Income insights:
Better for bonds, for now

September 2017

- Macro data remains threateningly resilient, if not enough to stoke inflation
- Valuations are still extended by central banks' liquidity injection
- But the bond bubble may not burst just yet
- Investors have to take on ever more unreasonable risks to find their income or returns

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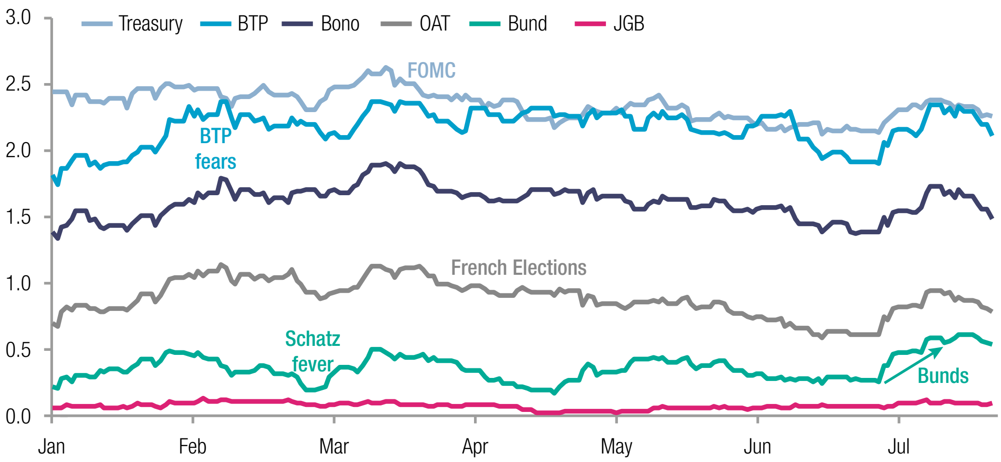
Riddle me this

Earlier this year we were rather pessimistic about the outlook for bonds. There were so many factors at play it looked like 2017 really would be the year the bond bubble finally burst. Not for the first time, those expectations have been confounded. Fast forward a few months and things are looking a little less worrying. Most bonds are range-bound, with a breakout seemingly unlikely for now.

10-yr yields: only bunds are near YTD highs



Source: SG Cross Asset Research, Rates Strategy, August 2017.

Macroeconomic data remains resilient, but inflation stubbornly weak. True reflation is a riddle yet to be solved. President Trump's troubled apprenticeship on the Hill has cast doubts on whether he'll ever be able to implement any of his flagship fiscal policies in the guise he initially intended. Meanwhile, political risk in Europe has eased as populism has faded, providing a boost to corporate bond holders. Peripheral eurozone bond spreads have fallen, credit spreads have tightened and emerging markets have outperformed.

For the bond bears to be (ultimately) proven right, we need more than good data. We need a significant shift in positioning, some hints that inflation (wage-related in particular) is on the mend and less caution from the central bank fraternity. All this is still possible. And the markets are more fragile than they might otherwise appear. So what's next?

Government bonds

Central bank intentions still unclear

All eyes are on the central banks, which are likely to play a critical role over the coming months. Jackson Hole gave little away. The hawks are sounding more dovish, making their short-term intentions harder to read. The minutes from recent ECB meetings haven't given much away on its tapering plans and have highlighted some uneasiness with the euro's strength. The Fed meanwhile is still split between those who want to shrink the balance sheet within the next few weeks and those who need more evidence that the US economy is recovering strongly.

Bearish on rates

We recommend investors stay on their guard when it comes to rates. For our part, we're still bearish and expect to remain so into the end of the year. The better global growth and inflation picture, economic policy rotation and stretched valuations have kept us short duration since last September. These forces are still at play, although their intensity has slackened somewhat.

Neutral on eurozone government bonds

With the ECB extremely wary of choking off the recovery, any upside risks to rates seem more likely to come from the US. Weak inflation and encouraging economic growth support tighter eurozone sovereign spreads in the medium term. Yet we're remaining neutral because we're wary of further volatility linked to ECB pronouncements. Another threat to yields, more particularly those of bunds, is the recent strengthening of the euro against the US dollar. Policymakers are already trying to talk the euro down by warning policy could change if currency markets overreact. As for the much-talked about taper, we see the process as being very drawn out. And we don't see it starting before January.

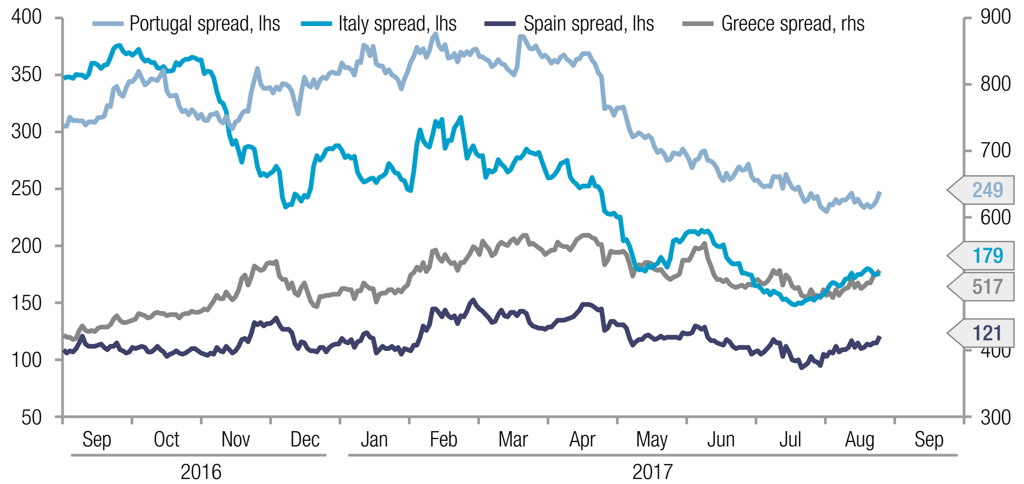
Playing the periphery

Peripheral spreads have proven remarkably resilient recently. We like Spanish bonds in the main, but Italian government bonds should also provide some carry and possibly even tighten in the near term. For now we continue to run the gauntlet of long-term uncertainty and like holding peripheral risk.

Politics was always our concern, but the situation is much calmer than it was some months ago. Italy's elections should be in May next year, while Catalonia may postpone its 1 October referendum. In Germany, Angela Merkel's re-election is an increasingly sure thing.

Spreads have been resilient

Yields spreads with Germany



Source: SG Cross Asset Research, Rates Strategy, August 2017

Overweight gilts

Meanwhile in the UK, a gradual worsening of economic data following the Brexit vote and the political uncertainty since the June elections suggest the Bank of England will stay on the side of the doves. With this in mind, we're still overweight gilts.

Mind your head

The US government should hit its debt ceiling by early October. This could result in a shutdown like we saw in October 2013. Government bond markets tend to rally at such times as investors seek out safer havens. Indeed, during the 2013 shutdown, equities tumbled and credit spreads widened while Treasuries and gold rallied. Don't be too underweight Treasuries just yet. They are one of very few assets to combine safe haven characteristics and some reasonable carry.

Rates to rise over the longer term

Fed officials still seem set to announce their intent to reduce their balance sheet later this year, probably in September. A rate hike still looks likely in December. Over the longer run, the only way real yields (still close to zero) can go is up. This should push 10-year treasury yields up by around 40–60 basis points over the coming year.

Credit

A positive short-term outlook for credit...

We don't see too much on the horizon that could derail the credit markets in the short term. While valuations in many segments are, on the face of it, too rich, credit fundamentals still look good. Some investors fear the European markets would become more vulnerable if the ECB starts to taper its corporate sector purchase programme, but we think not. Much of the tapering is already priced in – and credit will be far from first on the list.

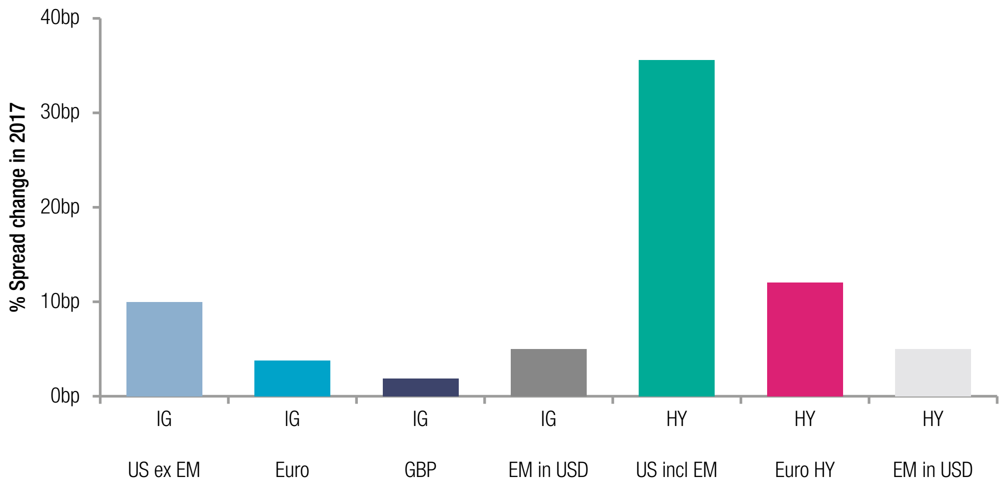
...but stay on your guard

Credit risk can be borne for now, but investors should be prepared to reconsider their positions later in the year. Over the medium term, we think the credit markets should still enjoy a final tightening leg, but spreads could rise again before we get there. Overbought markets, rising rate volatility and a higher VIX* are all good reasons for caution. The price of oil could also become a factor, especially in the US, if its recent bounce reverses. What's more, while politics has (somewhat surprisingly) been more or less irrelevant to credit markets so far this year, it could come back into focus at any time.

Tread carefully in high yield markets

For optimists, European high yield could still appeal. That said, were government bond yields to move much higher, it could choke off demand for riskier credit. Spreads could widen sharply in this scenario. They are already wider than they were.

Credit spreads have widened since the end of July



Source: SG Cross Asset Research, Credit Strategy, August 2017

*At the time of writing, overbought markets, rising rate volatility and a higher VIX are all good reasons for caution.

Emerging markets

Emerging debt to continue its rise

Emerging bonds have performed very well so far this year, and we expect further positive returns over the coming months – although they may not be quite as impressive as they have been. Accommodative central bank policies should offer support for a while yet. The crawl towards tighter policies in developed markets should reinforce capital flows into higher-yielding assets.

Currencies to remain a major driver of returns...

The appreciation of emerging currencies has been responsible for around three-quarters of local bonds' returns so far this year. We expect these currencies to continue to rise over the coming months, raising the prospect of further attractive returns for local debt. Improving fundamentals, increasing evidence of the dollar peaking against G10 currencies, slow policy normalisation in developed markets, yield-seeking behaviour among investors and the reduction of underweight allocations make a strong case for further currency appreciation.

...but credit looks expensive

However, emerging credit could suffer: rising rate expectations on both sides of the Atlantic are pressuring hard-currency emerging bond markets, and this means credit spreads could widen in turn. What's more, corporates are pricy compared with hard-currency sovereigns – after their sharp outperformance in 2016, corporate spreads are more or less in line with sovereign spreads. We think this leaves the corporate market looking vulnerable, so the narrowing of the spread differential we saw in 2016 could reverse, especially if oil prices dip below $40/bbl.

Finding the sweet spot

Targeting the highest risk-adjusted returns, rather than banking on all bonds, may be more rewarding. In our view:

- Three European countries are of most interest:
  - Spain – where Bonos should enjoy extended recovery dynamics while wage pressures and political risks are subdued. Carry is sizeable and we see little risk of disruption, even if the ECB tapers
  - France - where OATs should enjoy a probable rating outlook upgrade. The carry is less, but it's a better option than bunds for an ultra safe hold
  - The UK - despite some Brexit-based risk, growth and inflation data should keep the BoE on hold and yields stable at comfortable levels.
- Away from Europe, US treasuries are the only hiding place for doom-mongers (or those convinced the Trump administration is on the verge of collapse). A yield of over 2% means they will be well paid.
- For the optimists, we see two decent options where carry is at its highest – emerging markets and European high yield. We believe the ECB will extend its programme, and will pay particular attention to the last segment it touched (i.e. corporate bonds) so strong economic fundamentals, light leverage and a massive buyer should keep high yield credit safe. The EM story (hard and local currency alike) rests on much-improved domestic credit-worthiness. However, flows have been mighty and exposure to the Fed is still crucial, so we are slightly less convinced.