strengthening against most currencies)
- Some of these assumptions are probably correct
  - Especially the FX
- Others are not……

How did we get here?

- Countries most affected by the financial crisis
  - US
  - UK
  - Euro Area
  - China
- Others were less affected (Japan)
- Some not at all

Not All Countries ….



How did we get here?

- Different countries => different responses
- US :
  - Sharp Monetary easing + QE, Fiscal stimulus
- UK :
  - Slow but sharp Monetary easing +QE, some Fiscal stimulus, followed by sharp austerity

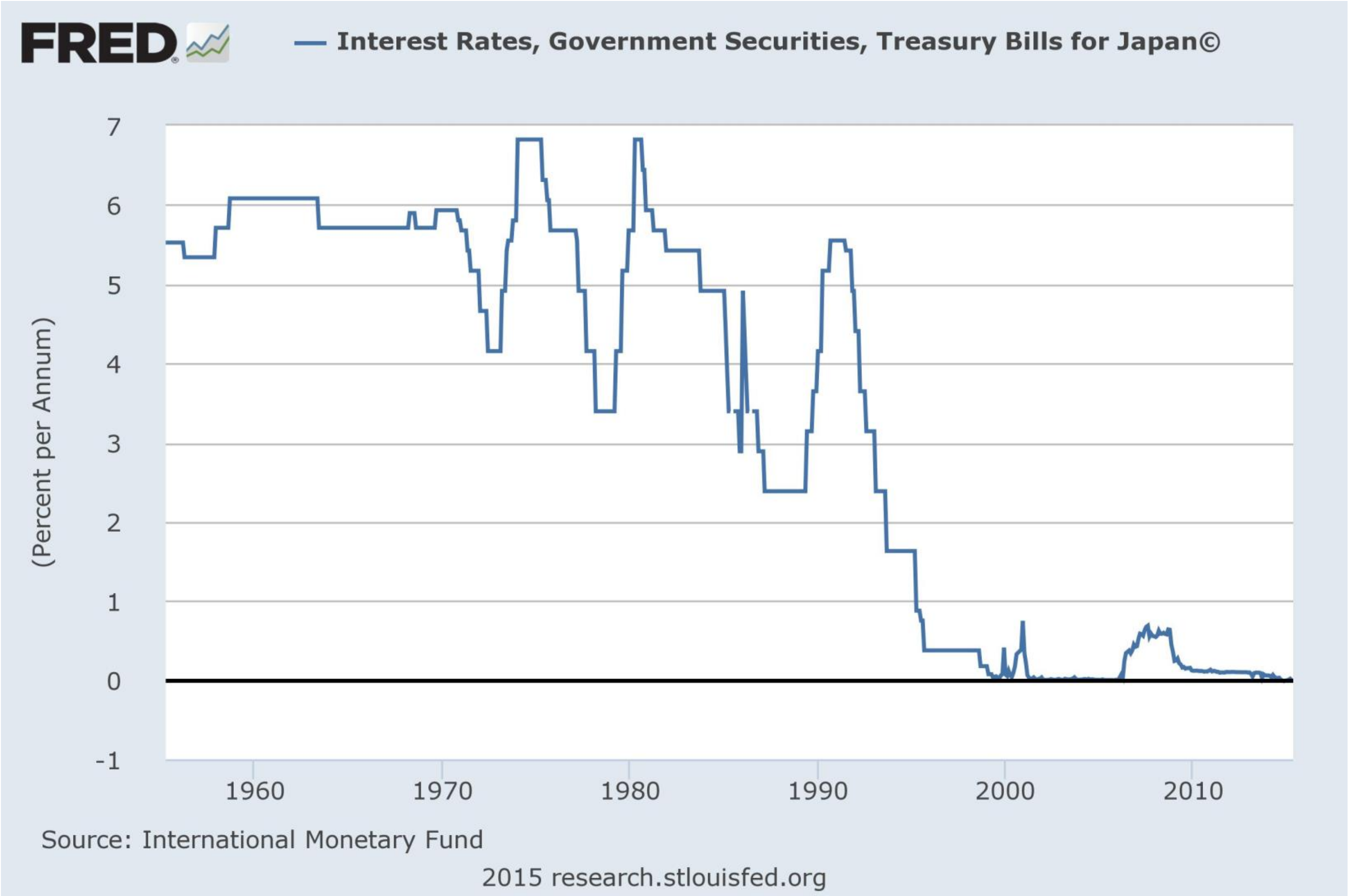
How did we get here?

- Euro Area:
  - Very weak and slow Monetary response (including a rise in rates), Fiscal austerity
- China :
  - Indirect effect, via collapse in global demand
  - Immediate (but short-lived) Monetary response, <u>very large Fiscal stimulus</u>
    - Nov 2008 – 14% of 2008 GDP to spend in two years!

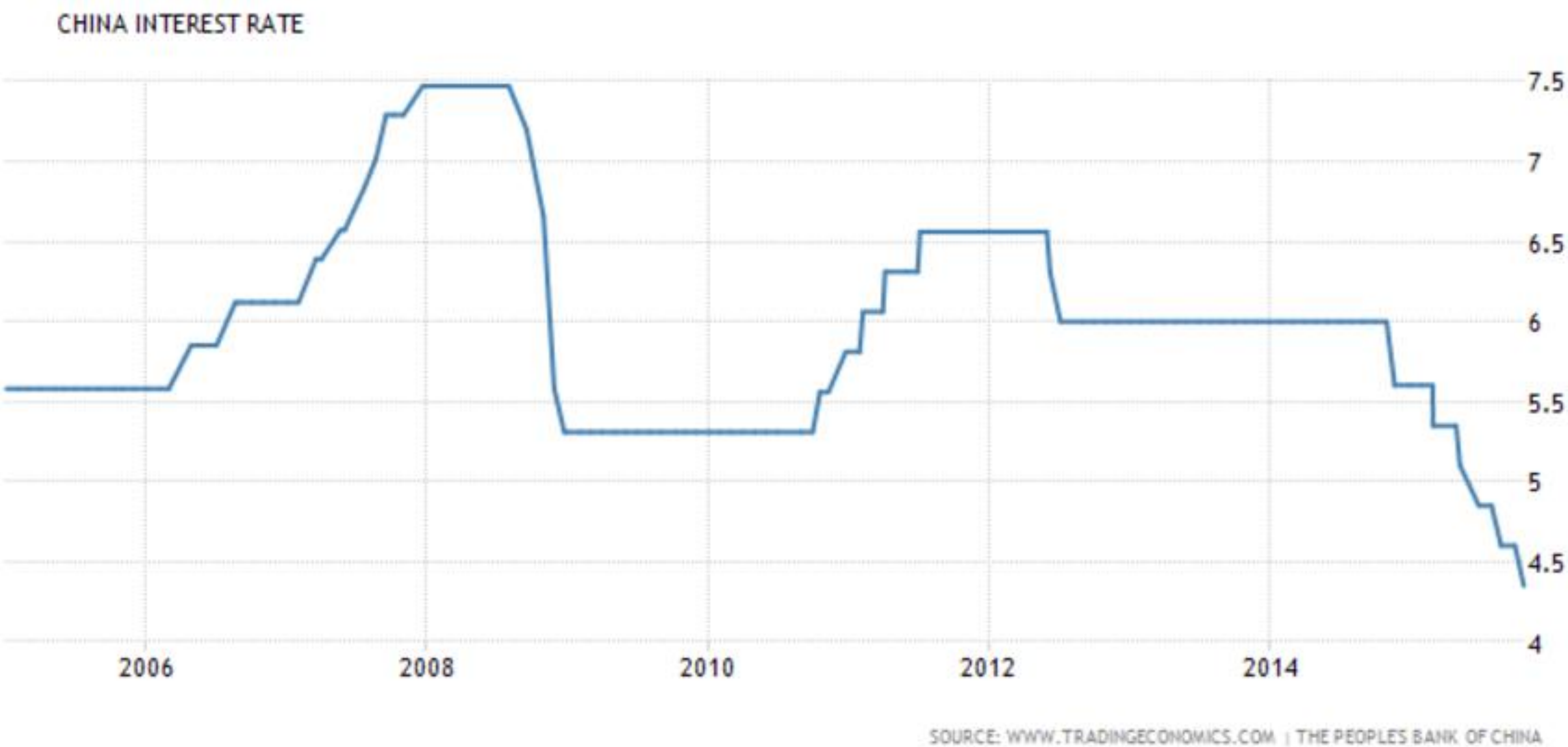
The Official IR Story

Official Rate : Japan

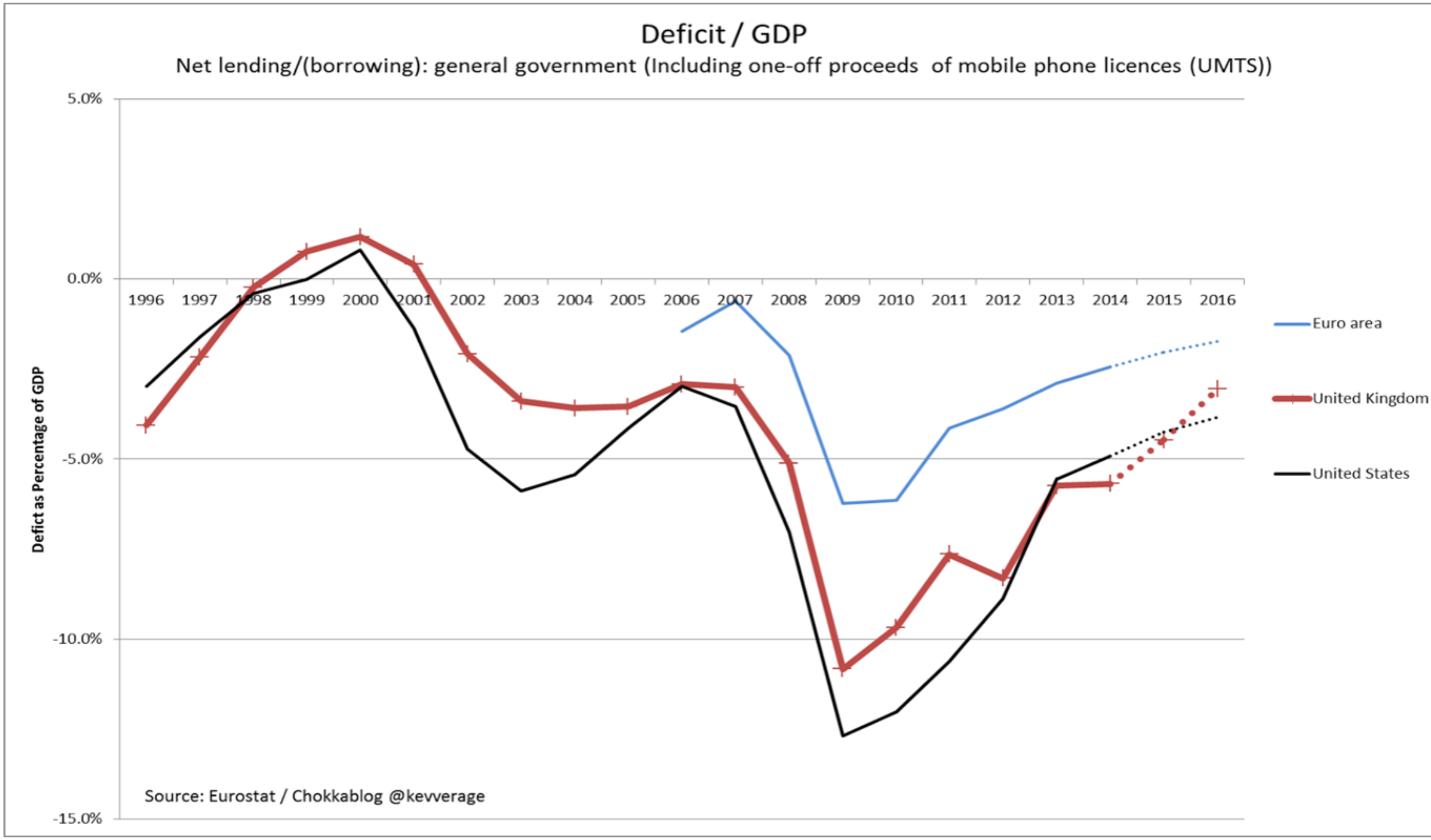
Official Rate : Japan…..
in perspective



Official Rates: PRC



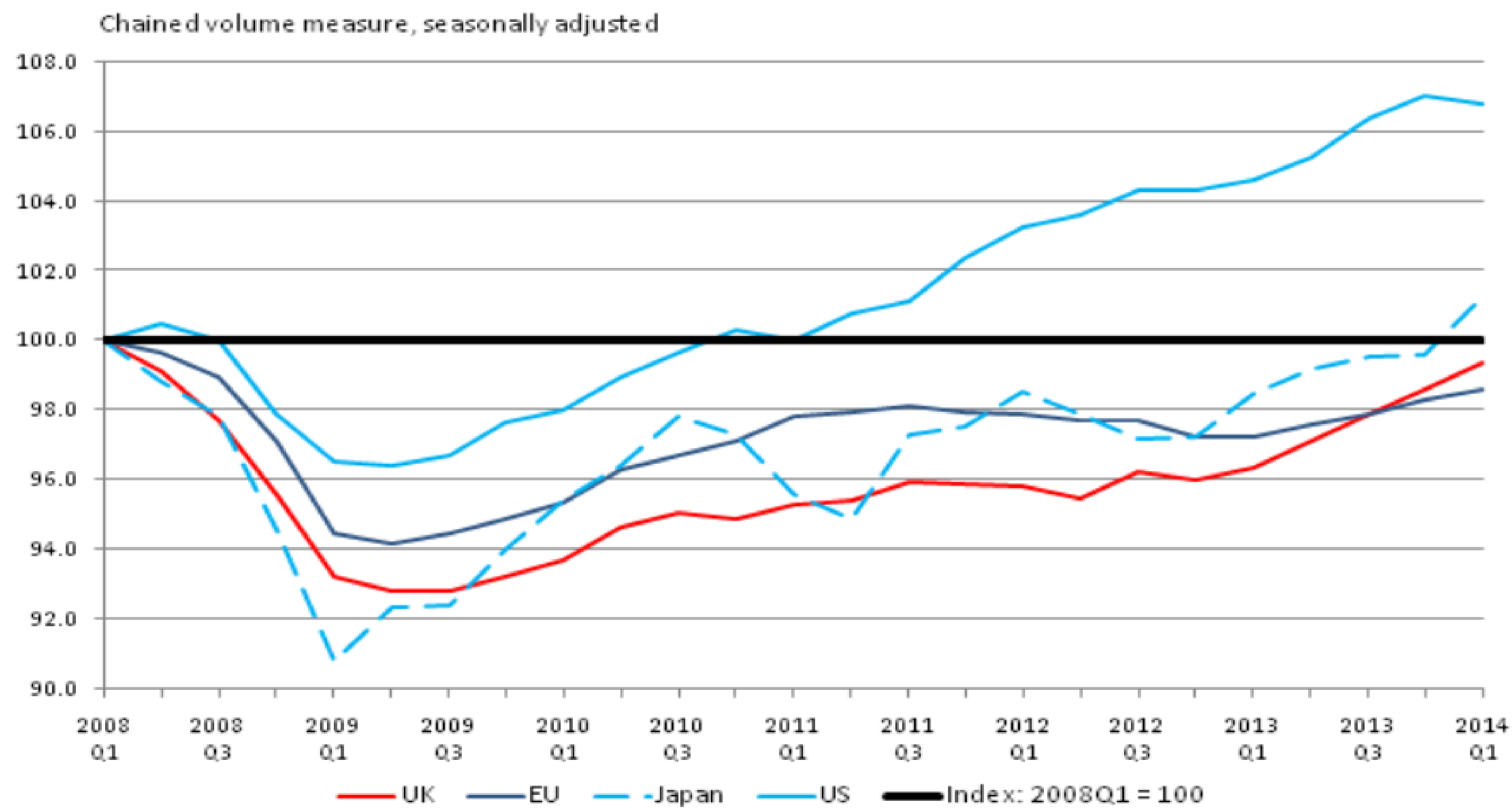
Deficits
Measures of Stimulus



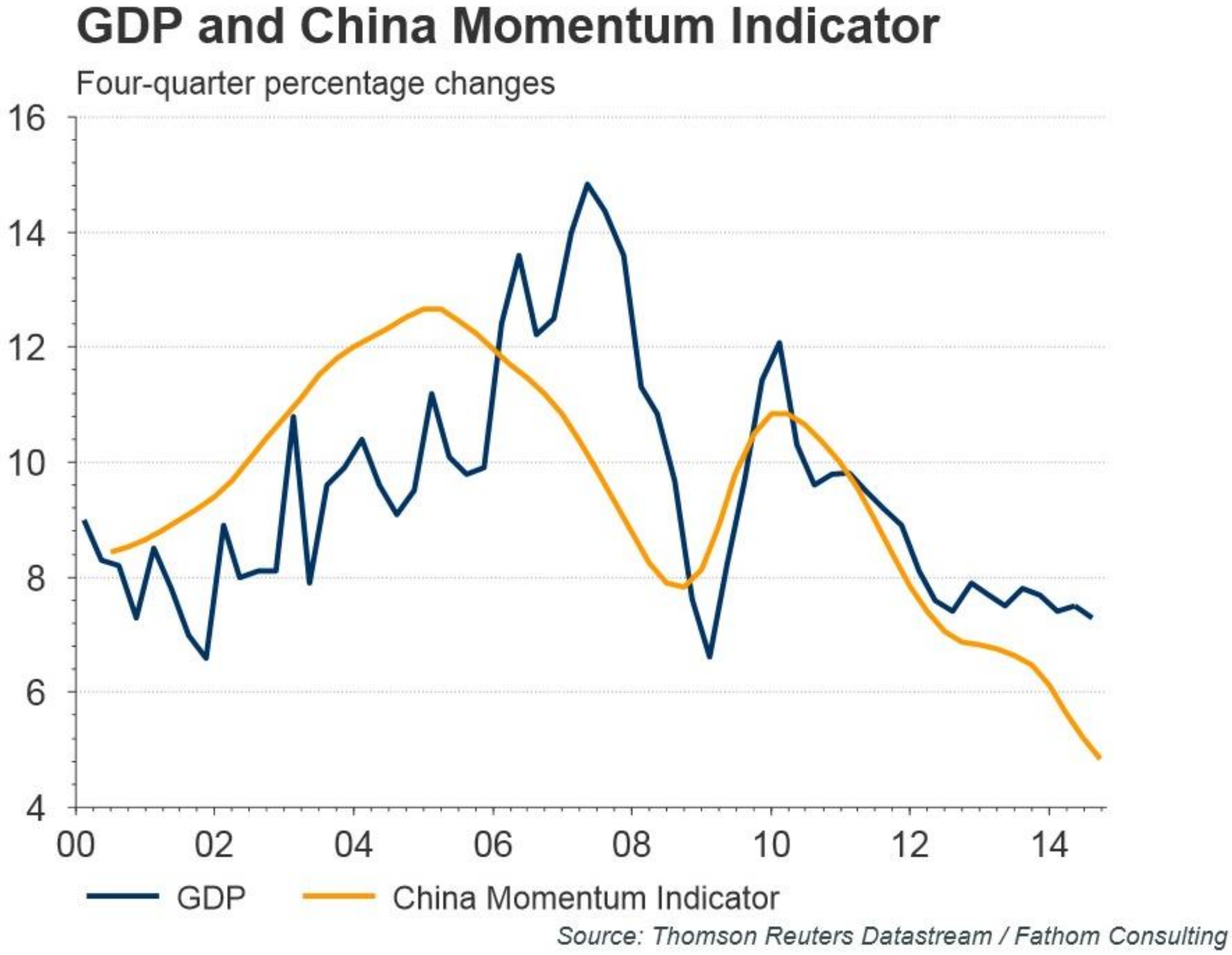
So how did that work out? Divergence begins

- Different responses led to divergent results

Figure 19: International GDP growth rates, quarter-on-quarter, indexed to Q1 2008=100



GDP - PRC


GDP and China Momentum Indicator
Four-quarter percentage changes
16
14
12
10
8
6
4
00
02
04
06
08
10
12
14
GDP
China Momentum Indicator
Source: Thomson Reuters Datastream / Fathom Consulting

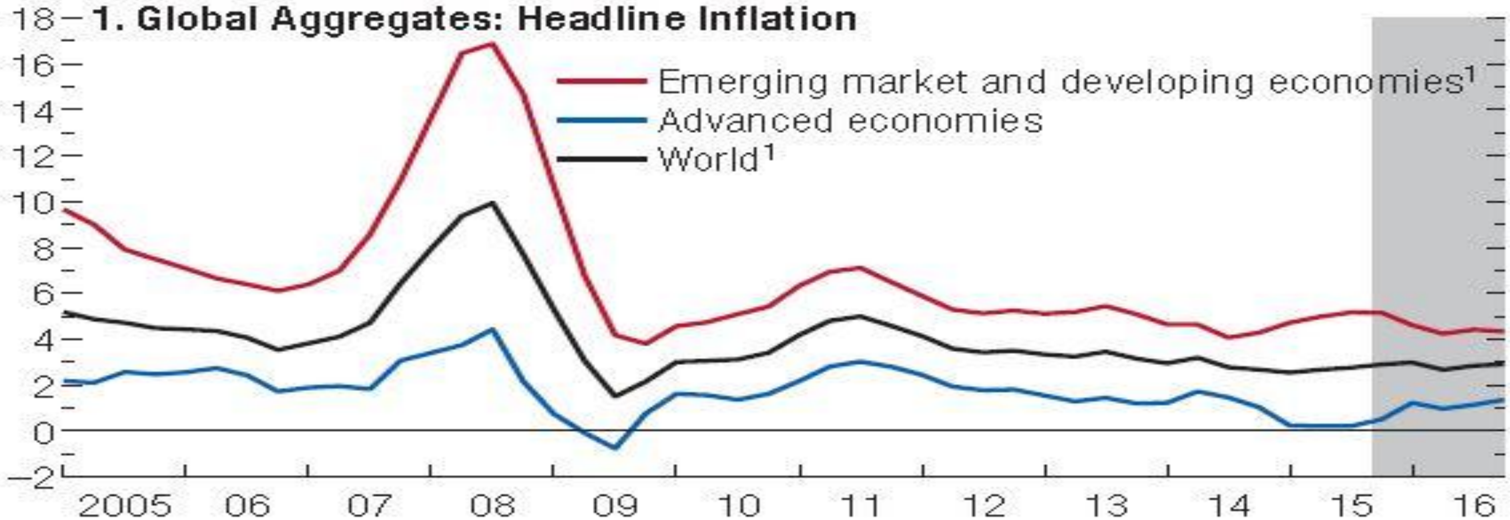
How we got here: Conclusion

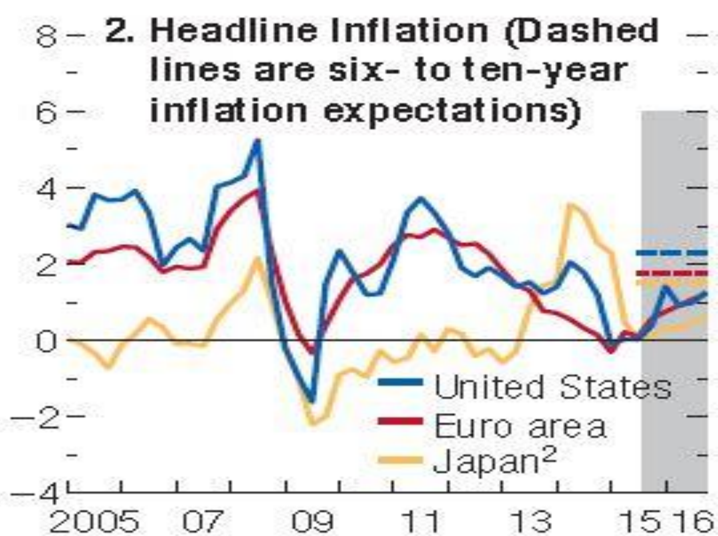
- The “Great Divergence”
- Began with the first reactions to the crisis!
- And “we” have been diverging ever since
- With different timetables for
  - Economic recovery
    - Both GDP
    - And Employment
  - Official rate cycle change

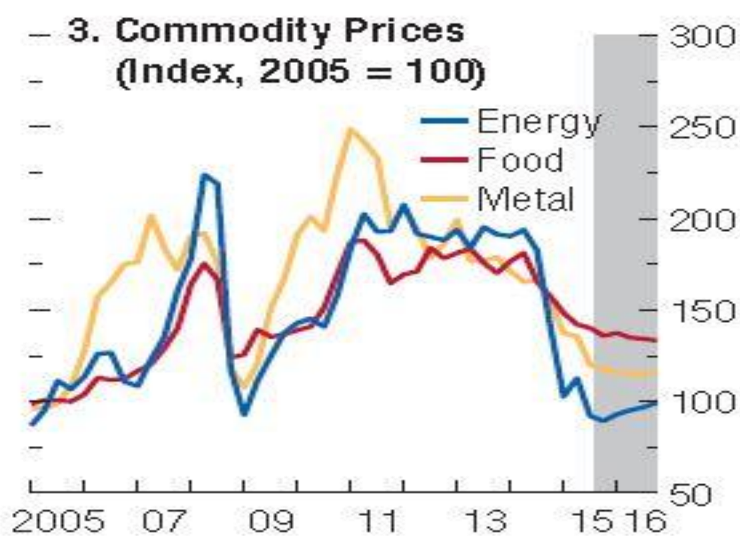
How we got here: Conclusion

- The only important statistic showing very little divergent behaviour is
- INFLATION
  - Which, if anything, has been converging

Inflation Convergence



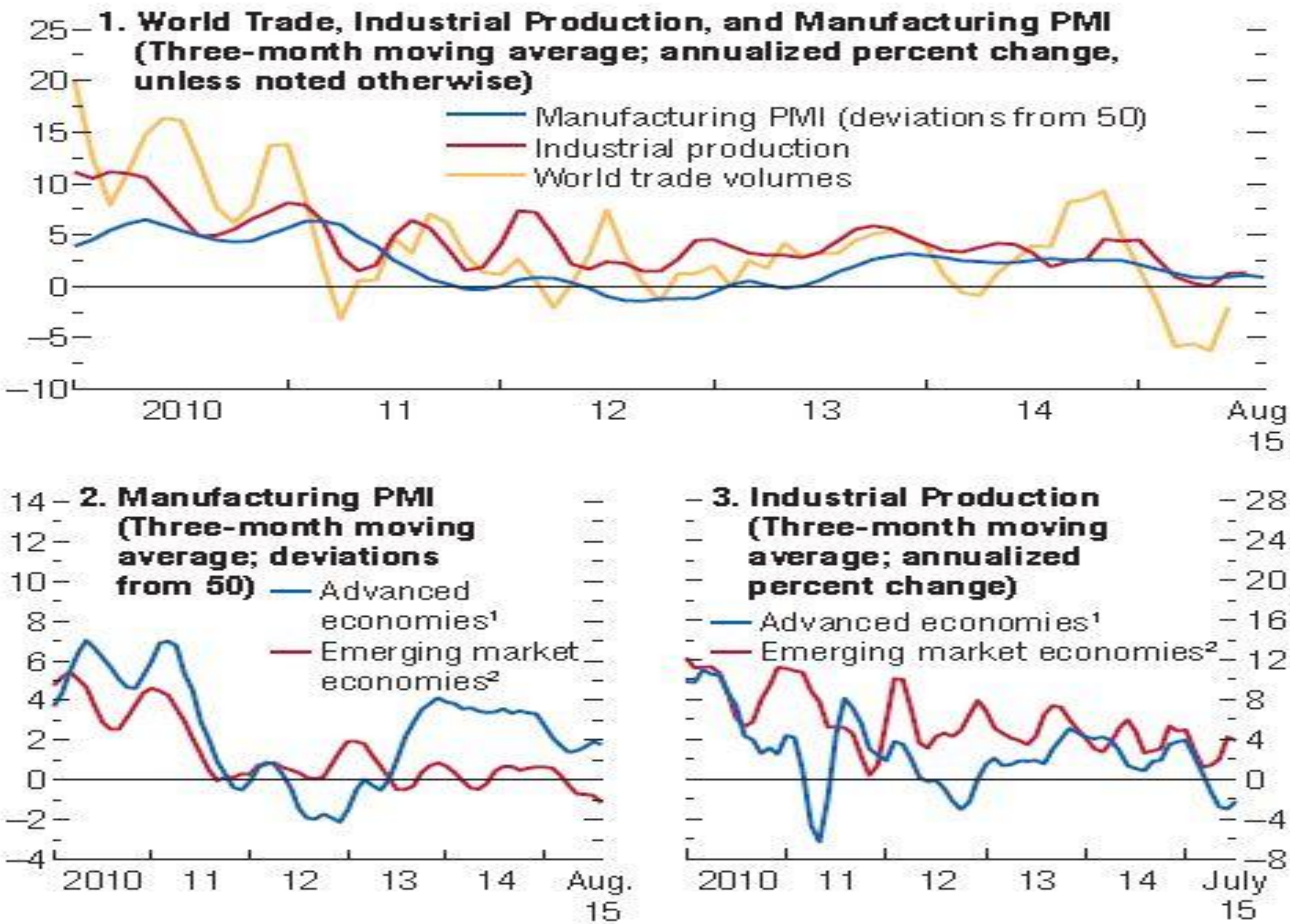




What Now?
Overview of the Overview

- Global economic conditions are weak
  - IMF data
  - WTO trade data weak
  - Baltic dry index through all-time 1986 low of 554
  - On 4th November at 498
    - dangerously close to the combined operating costs of vessels, fuel, and crews….
  - Commodity supercycle heading down
    - China!
- We have not escaped the problem of VELOCITY
- And LEVERAGE

IMF Data

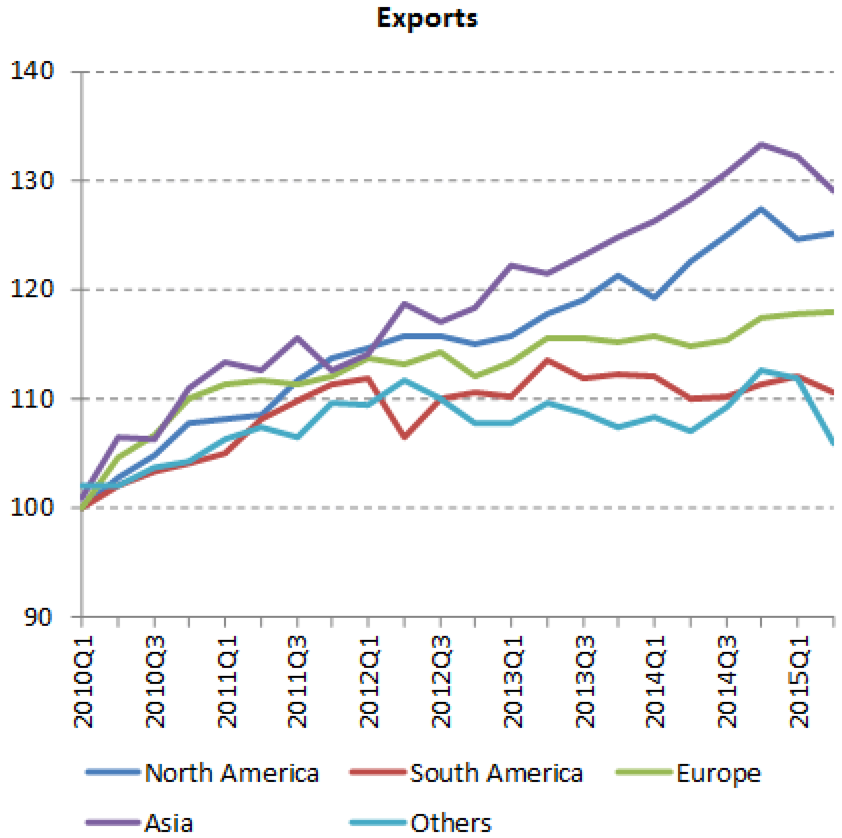


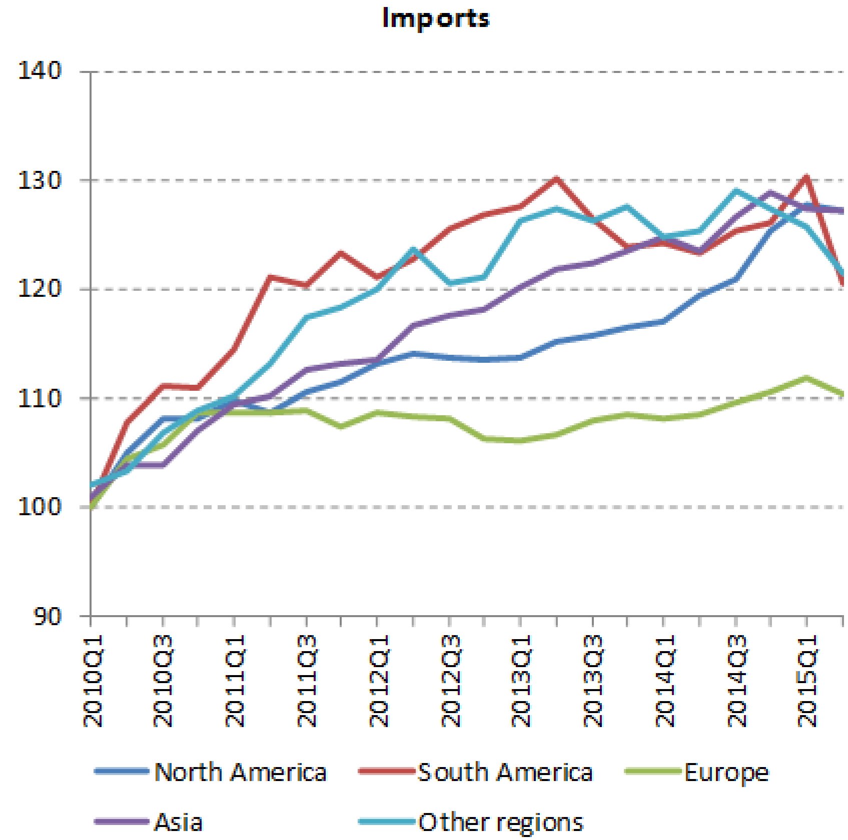
1. World Trade, Industrial Production, and Manufacturing PMI
(Three-month moving average; annualized percent change, unless noted otherwise)
Manufacturing PMI (deviations from 50)
Industrial production
World trade volumes
25
20
15
10
5
0
–5
–10
2010
11
12
13
14
Aug. 15
2. Manufacturing PMI
(Three-month moving average; deviations from 50)
Advanced economies¹
Emerging market economies²
14
12
10
8
6
4
2
0
–2
–4
2010
11
12
13
14
Aug. 15
3. Industrial Production
(Three-month moving average; annualized percent change)
Advanced economies¹
Emerging market economies²
28
24
20
16
12
8
4
0
–4
–8
2010
11
12
13
14
July 15

Trade Slowing Globally

Chart 2: Volume of merchandise exports and imports by region, 2010Q1-2015Q2

(Seasonally adjusted volume indices, 2010Q1=100)





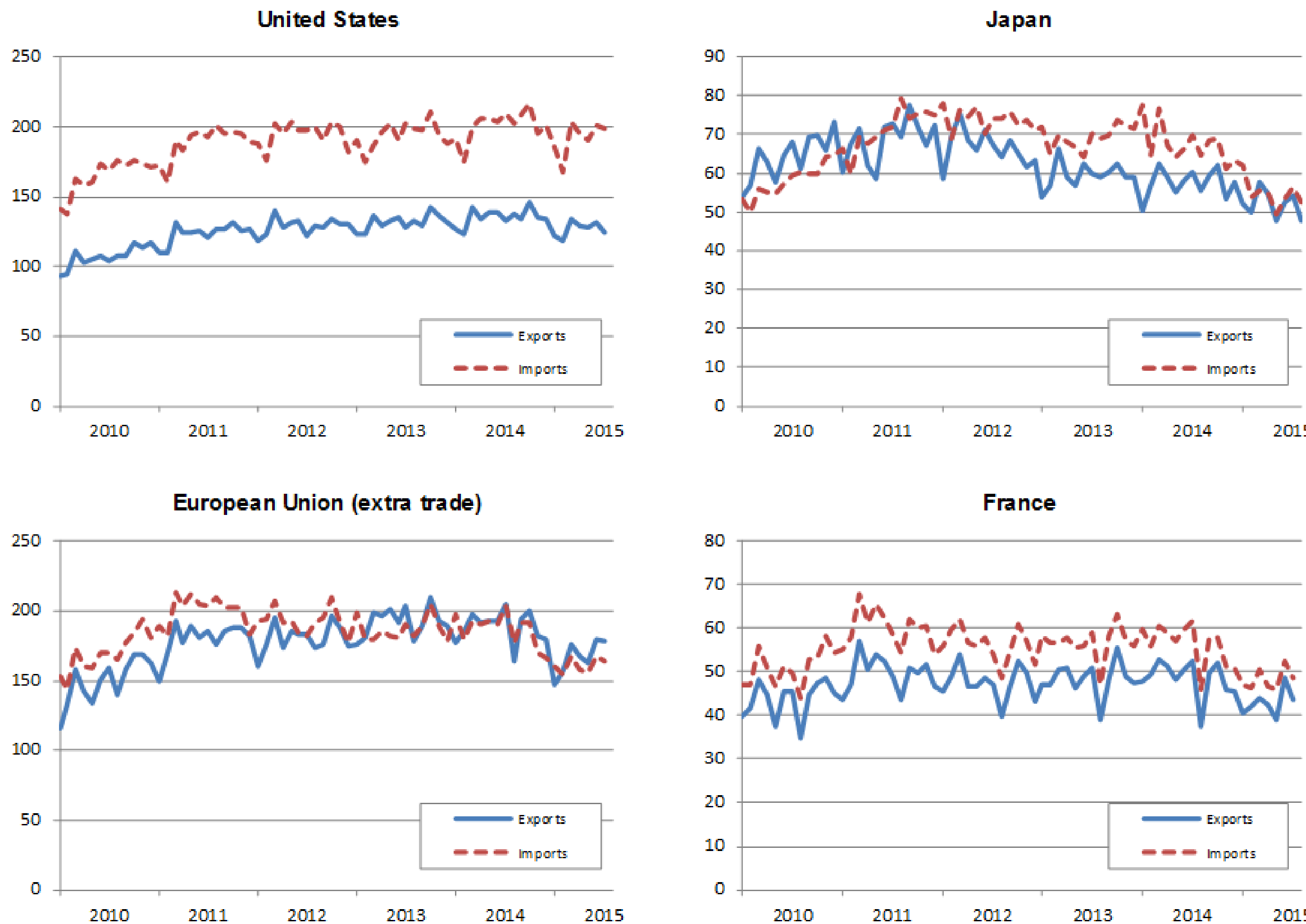
Source: WTO and UNCTAD Secretariats.

Trade Slowing - by Country

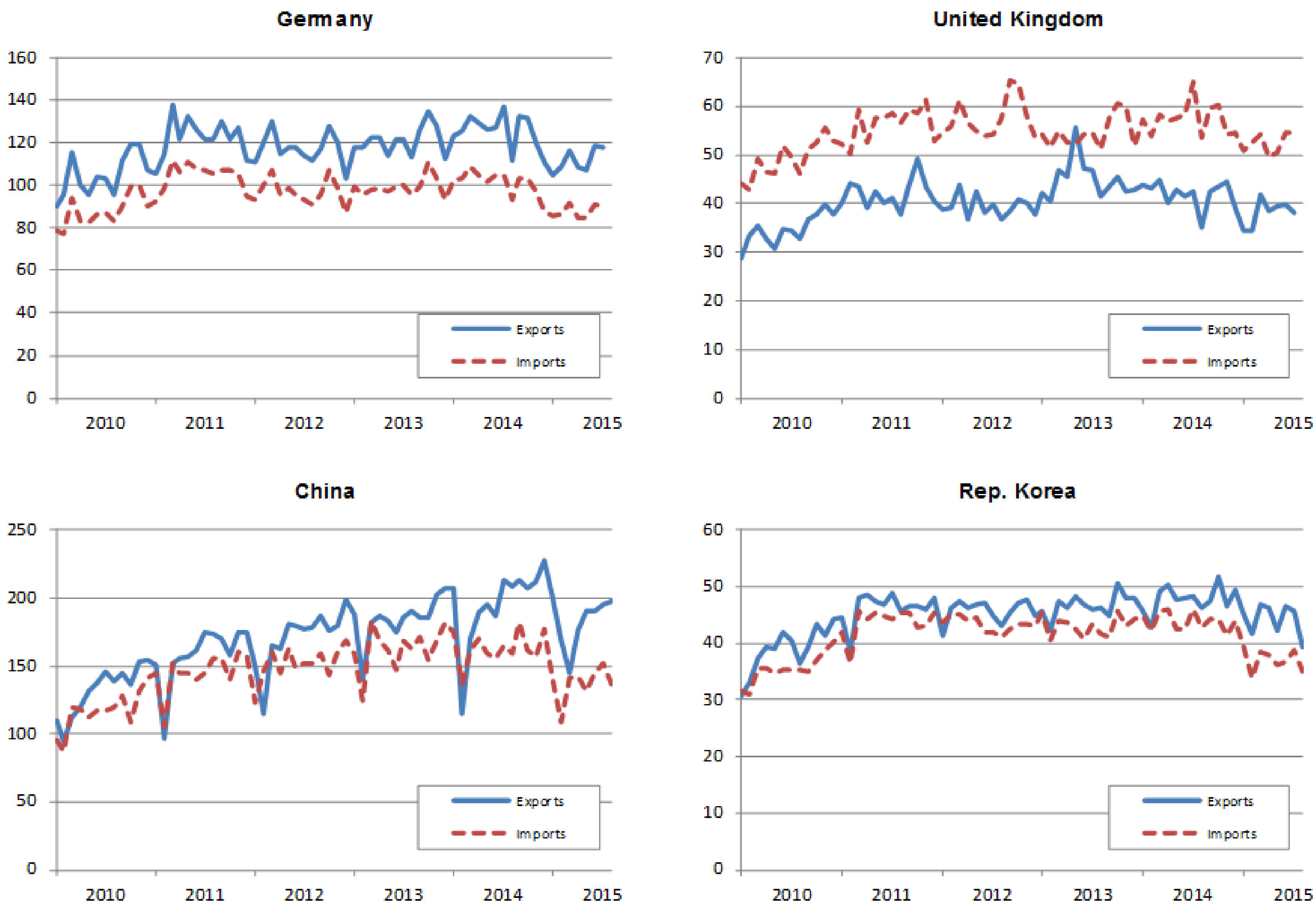
Chart 4

Merchandise exports and imports of selected economies, January 2010-August 2015

(Billion dollars)



Trade Slowing - by Country

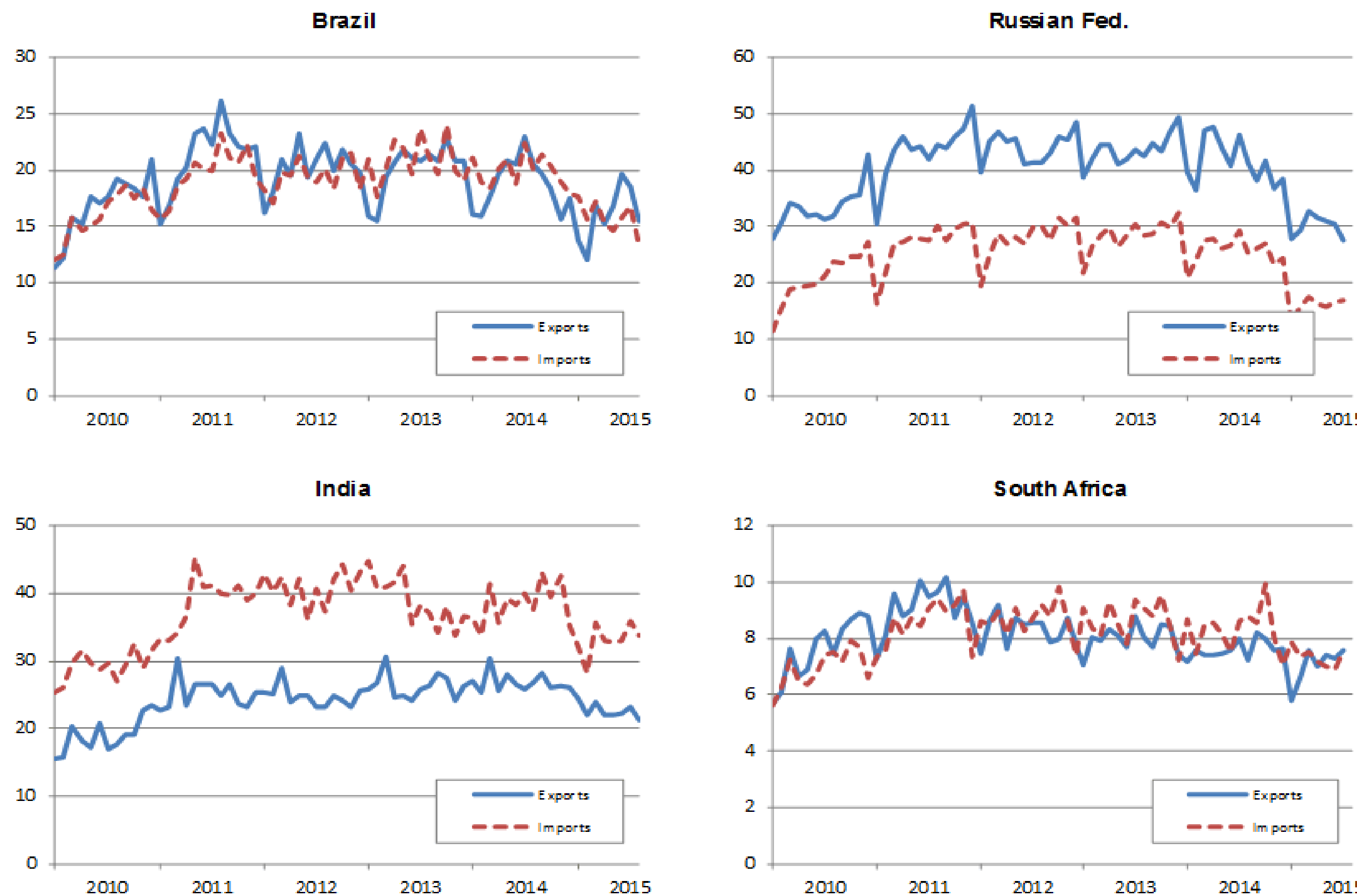


Trade Slowing - by Country

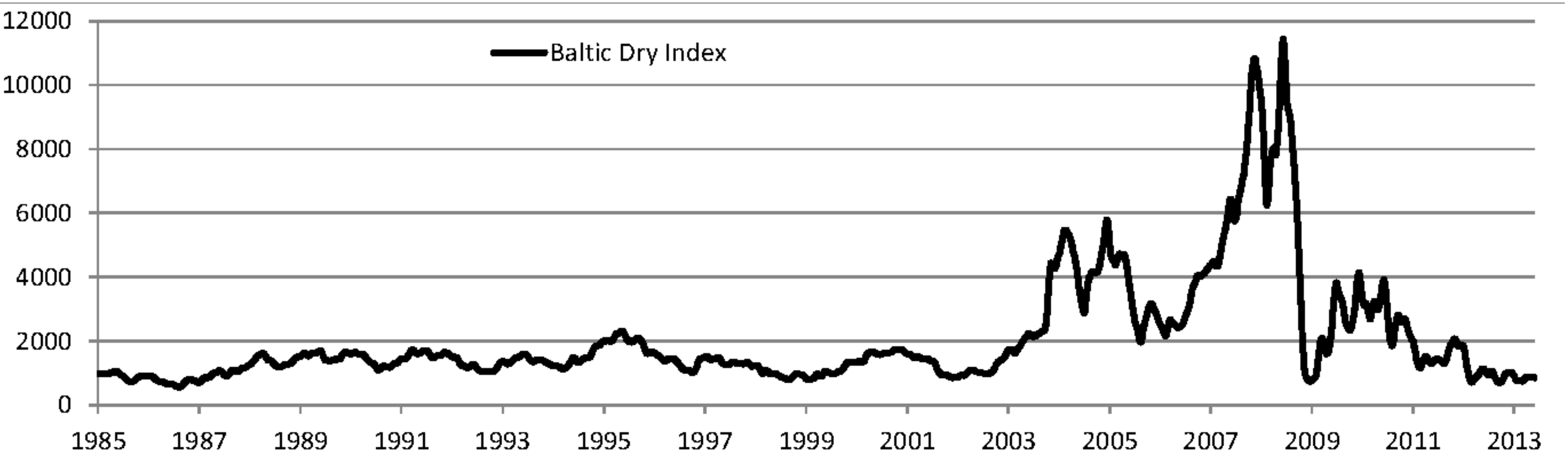
Chart 4 (continued)

Merchandise exports and imports of selected economies, January 2010-August 2015

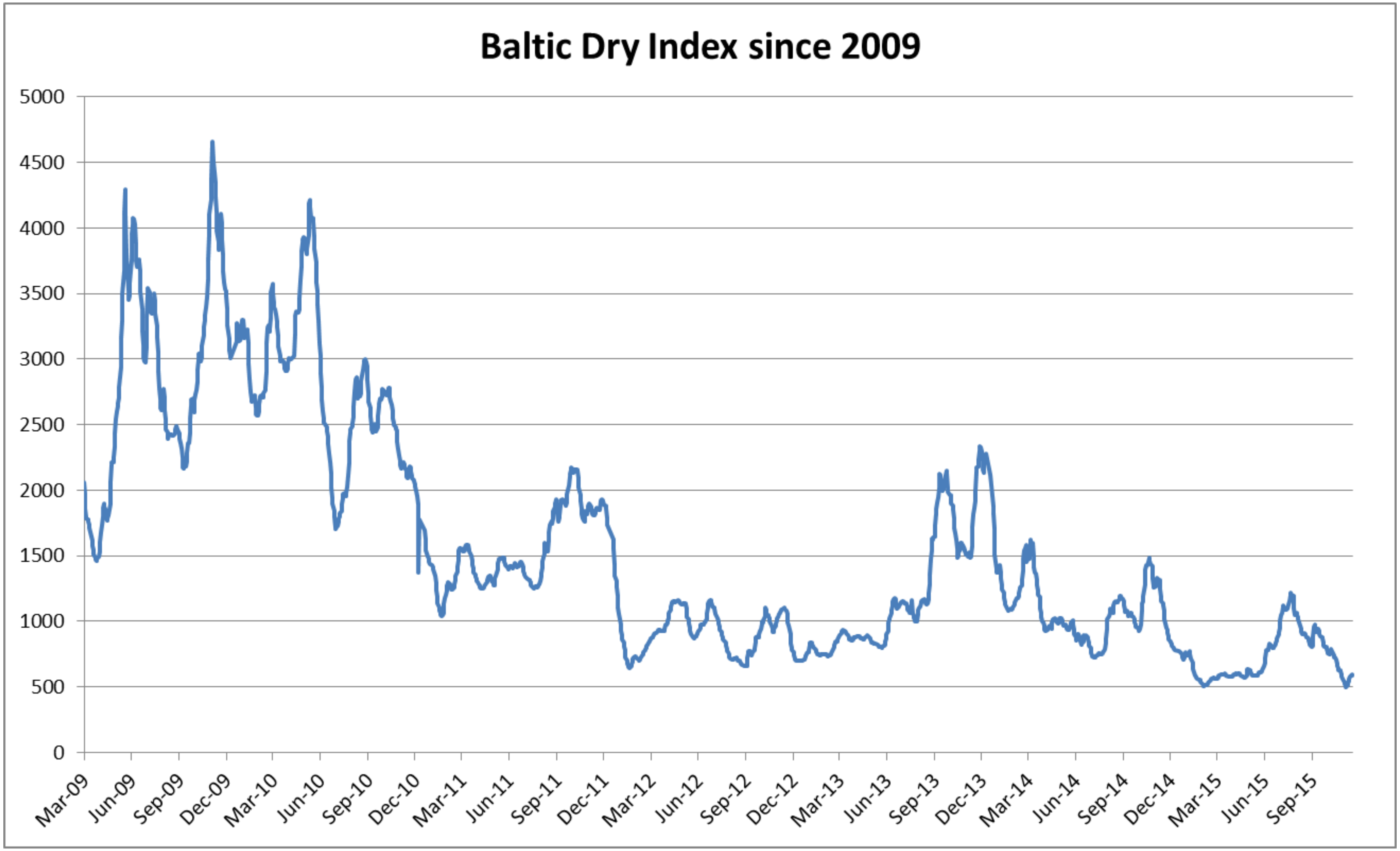
(Billion dollars)



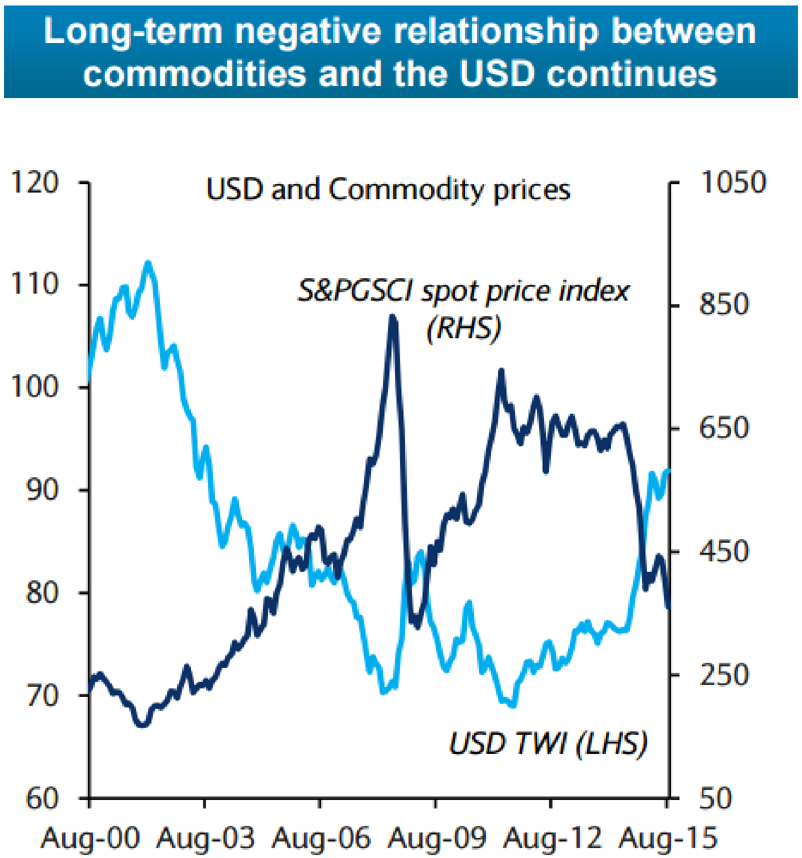
Baltic Dry Index

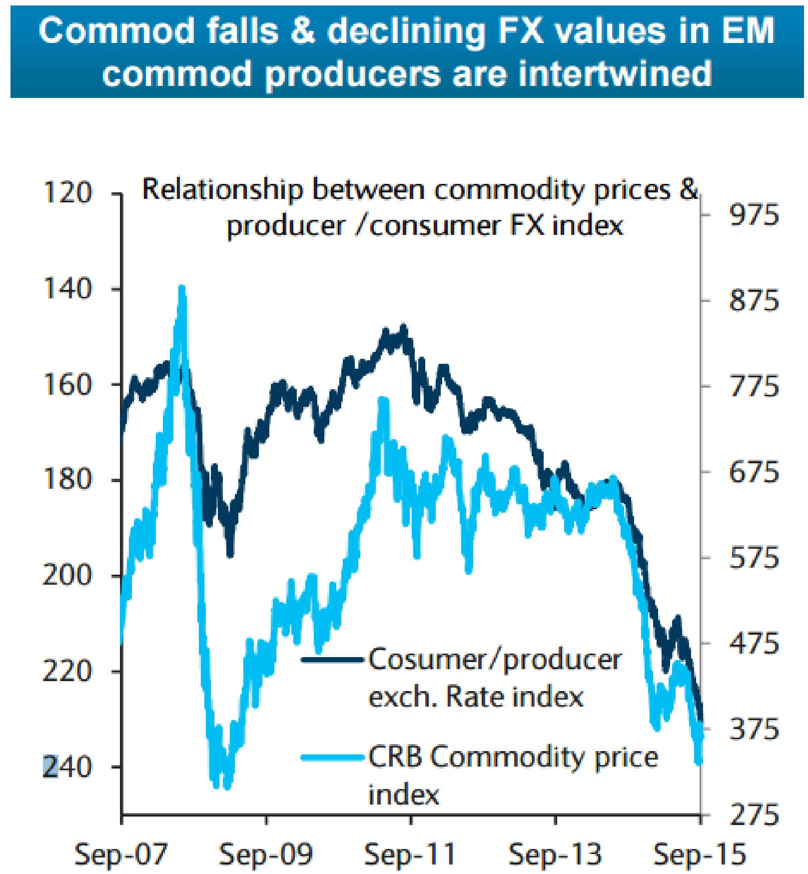


Baltic Index now at Lows



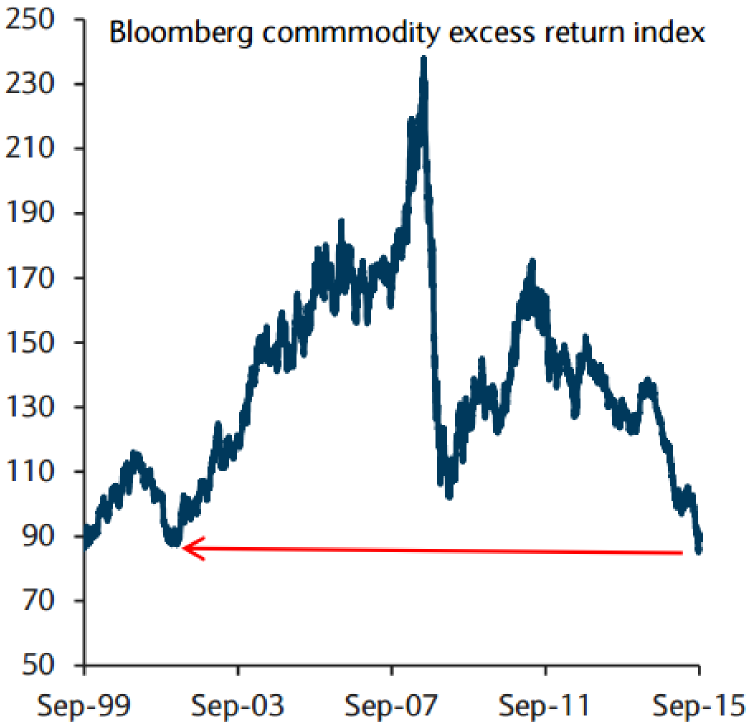
Commodity Prices



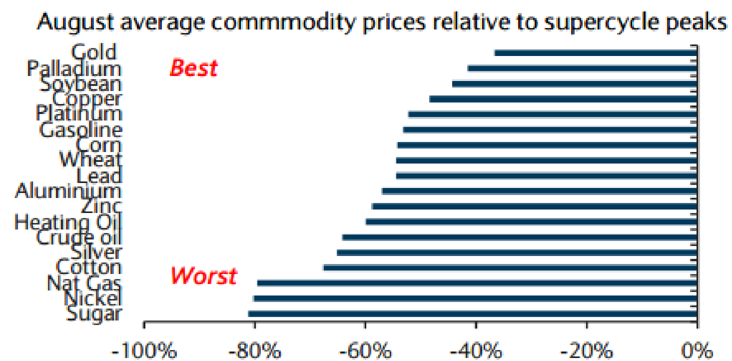


Commodity Prices

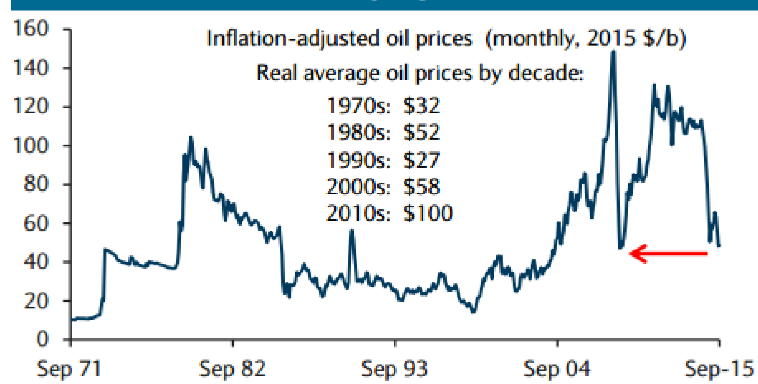
End of the supercycle: Commodity indices back at levels not seen for 14 years



Most major commodities are 40-80% below their supercycle peak



In real terms, oil prices are back at 2009 lows

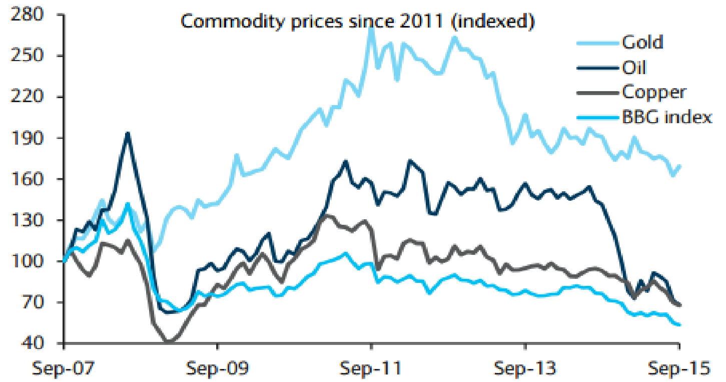


Source for all charts: EcoWin, Barclays Research

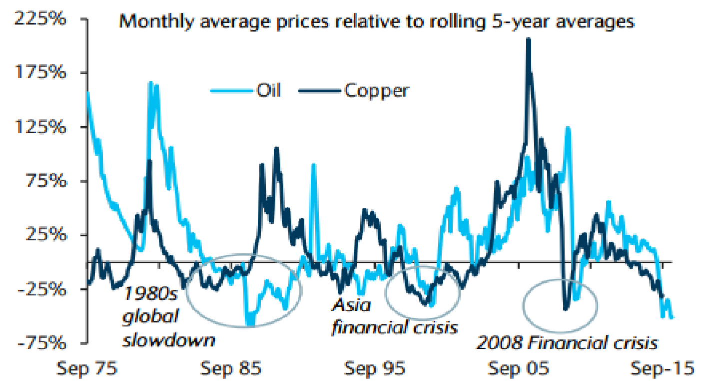
Commodity Prices

The bottom is in for prices, but it could prove a prolonged one

Prices have been in a downward trend since early 2011



Scale of price declines now on par with previous crises…

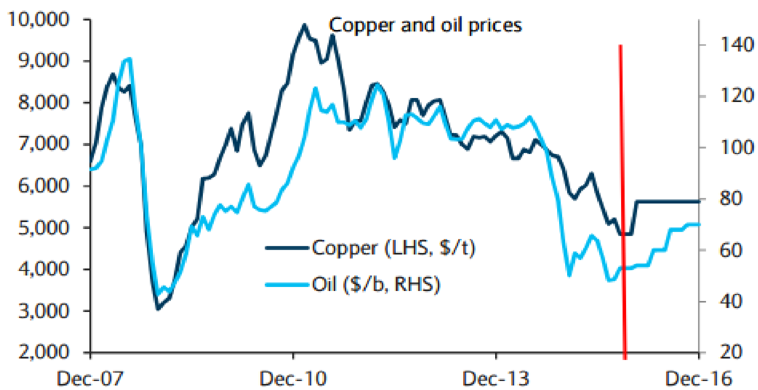


…but history suggests bottoming out will take a while yet

Comparison of current price levels with previous cyclical lows

	Low point (relative to the 5-year average price)		
	Current low as % of previous cycle lows	September	Avg. Low in previous cycles
Copper	84%	-31%	-36%
Oil	114%	-51%	-45%
	Months spent more than 20% below 5-year average price		
	Current duration as % of previous bottoming out periods	Current	Avg. spent in previous cycles
Copper	60%	9	15
Oil	58%	11	19

Our forecasts imply limited price gains in 2016

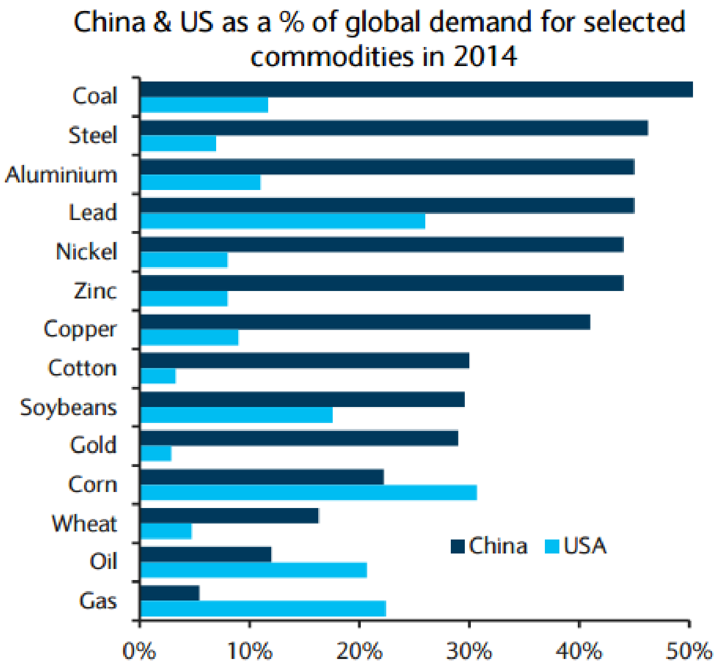


Source: Haver, Barclays Research

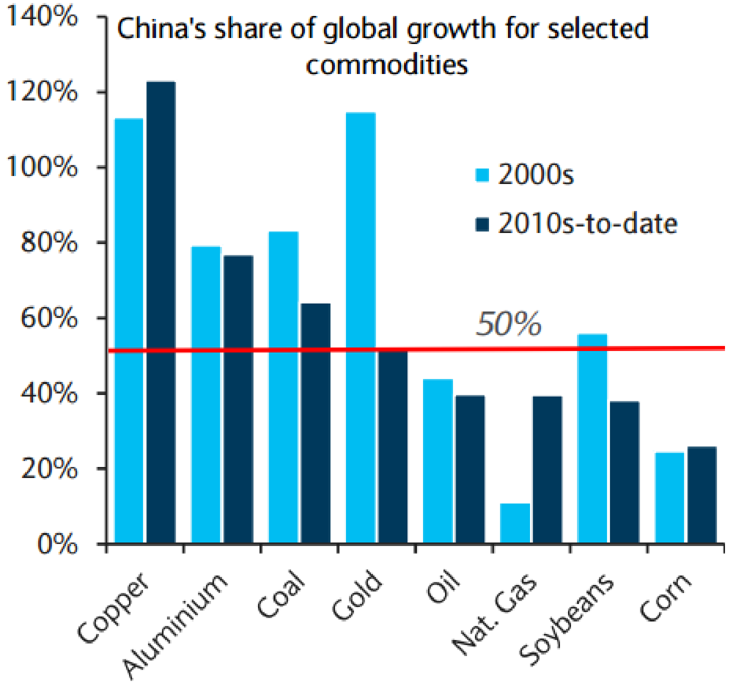
BARCLAYS

Commodities and China

China is (by far!) world's largest consumer in all but a few global commodity markets...



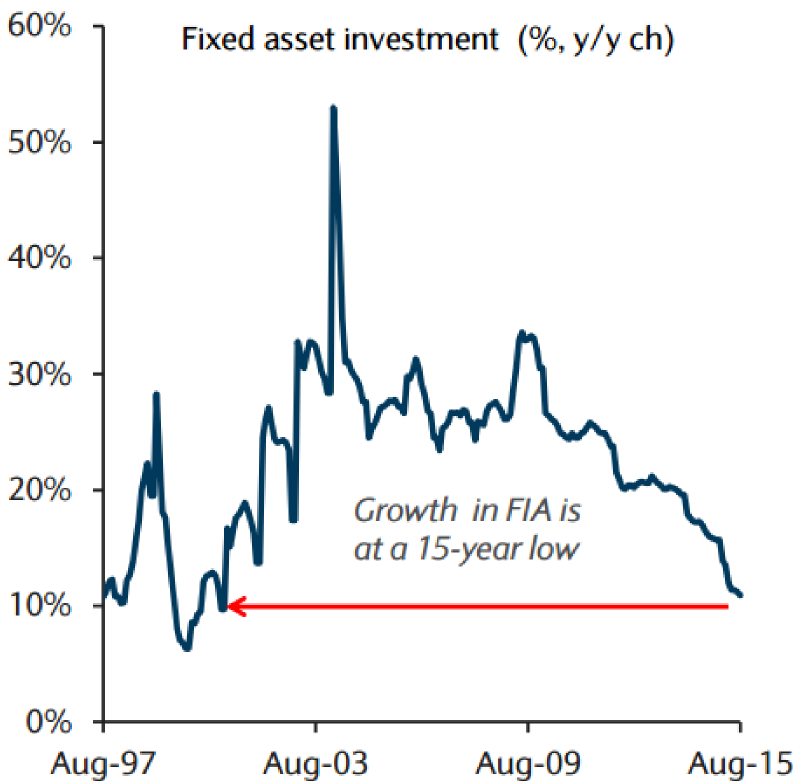
... & is even more important as *THE* driver of global commod. demand this century



Source for both charts: Bloomberg, Barclays Research

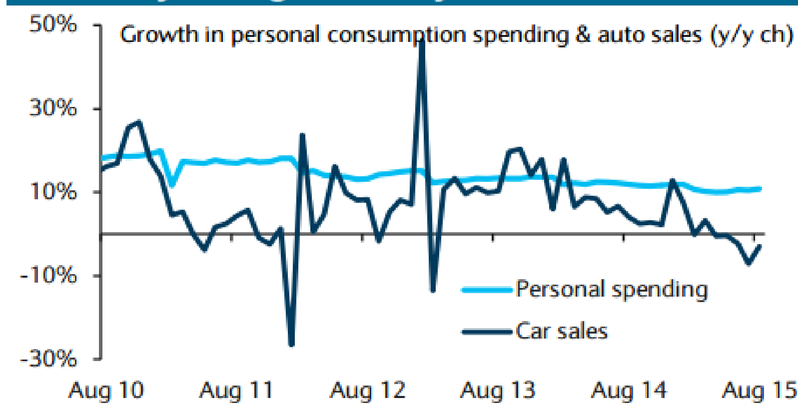
Commodities and China

The rise and fall of infrastructure spending



Economic activity at 2009 lows....

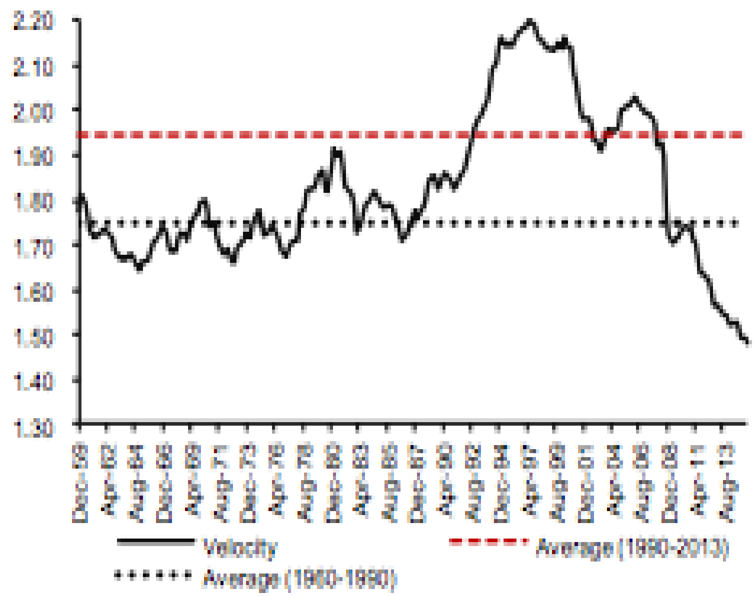
... and hoped for new growth drivers are yet to gather any momentum



Source for all charts: Bloomberg, Barclays Research

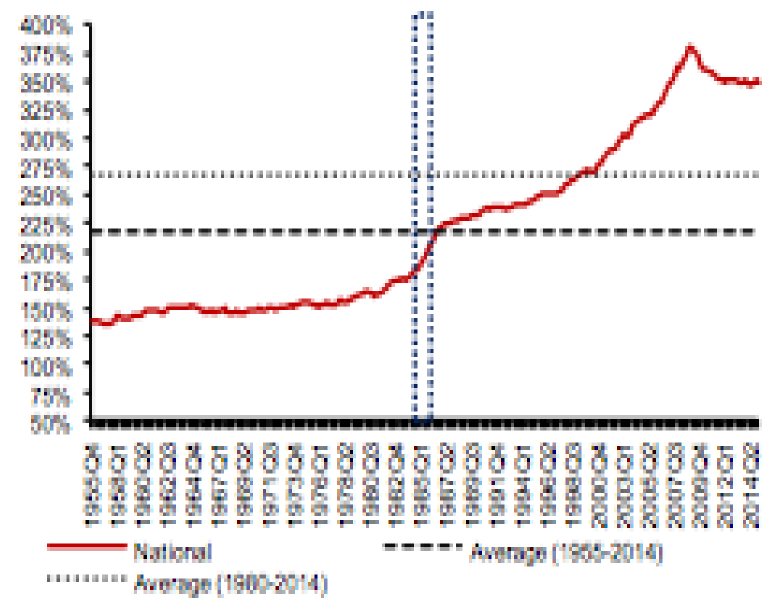
Velocity and Leverage

Fig 23 US – Velocity of Money (GDP/M2) (x)



Source: Federal Reserve; Macquarie Research, November 2015

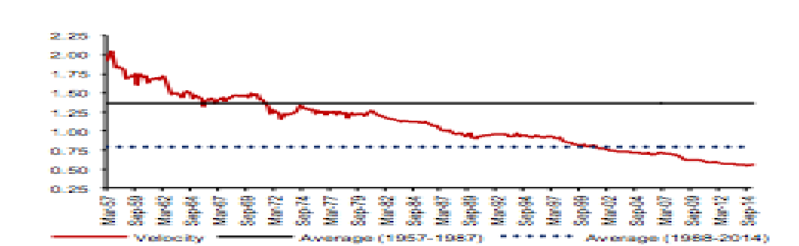
Fig 24 US leverage (private + public sectors (% GDP)



Source: Federal Reserve; Macquarie Research, November 2015

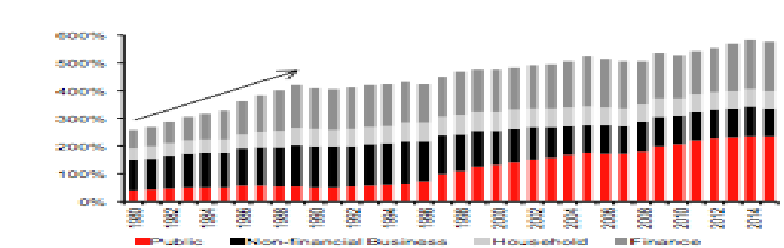
Velocity and Leverage

Fig 25 Japan – Velocity of money (GDP/M2) (x)



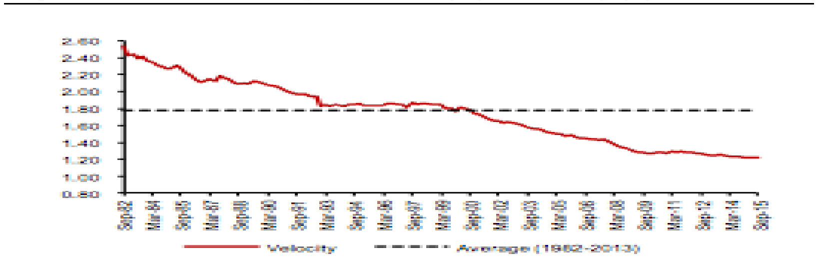
Source: CEIC; Macquarie Research, November 2015

Fig 26 Japan leverage (private + public sectors (% GDP)



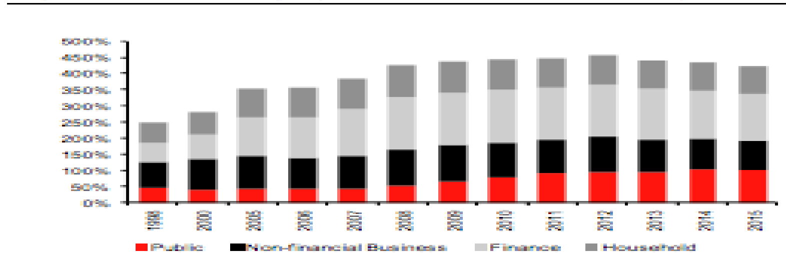
Source: CEIC; Macquarie Research, November 2015

Fig 27 UK – Velocity of money (GDP/M2) (x)



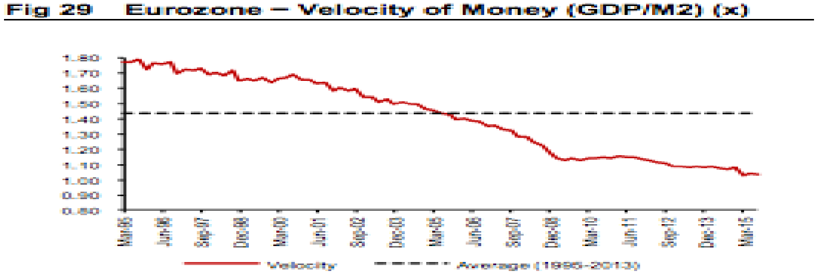
Source: CEIC; Macquarie Research, November 2015

Fig 28 UK leverage (private + public sectors (% GDP)



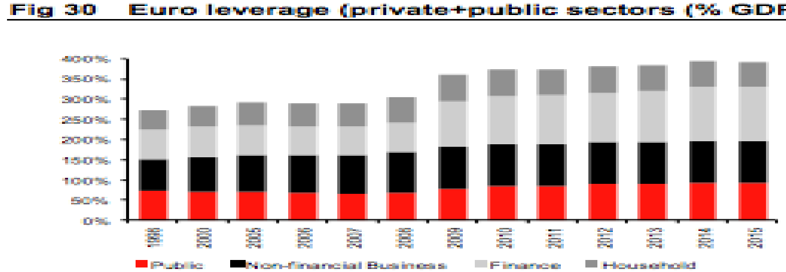
Source: CEIC; Macquarie Research, November 2015

Fig 29 Eurozone – Velocity of Money (GDP/M2) (x)



Source: CEIC; Macquarie Research, November 2015

Fig 30 Euro leverage (private+public sectors (% GDP)



Source: CEIC; Macquarie Research, November 2015

US

- Growth is anaemic
- Unlikely to pick up significantly
  - Particularly if rates rise
- Inflation just on target
  - But deflation unlikely
- Unemployment at reasonable level
  - Labour Participation not relevant

Euro Area

- Growth is significantly sub par
- Unemployment still very serious
  - In most countries
- QE is having an effect
  - But more is needed
- Rates likely to go lower before they rise again

Where are we going?
Overview of the Overview

- What's driving rates?
  - In the US
    - The recovery has not reached escape velocity
    - Raising rates risks crushing recovery
      - But Unemployment is reaching NAIRU
    - Core inflation JUST reaching 2% target
    - 50% chance of Fed Fund move in Dec
      - Depends a lot on today's NFP number
      - Even if NFP is good, a rate rise is not certain
  - In the Euro Area
    - Recovery weaker than in the US
    - Possible deflation
    - Fear of TRIPLE dip
    - ECB policy to continue QE, and reducing rates
    - BTW QE does work

Where are we going?
Overview of the Overview

- What's driving rates?
  - Japan
    - A weak economy
    - With no price pressure
    - And worsening demographics
    - So no change yet
  - UK
    - Continuing austerity rather than growth
    - GDP per Capita still below 2008 peak
    - Deficit not yet under control
    - Rate hike risk receding (too late 2016 at earliest)

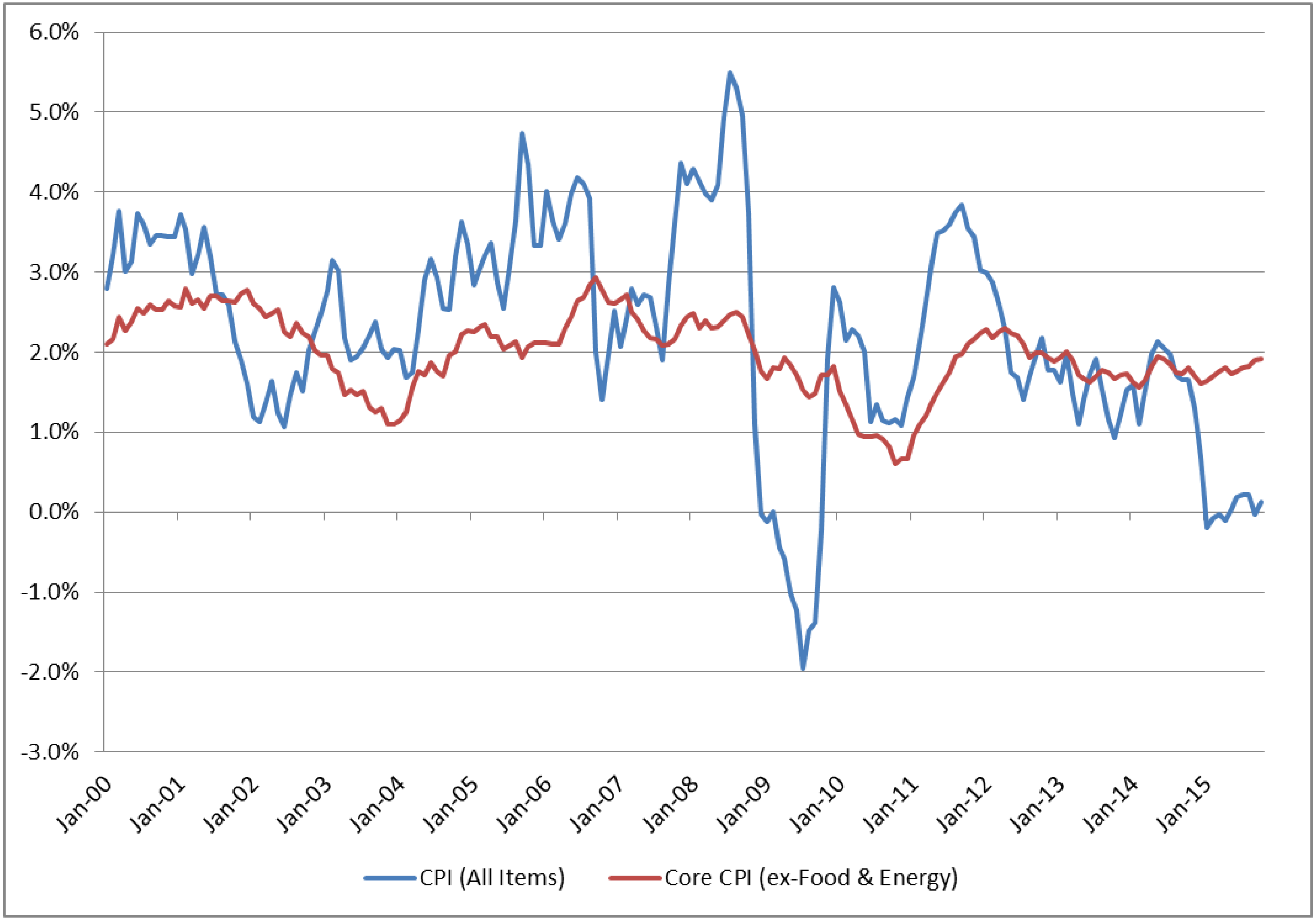
Where are we going?
Overview of the Overview

- What’s driving rates?
  - China
    - Steadily weakening (but still relatively high) growth
    - Structural adjustments
    - Rates still dropping, and will continue to do so

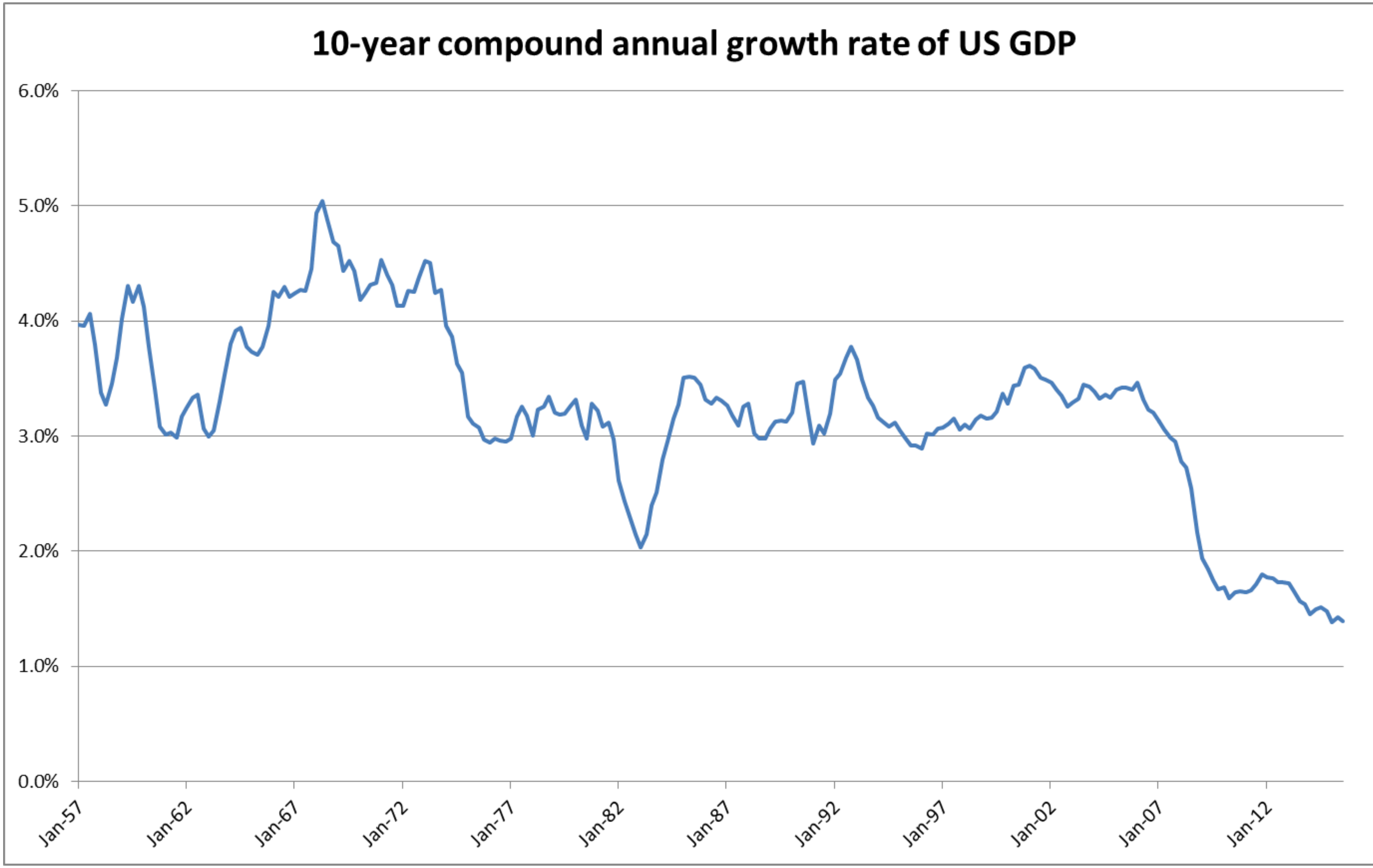
US Inflation

- Fed watches Core CPI (i.e. ex-Food & Energy)
- Core inflation has now reached 2% again
- And y-o-y wage growth has exceeded inflation
  - For the first time in many years
  - At 2.5% y-o-y

US Inflation



Escape Velocity……



Central Bank Policy : General

- 1] Different CBs have different mandates
- 2] CB IR policies are asymmetrical
  - You cannot push on a piece of string
  - Zero rates intervene
- 3] So "Unorthodox Measures" are required
  - QE, Credit Easing, Forward Guidance etc

Summary

- What is QE & What is it for?
- Effects of QE - (generally intended)
- The Real Point of QE
- Factors Affecting QE Success

What is QE & What is it for?

- Usually, increasing interest rates slows growth
  - By making credit more expensive
- And deceasing them accelerates growth
  - By making credit cheaper
- This will not work if rates are already very low
  - Or zero (hence “ZLB” or Zero Lower Bound)
- So to increase credit supply, the CB buys assets from the banks
- It is called Quantitative Easing for a reason!

Effects of QE (generally intended)

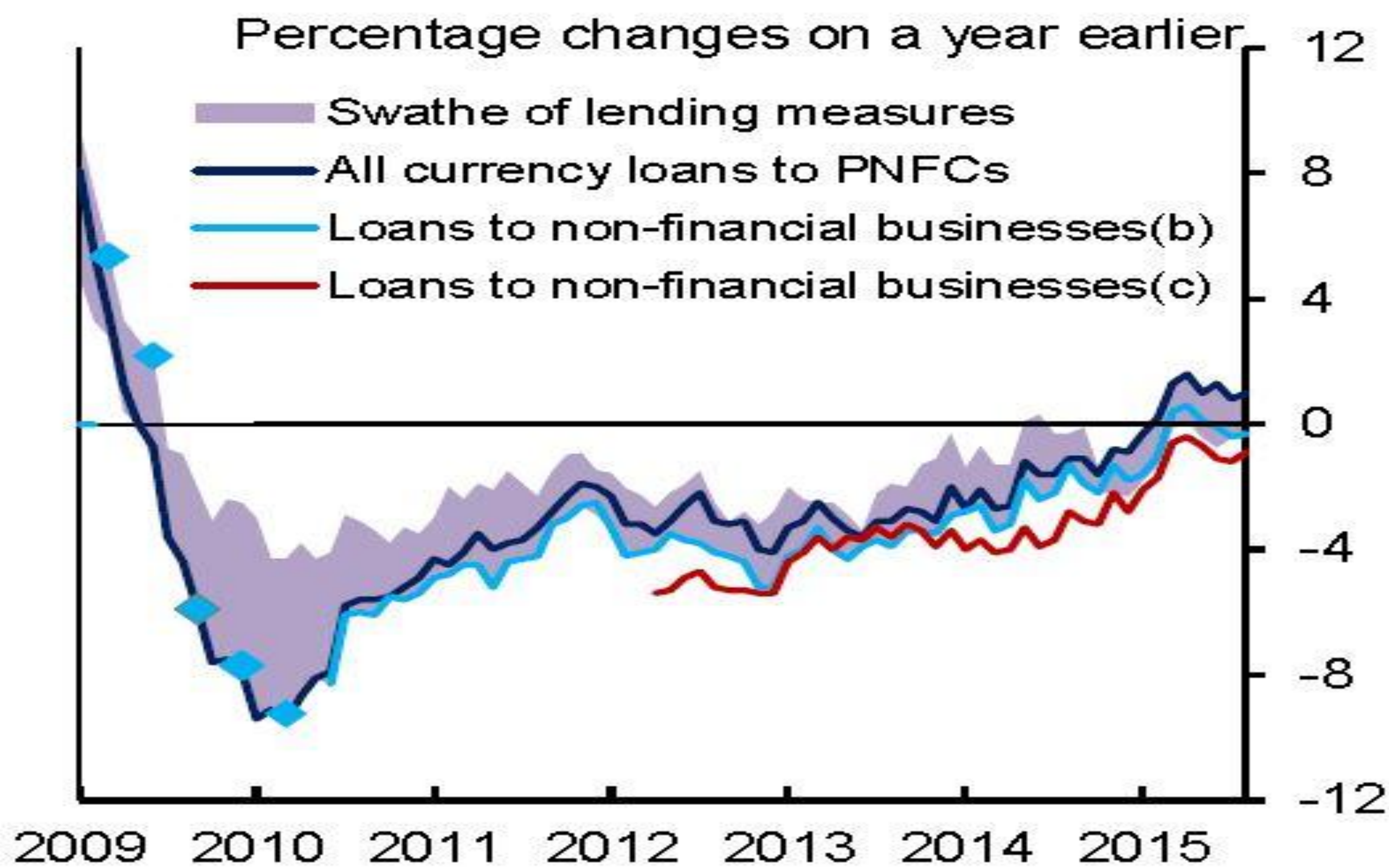
- There are other goals stated for QE
- The Economist gave 3 ½ of them:
  - Reduce Bond Yields
    - Changing the shape of the yield curve
  - Increasing Inflation Expectations
    - (*A word about deflation*)
  - Weakening the currency (i.e. in this case the €)
- But these are not the central aim
- QE EASES monetary conditions

The Real Point of QE

- The various CBs occasionally state different goals
- But **the key one** is simply to get banks to make more loans
- This has clearly worked in the US
- UK?.... Kinda getting there…
- Euro area: right direction but started late
- Japan: zombie banks

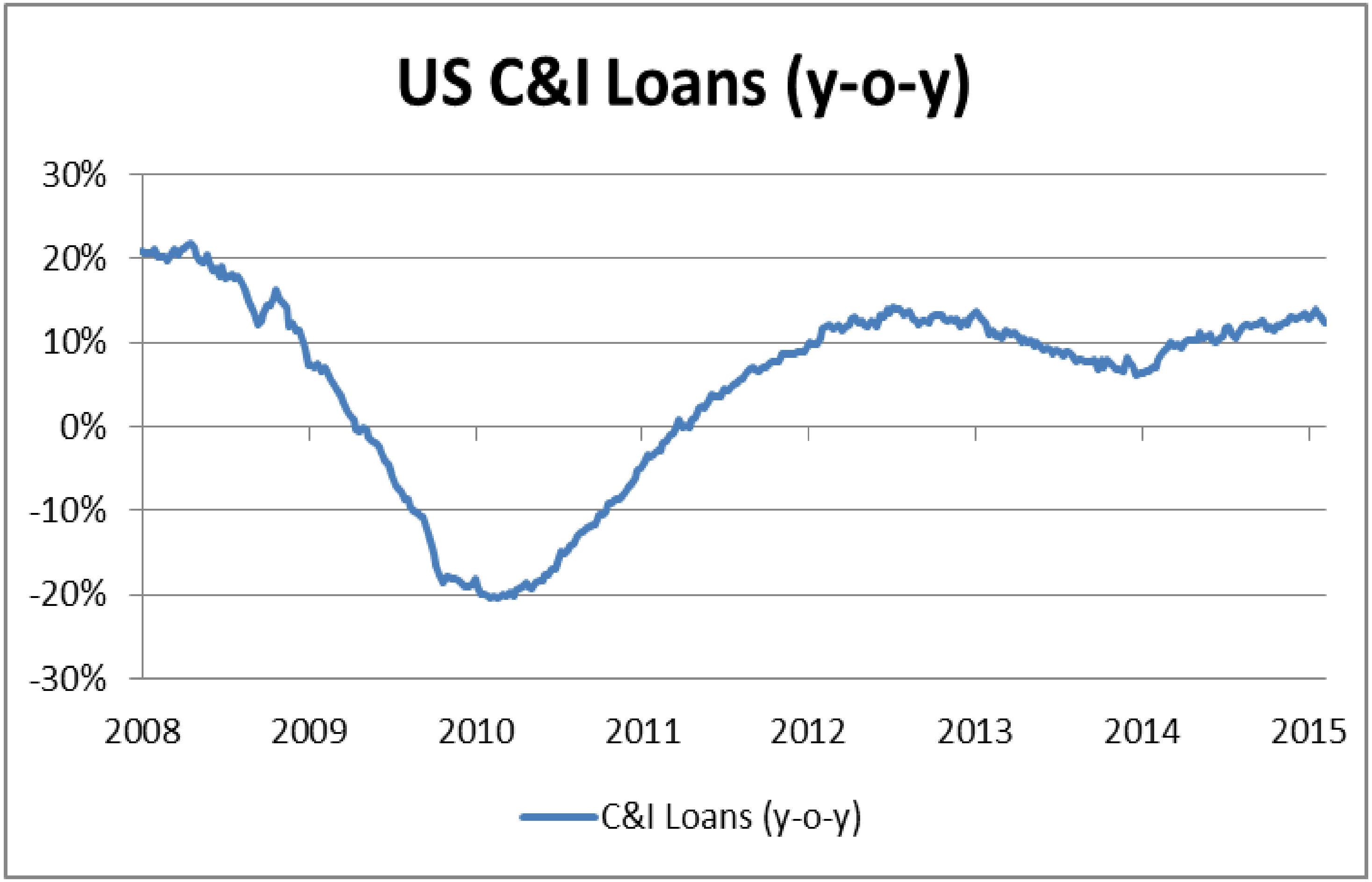
UK Bank Lending (to June 2015)

Chart 5: Lending to UK businesses[a]



Source: Bank of England Credit Conditions Review 2015 Q2

US Bank Lending (to end of QE)



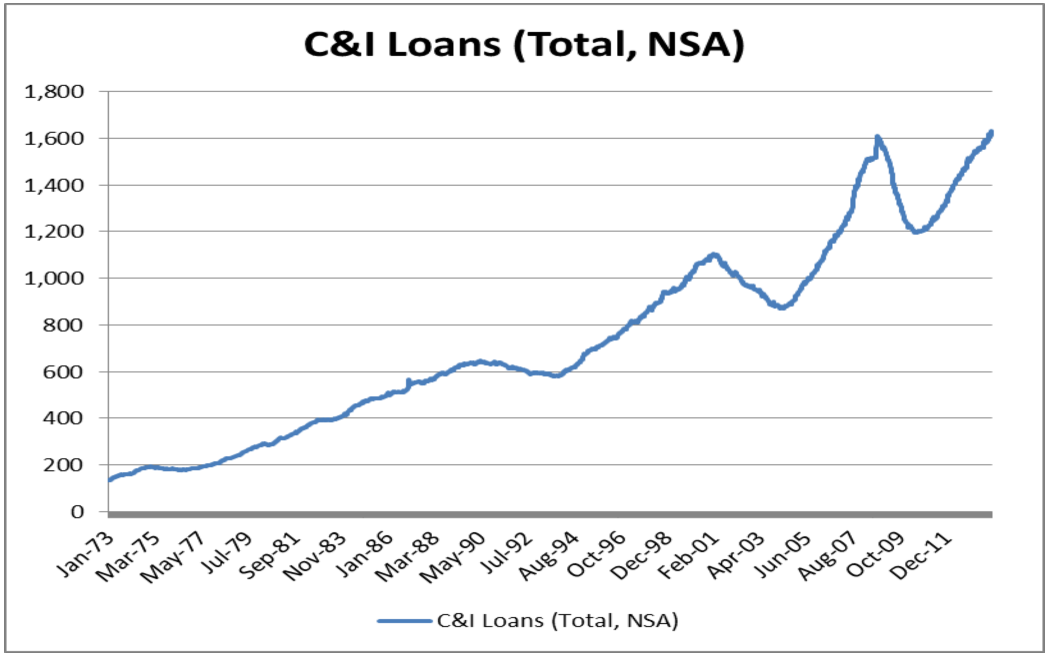
Source : FRED

Factors Affecting QE Success

- Reliance on banking vs capital markets
  - Do corporates borrow from banks?
  - Or do they issue bonds
- How healthy are the banks?
  - Deleveraging
  - Recapitalisation

Possible Side-Effects of QE
Other Questions

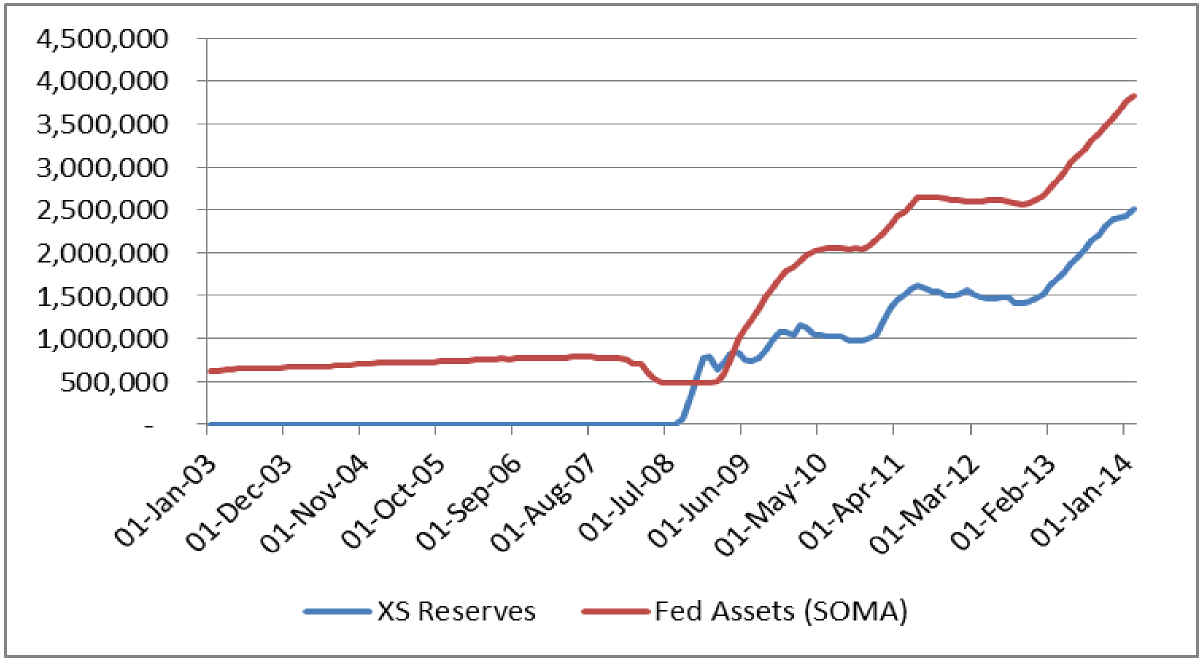
- US bank lending collapsed…..



- But eventually recovered (after lots of QE)

Possible Side-Effects of QE
Other Questions

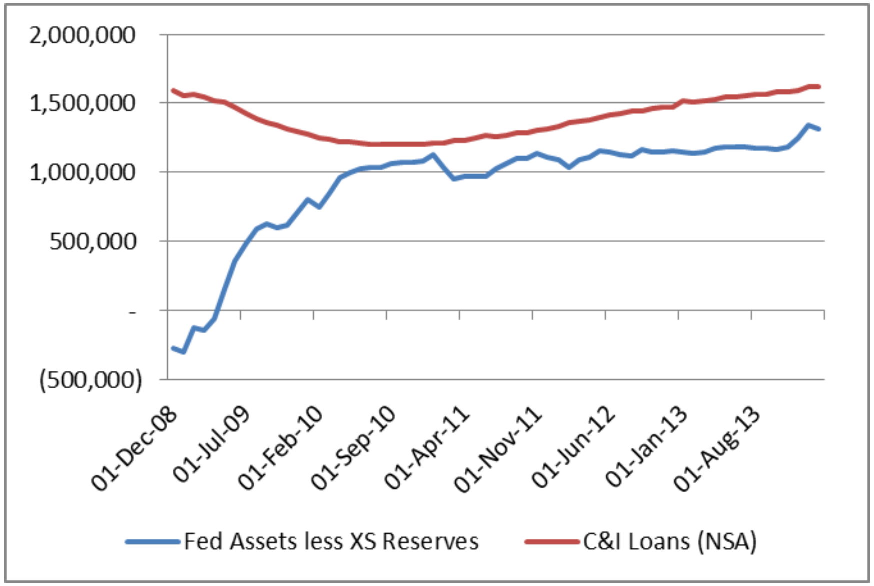
- Most of the growth in Fed Assets….



- Has stayed in the Fed as Excess Reserves

Possible Side-Effects of QE
Other Questions

- And what "leaked"…..

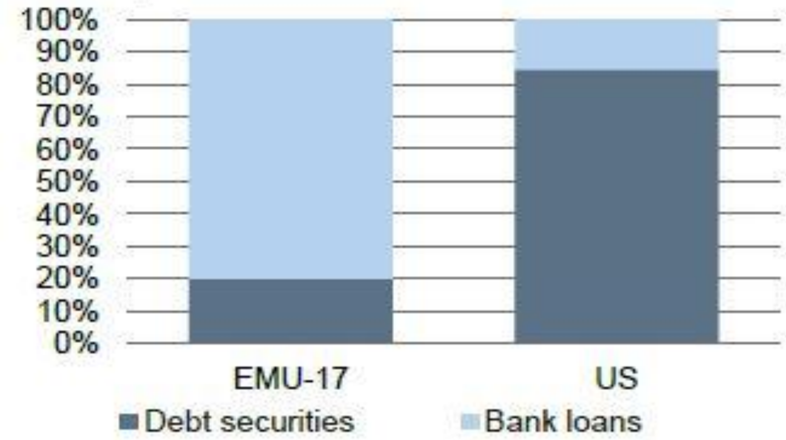


- Eventually turned into loans
- QE WORKS….! But it takes time

Eurozone Corporates

- They still rely on bank lending

Non-financial corporations, selected outstanding liabilities, 2013 Q4 or latest



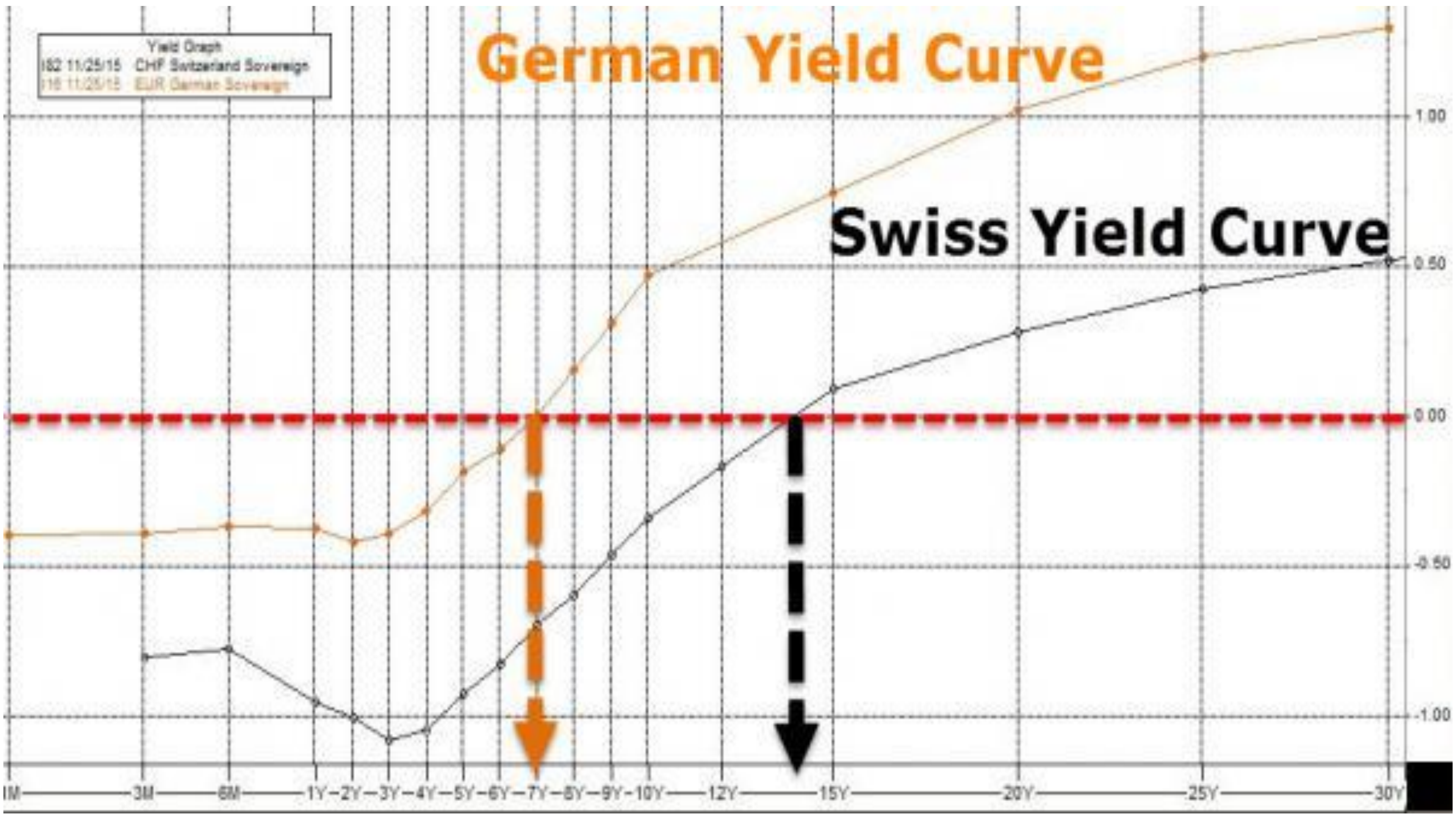
Bank loans represent loans from domestic depository institutions. Loans from other financial institutions such as insurance corporations, pension funds, financial auxiliaries as well as loans from government, households, other non-financial firms and from foreign banks are excluded.

Sources: ECB, Fed, Deutsche Bank Research

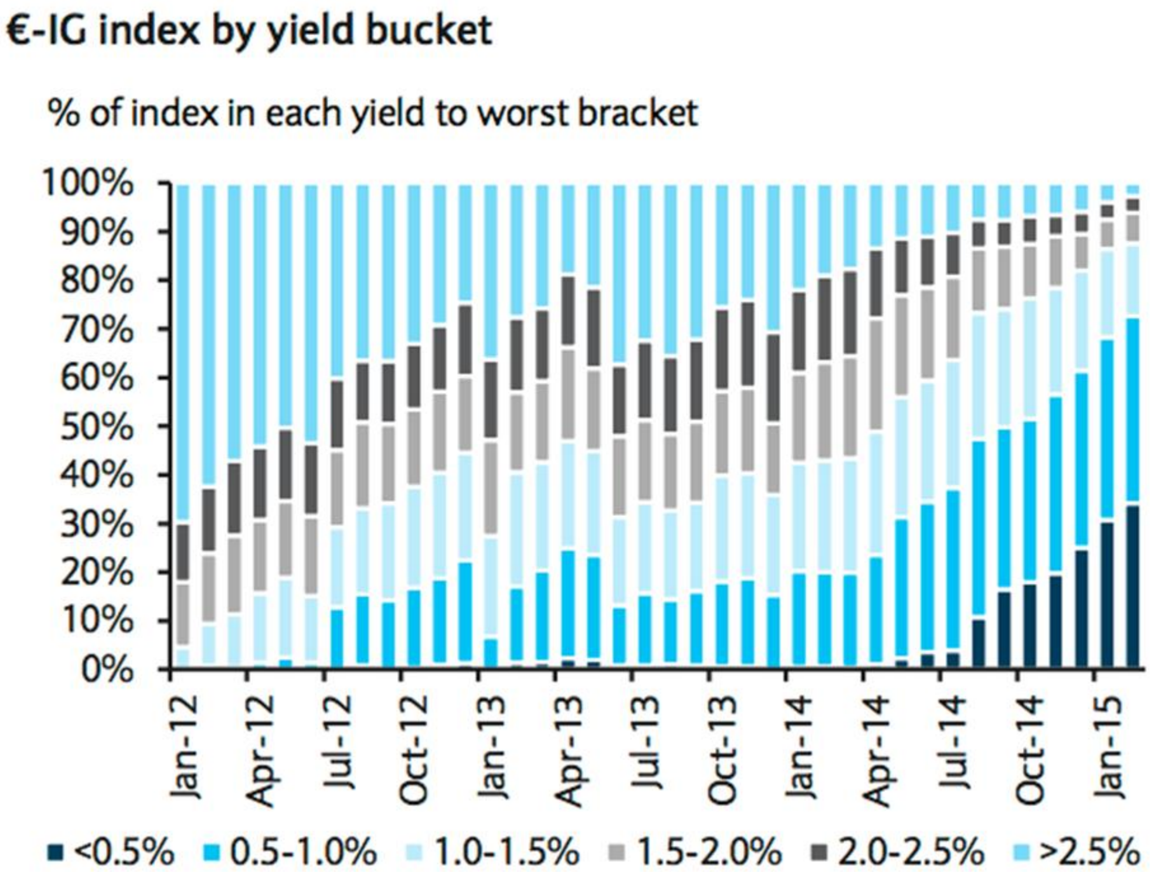
- …much more than US corporates

QE in Euro Area

Negative Yields



Negative Yields Earlier this Year

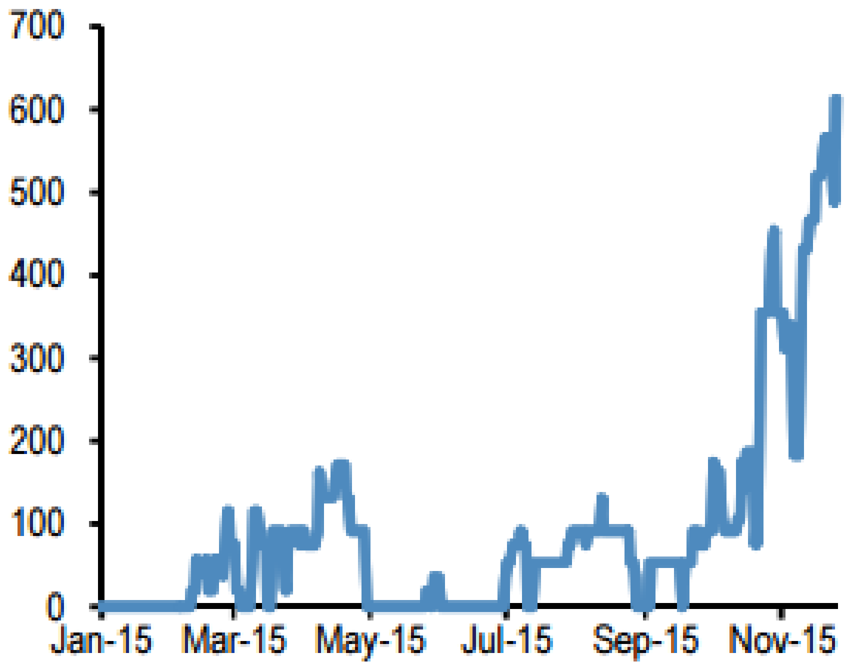


Source: Barclays Research

Negative Yields Now!

Figure 1: Euro area govt. bond with maturity >2 yr and yield <-0.2%

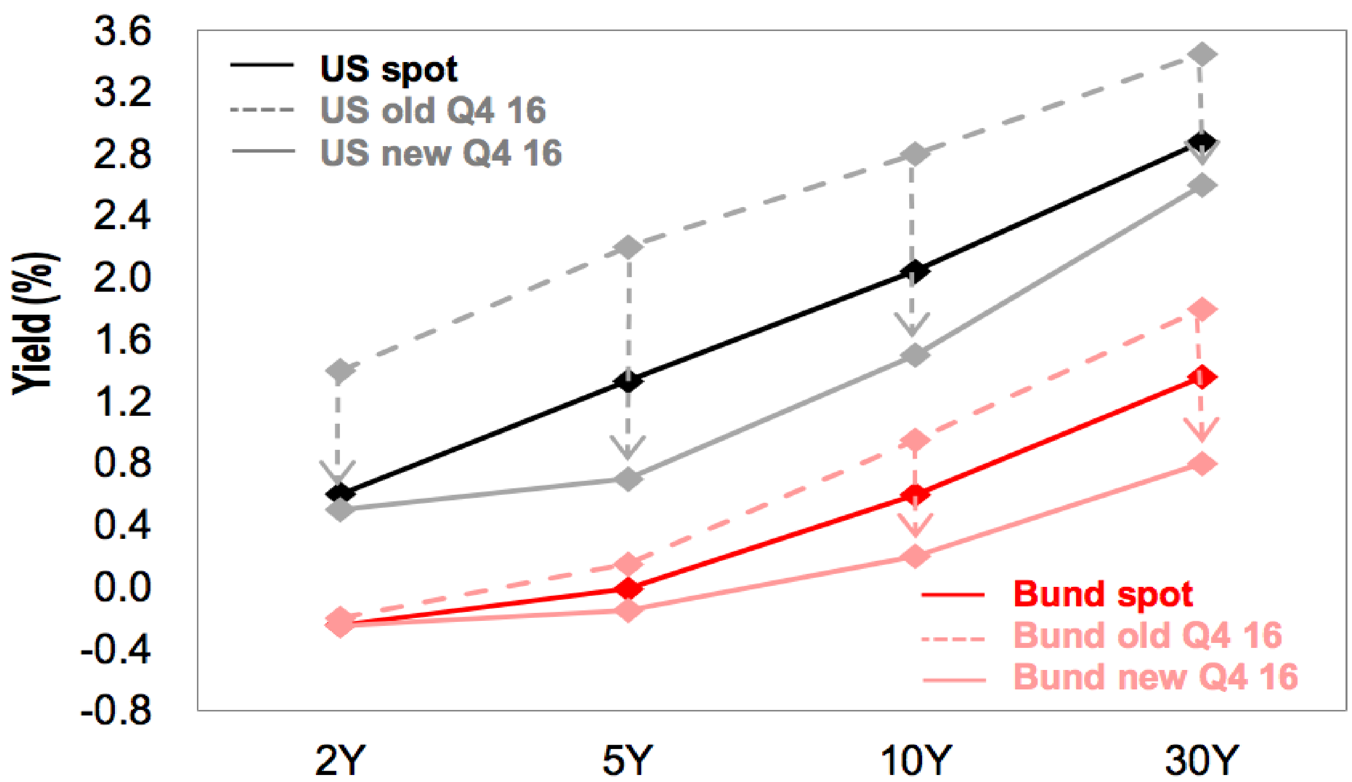
In €bn. Analysis is based on JPM GBI Broad Index.



Source: J.P. Morgan

Conclusion

Figure 1. Q4 16 Treasuries and Bund yield forecasts cut significantly



Source: HSBC FI estimates , Bloomberg