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Fixed Income Strategy

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European rates: How low can you go?

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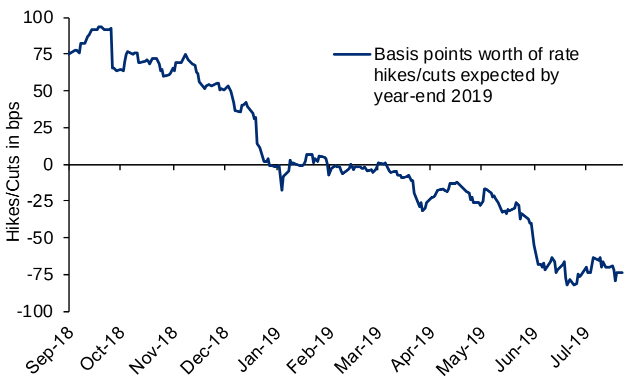
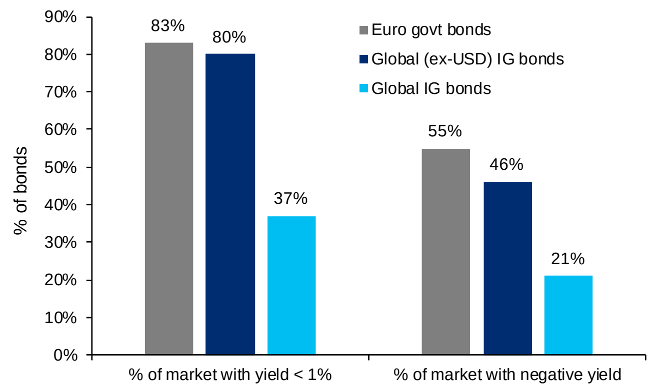
- **Summary:** Bond yields around the world have been falling for most the year, as trade policy uncertainty and decelerating growth has created an environment of synchronized policy easing. Today, global aggregate bond indices yield around 1.5%, its lowest since November 2016. We largely expect the Federal Reserve to cut policy rates at their July 31 meeting, though the European Central Bank is also shifting towards additional accommodation. We think the situation in Europe can have a meaningful impact on global fixed income markets, as the search for higher yields intensifies.
- **Our base-case is for the Federal Reserve to cut policy rates 25bp at their July 31 meeting.**
  - Fed Chair Powell's testimony to Congress on July 10-11 reinforced the likelihood we will see a rate cut from the Fed on July 31. Futures markets are fully priced for a 25bp cut, with a decent probability we could see the Fed ease 50bp **(Fig. 1)**. While we think a 25bp cut offers the path of least resistance, Fed surprises (when they happen) tend be dovish. In a recent strategy note, we show that when the Fed has surprised markets, it has delivered dovish surprises twice as often as hawkish shocks.
- **Our base-case is for the European Central Bank (ECB) to use several measures to support the economy further.**
  - The ECB have recently indicated that the criteria for further easing measures would only be a lack of improvement in the economic data (not necessarily a deterioration). At their July 25 meeting, the ECB is likely to adjust their forward guidance and signal a rate reduction at their September meeting. We expect a cut of 10bp in the deposit rate to -0.5%.
  - A framework to protect banks' profitability through "tiering" of bank deposits might also be announced. This might help countries that are net depositors with the ECB (i.e., Germany, Netherlands). However, periphery banks (i.e., Italy, Spain, Portugal) who are net borrowers, are unlikely to see much benefit.
- **A restart of quantitative easing (QE) in Europe is becoming more likely**
  - The ECB stopped expanding their balance sheet at the beginning of the year, though the reinvestment of maturing assets has been ongoing. In an effort to stimulate growth and inflation dynamics, we believe the central bank will restart their asset purchase program (APP) towards the end of the year. Similar to QE 1.0, we expect new monthly purchases to include both Eurozone sovereign and non-financial corporate debt (euro-denominated only).
  - Under the current QE framework, the ECB is limited to owning 33% of any particular sovereign issuer and 70% of any specific corporate security. In an effort to reduce bond scarcity, we would expect the ECB to consider raising the issuer limits, particularly on sovereigns. Raising limits will also create an opportunity for a more robust stimulus package. They might also introduce different limits for different countries.
- **If implemented, QE 2.0 will likely drive yields in the Eurozone lower and bring others down with them**
  - Today, 80% of the world's bonds (ex-US markets) already trades with a yield below 1.0% **(Fig. 2)**. Half of the Eurozone trades with a negative yield, which now even includes a handful of euro high yield (HY) bonds. If the ECB again becomes an indiscriminate buyer, the remaining net supply of available bonds for private investors will decline.
  - In turn, yields and spreads in euro periphery and credit markets would likely fall further. Moreover, the demand for higher yields would likely persuade investors to look at other markets outside the ECB's QE reach. This could include euro HY, emerging markets and US corporates (IG and HY).
- **Investment strategy:**
  1. **We expect spreads in euro corporate markets to narrow further.** Unfortunately, low yields in the Eurozone pose problems for more traditional, income-oriented buyers. Unless we begin to treat bonds like stocks, we prefer higher yielding opportunities in US dollar markets **(Fig. 3)**.
  2. **Add duration.** The squeeze on yield from a restart of QE lends to the likely outperformance of long-duration bonds. We prefer adding duration in credit markets, where yield and spread curves are relatively steeper.
  3. **Overweight emerging market (EM) USD debt.** Valuations in EM debt have risen, though still provide versus US credit **(Fig. 4)**. If global yields remain low (or move lower), EM spreads may benefit. We favor globally diversified strategies.

Figure 1. Expectations for Fed policy have reversed



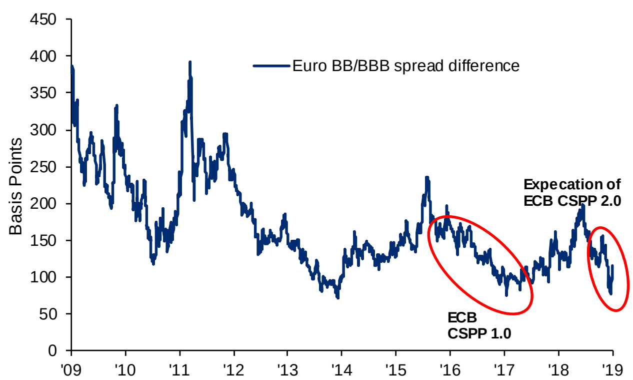
Source: FactSet as of July 22, 2019

Figure 2. Potential rate cuts and QE driving yields lower



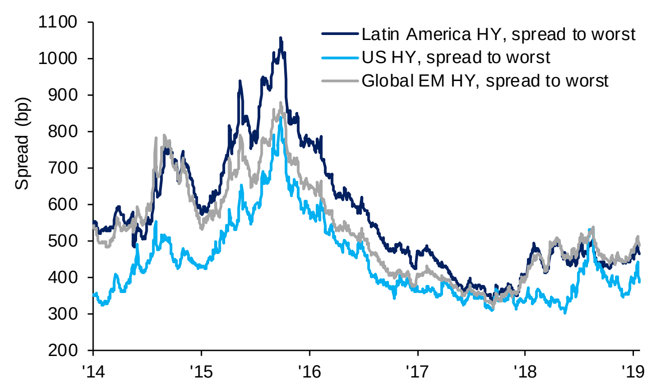
Source: FTSE Russell as of July 22, 2019

Figure 3. Asset purchases narrowed spreads in HY bonds



Source: Bloomberg Barclays Indices as of July 22, 2019

Figure 4. EM external debt offers value vs US HY



Source: JP Morgan Indices, Bloomberg Barclays Indices as of July 22, 2019

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