2020 a transition year. The start of a new decade characterised by higher rates

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The test

This year's Fixed Income outlook 2020 goes under the banner: **"Testing our 'low for longer' base case scenario. Inflation is not dead."** The objective of this qualitative test was to seek an answer to the question whether the 40 year old disinflationary trend in line with the slipping real growth path is structural and persistent or prone to change? Evidence pulled us towards the latter. The new long term base case scenario develops along the idea that change is upon us: disinflation will slowly turn into target or above target inflation and global real growth recovers towards a 3.00% sustainable pace. **Extremely depressed to negative interest rate term premia will start to rise**. We explain the role that 3 pivots will play in pushing up interest rate term premia. **Term premia** is the risk premium through higher rate levels that investors require when locking in money over longer time horizons.

Three pivots of change

The first and most important pivot is built on our conviction that on the one hand **monetary policy dominance will dissipate over the next couple of years whilst fiscal policy will become a stronger engine of investment growth**. The steep drop in core rates over the past 15 years has been the direct result of activist monetary policy (various QE programs, LTRO's…) alongside extreme dovish forward guidance. Since this summer, the majority of DM and EM central banks engaged into a prudent policy stance and refrained from cutting rates. The South Korea, New Zealand, Australia and Canada monetary authorities are a few examples as they ponder that volatile political rhetoric is not a good enough reason for action. The guiding ECB and the Fed allude that a **prolonged pause** in policy rates is upon us. We agree. That has been priced swiftly since September. It's the combination of accommodative, but passive, monetary policy with potent fiscal policy in the shape of productive public/private investments that will spur growth surprises over 2020 and beyond. This pivot will boost first and foremost **inflation expectations**. A study around fiscal multipliers proved that given low growth conditions and NIRP (negative interest rate policy) the positive effect of 1 euro spent returns between 1.5 to 2 euros in output. On top these high fiscal multipliers are persistent in time.

The second pivot that will push up term premia is rising **(underlying) inflation**. Above target inflation readings will be tested sooner than consensus believes. Wage inflation is clearly trending positively and results from ever tighter labour market conditions. The traditional Philips curve is alive and well. Increasing social unrest will only accelerate the fair-share debate and spur wage inflation across DM & EM countries.

Longer term, we note that dependency ratios have reached inflection points and start to accelerate. With a stalling youth share but an accelerating share of old people (65y+ share) we conclude that we crossed the tipping point. A distinct drop in the share of the active working population pushes the dependency ratio higher. A seminal BIS Study **(https://www.bis.org/publ/work722.pdf)** proved that such conditions lead to higher underlying inflation pressures as dissaving across channels drives up the natural rate of interest. Central banks will applaud upside inflation surprises without acting or guiding towards tightening i.e. they will apply a pressure cooker monetary policy style.

A third pivot is represented by the arrest in globalization. **Globalization has been disinflationary at the core**. That explains why the Japanese demographic shock never turned inflationary. Japan's action to reflate their economy since the start of the century occurred at the very moment the global disinflationary boom was strongest. Current protectionist strategies will see an increasing regionalization in trading blocks. Value chains will slowly shift towards the regional level. Such complex changes might create supply disruptions alongside fights over tariffs and non-tariff regulation. Those factors can render support to inflation pressure in goods and services. The current negative growth impact will be transitory. Over 2020, **the US-China trade dispute will have impacted investment sentiment over 2 years**. We ponder that the worst is behind us and economic policy visibility will start to clear.

Impact across bond sectors

A less mentioned side effect of the above is our expectation that rates volatility will increase. The bond equivalent for the equity VIX index is the MOVE index. We expect a mean reversion towards the longer term 80bp to 120bp range for the MOVE index. Over the past years this **US rate volatility measure** fell into a depressed range between 45bp to 85bp as monetary policy was dominant. **Less monetary policy anchoring will transform the low volatility rate regime into a higher rate volatility regime**.

We expect a protracted bear steepening bias to impact core EU and US government bond curves. Our EU and global government bond strategies engage in smart country and curve diversification, alongside an underweight in interest rate sensitivity. We turn **positive for our global inflation linked government bond strategy**. An improving growth background and supportive demand/supply balance leaves us **neutral on EUR IG credit as well as on EUR High Yield**. We seek **quality carry in EM local currency government bonds**. We do stress that our **sustainable country selection process** and **in-house researched convictions** are a key ingredient to run **a quality portfolio in a highly volatile sector**. Over the past three years the value add of unconstrained global IG and HY strategies has been confirmed. **Flexibility within an unconstrained solution becomes a quality asset** in every fixed income allocation and increases the overall capital protection characteristics. **Convertible bonds stand out** as the sector performs well when rates go up. Participate!

Conclusion

Investors that construct their fixed income allocation based on the safety offered by the ‘low for longer’ rates consensus should be careful. We sense that the bond winds are changing. We are prepared to tackle rate normalization. However, we are not naïf and do acknowledge that the bond bull will not surrender easily!

KEY TAKEAWAYS

- **We Rates**: Combination of easy monetary policy and fiscal pivot will likely cause bear steepening of US and European curves.
- **Inflation linked**: Combination of easy monetary policy and fiscal pivot will support inflation expectations.
- **Euro IG credit**: ECB buying is supportive but low yields offer limited buffer.
- **Euro HY credit**: Spread compensative increased default probably. Expect buyers to emerge on weakness.
- **Emerging markets (local currency)**: Like the carry of local FX. Remain diversified.
- **Alternatives**: Convertible and unconstrained mandates have ability to navigate rate increases.

RATES

Combination of easy monetary policy and fiscal pivot will likely cause bear steepening of US and European curves

LINKERS

Combination of easy monetary policy and fiscal pivot will support inflation expectations

EUR IG CREDIT

ECB buying is supportive but low yields offer limited buffer

EUR HY CREDIT

Spread compensates increased default probably. Expect buyers to emerge on weakness

EMD LC

Like the carry of local FX. Remain diversified on countries with high ESG standard

ALTERNATIVES

Convertible and unconstrained mandates have ability to navigate rate increases

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