Insight INVESTMENT

MONETARY POLICY DIVERGENCE

OPPORTUNITIES AND THREATS FOR GLOBAL FIXED INCOME INVESTORS

MARCH 2019

> After a prolonged period of convergence following the global financial crisis, monetary policy divergence between the US and other major economies has returned. We expect to see this divergence continue over the short term but convergence to return over the medium term. We outline the opportunities and threats for global bond investors.

Part of BNY MELLON

EXECUTIVE SUMMARY

FROM CONVERGENCE TO DIVERGENCE

Post-crisis monetary policy convergence:

- Key global central banks coordinated monetary policy easing after the financial crisis
- Global interest rates were slashed but challenges remained. Central banks responded with unconventional approaches – most notably, asset purchases

Central bank policies have diverged:

- Central banks are typically independent institutions beholden to their domestic mandates. As economic conditions diverged, so too did monetary policies
- US monetary policy normalisation is now well advanced, while the rest of G4's progress has been far slower. US-eurozone policy rate divergence is approaching historical wides

WILL DIVERGENCE PERSIST?

- We expect to see continued divergence of policy rates in the short term, although divergence of longer-dated bond yields might have peaked
- Over the medium term, we expect policy rates to converge again

WHERE ARE THE OPPORTUNITIES AND THREATS?

Short-term divergence

Opportunities

- Relative yield curve shapes
- Outright duration positions
- Corporate credit sector positioning across regions
- Take advantage of differing investor behavioural dynamics across regions

Threats

- Risk of prolonged policy divergence: Europe becoming another Japan

Medium-term divergence

Opportunities

- Cross-market strategies at the point of peak divergence

Threats

- US tightening spillover forcing other major central banks to tighten prematurely

FROM CONVERGENCE TO DIVERGENCE

THE WORLD'S KEY CENTRAL BANKS COORDINATED MONETARY POLICY TO AN UNPRECEDENTED EXTENT DURING THE FINANCIAL CRISIS LEADING TO A PERIOD OF SIMILAR POLICY THAT PERSISTED FOR SEVEN YEARS. HOWEVER, CENTRAL BANKS ARE TYPICALLY INDEPENDENT INSTITUTIONS AND AS DOMESTIC ECONOMIC CONDITIONS HAVE DIVERGED, SO HAS MONETARY POLICY.

POST-CRISIS MONETARY POLICY CONVERGENCE

An unprecedented policy response to a global crisis

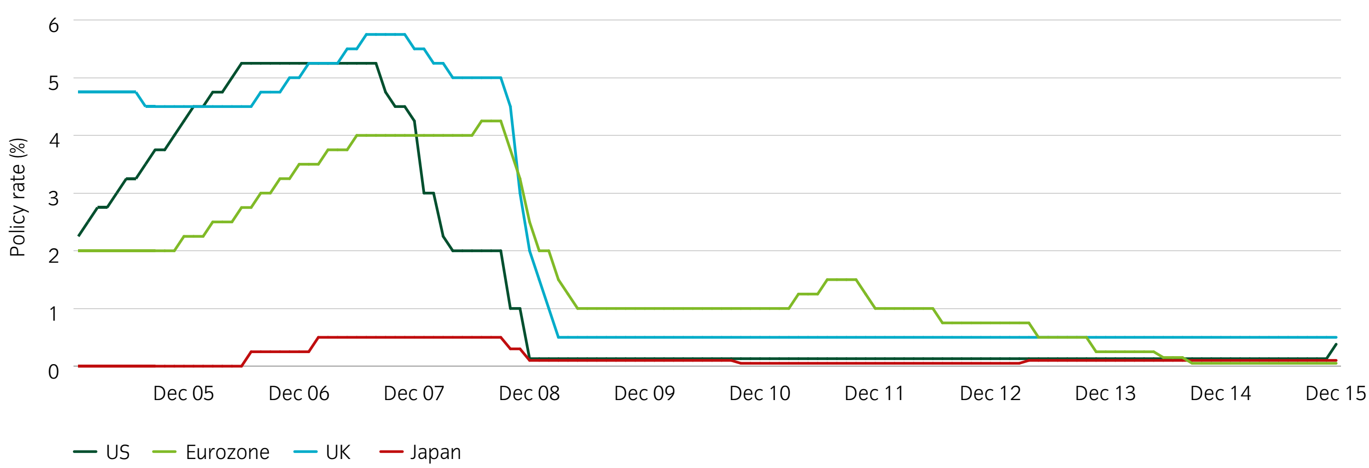
Back in 2008 as the global economy was in the grip of a severe financial crisis, the world's major central banks banded together to orchestrate a series of deep interest rate cuts. Although this was a crisis that manifested in the US housing and mortgage markets, its roots were very much international in origin, and its after-effects reverberated far beyond US shores. Within a very short space of time key global interest rates were at or approaching zero and so began a prolonged period of monetary policy convergence that would persist for the next seven years (see Figure 1).

The shift to unconventional monetary policy

With growth on a downward spiral, deflationary pressures threatening and the limits of conventional monetary policy quickly exhausted, central banks resorted to unconventional measures in order to ensure an effective transmission of policy to the real economy.

The Federal Reserve (Fed) engaged in three rounds of quantitative easing between 2008 and 2014 in an effort to place downward pressure on longer-term interest rates and, ultimately, corporate and household borrowing costs. The Fed's balance sheet assets swelled to US$4.5trn at their peak. After the global financial crisis, the European Central Bank (ECB) had to contend with a sovereign debt crisis. Over six years it accumulated €2.5trn worth of bonds in various asset purchase programmes, taking its balance sheet to €4.5trn overall by the time its programmes were completed.

Figure 1: Major central bank slashed rates after the crisis[1]



[1] Source: Insight, Bloomberg, March 2019.

Figure 2: Chronology of Fed and ECB asset purchase measures[2]

Fed	Date	ECB
QE1 (US$600bn of agency and mortgage-backed securities announced)	Nov 2008	
QE1 extended, via mortgage-backed securities and addition of Treasuries	Mar 2009	
	Jul 2009	Covered bond purchase programme (CBPP1) launched. This is the ECB's first outright purchase programme
QE1 ends after US$1.5trn in bond purchases	Mar 2010	
	May 2010	Purchases expanded to include sovereign bonds through a securities markets programme (SMP)
	Jun 2010	CBPP1 ends after reaching a nominal amount of €60bn
QE2 announced with intention to purchase US$600bn of long-dated Treasuries	Nov 2010	
Operation Twist announced to extend profile of bond holdings	Sep 2011	
	Oct 2011	Long-term refinancing operations (LTROs) and CBPP2 announced
	Dec 2011	Adds two very long-term refinancing operations (VLTROs)
QE2 ends after further US$800bn+ of Treasury purchases	Jun 2012	
	Jul 2012	Draghi's 'whatever it takes' speech
QE3 announced and begins in September, and expanded in December	Sep 2012	SMP replaced with outright monetary transactions (OMT)
	Oct 2012	CBPP2 ends after reaching nominal amount of €16.4bn
Begins to taper QE3	Dec 2013	
	Jun 2014	Deposit facility rate (DFR) cut to negative territory
	Sep 2014	Asset-backed securities purchase programme (ABSPP) and CBPP3 announced
QE3 terminated	Oct 2014	SMP replaced with outright monetary transactions (OMT)
	Jul 2015	Expanded asset-purchase programme (APP) announced
	Oct 2018	Tapering begins
	Dec 2018	Ends net purchases under APP

The reasons behind US/eurozone divergence are complex and include, amongst other things, the subsequent emergence of Europe's sovereign debt crisis, as well as unique institutional challenges and rigidities affecting the eurozone not faced by the US

CENTRAL BANK POLICIES BEGIN TO DIVERGE

Divergence in US/eurozone economic performance

Close policy coordination continued while the global economy struggled with high unemployment, sluggish growth and subdued inflation. While the international dimension of the crisis clearly warranted such close cooperation, central banks are typically independent institutions beholden to their respective domestic mandates. And although all central banks prioritise price stability in their statutes most also acknowledge, and are influenced by general economic indicators such as growth, financial stability and employment. As time moved on, and the respective monetary and fiscal prescriptions had varying results on domestic economic performance, G4 central bank monetary policies started to diverge (see Figure 3).

Fed policy normalisation is now advanced

The Fed's shift into formal tightening began in late 2015 when it implemented its first rate hike in nine years. Policy normalisation is now well under way: it has since hiked a further eight times (at February 2019) and is in the process of unwinding its balance sheet. US economic performance warrants this shift in stance: unemployment has fallen to multi-decade lows (Figure 4), wage growth is at nine-year highs, the Fed's preferred measure of core inflation continues to flirt with its 2% target (Figure 5), while growth prints have been strong. This combination of near-full employment, increasing wage pressures, near-target inflation and robust growth are likely to encourage the Fed to remain on its gradual tightening path, although this will be contingent on domestic growth data and the evolution of financial conditions.

The ECB's progress has been far slower

The ECB's ongoing dovish policy stance stands in marked contrast with the Fed. Current market pricing points toward a late 2020 first rate hike, representing an almost five-year policy gap versus the Fed. The reasons behind this US/eurozone divergence are complex and include, among other things, the subsequent emergence of Europe's sovereign debt crisis, as well as unique institutional challenges and rigidities affecting the 19-country currency bloc not faced by the US economy.

Notably, unemployment has been slower to improve in the eurozone versus the US. This is a function of not only softer domestic demand but also the labour market rigidities. The US economy is considerably more flexible allowing for quick readjustments in employment metrics when economic activity turns.

Figure 3: Major central banks' policy rates have diverged[3]

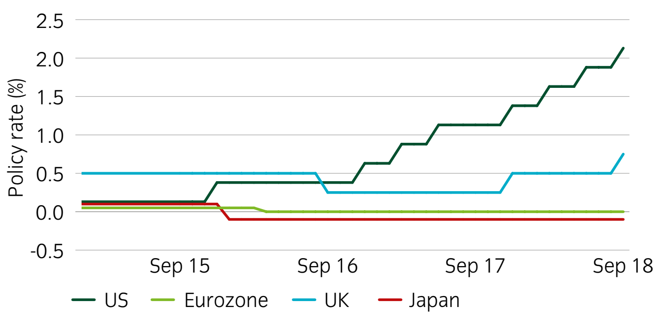


Figure 4: US unemployment has fallen markedly relative to other G4 nations[4]

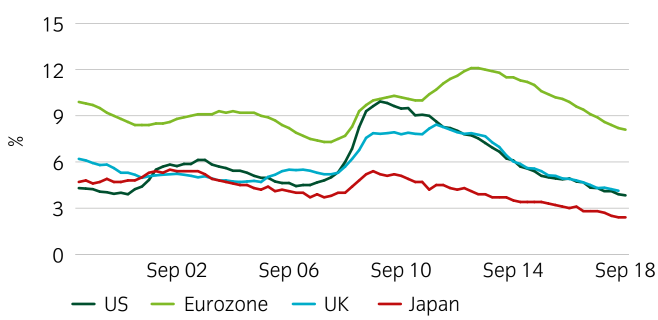
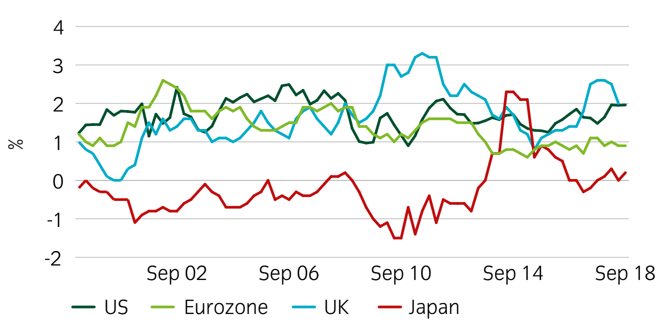


Figure 5: US inflation is close to its 2% target[5]

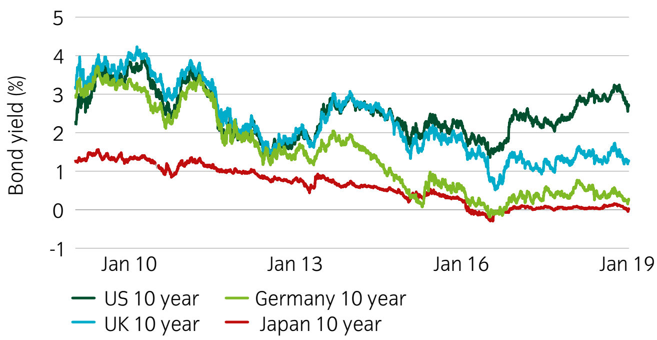


[4,5] Source: Insight, Bloomberg, February 2019.

BOND YIELDS HAVE ALSO DIVERGED

Our discussion so far has focused solely on policy rates and unconventional monetary policy tools. What about longer-dated bonds? Short-term rates tend to be well correlated with longer-term rates and hence have tended to show similar patterns of convergence and divergence over the last 10 years. Figure 6 presents G4 10-year bond yields, with German bunds serving as a proxy for the Eurozone. Trends since the crisis have been generally downward, rebounding for a period in 2013 following Ben Bernanke's 2013 'taper tantrum' speech, before returning lower and reaching a low mid-2016. Since then, the pattern has been one of divergence. US yields have pushed higher, UK yields to a lesser extent, while both German and Japanese yields have largely moved sideways (see Figure 6).

Figure 6: Bond yields trended down after the crisis, before diverging in 2016[6]

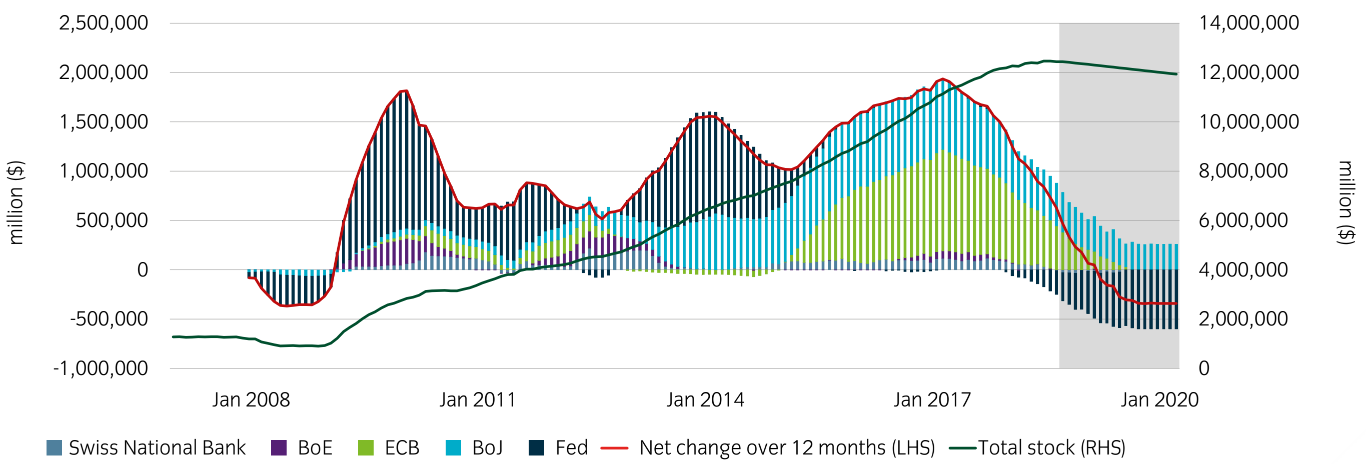


> The current divergence in G4 central bank monetary policy, especially between the US-eurozone, is approaching historical wides

Global quantitative easing has become quantitative tightening

The current divergence in G4 central bank monetary policy, especially between the US-eurozone, is approaching historical wides. As we discussed above, the Fed is already three years into its tightening cycle and is also advancing along its path of balance sheet reduction while the ECB has yet to start either raising interest rates or reducing its balance sheet. That being said, on aggregate the global economy has shifted from quantitative easing to quantitative tightening as the net impact of the Fed's liquidity withdrawal exceeds the Bank of Japan's continued expansion (Figure 7).

Figure 7: The shift from global quantitative easing to quantitative tightening has begun[7]



[6] Source: Insight, Bloomberg, February 2019. [7] Source: Insight Investment, as at end March 2019.

WILL DIVERGENCE PERSIST?

IN THE SHORT TERM WE EXPECT DIVERGENCE IN POLICY RATES TO PERSIST, WHILE FOR LONGER-DATED BONDS THE PEAK MIGHT HAVE BEEN REACHED. OVER THE MEDIUM TERM WE EXPECT BOTH POLICY RATES AND LONGER-DATED BOND YIELDS TO ONCE AGAIN CONVERGE.

KEY QUESTION FOR INVESTORS

Is monetary policy likely to remain divergent, or could it converge again in the near term?

SHORT-TERM DIVERGENCE OF POLICY RATES IS LIKELY TO PERSIST, WHILE LONGER-DATED YIELDS MAY HAVE PEAKED

In our view, while we might have reached the peak in longer-dated (e.g. 10-year) rate divergence, we expect to see continued divergence of policy rates in the near term.

Fed – continued short-term tightening

The market has rapidly repriced its 2019 outlook for Fed policy and now expects a comparatively dovish year relative to 2018. With the US economy remaining on a relatively firm footing, we do not necessarily think the current hiking cycle is over. While growth is moderating it remains above potential and labour market data – including employment growth, wage growth and labour force participation – are particularly strong. Despite this, the Fed has turned more cautious owing to heightened global risks – US/China trade discussions, Brexit and Italian concerns – and a sharp tightening of domestic financial conditions which could weigh heavily on both business and consumer confidence.

ECB – likely to remain on hold

We expect the ECB to remain on hold until 2020 given softening economic data and a resurgence of political risks. Industrial output has contracted driving much of the overall slowdown in GDP growth. While this can be attributed to the effects of new emission standards weighing on European auto production, purchasing managers' indices continue to decline, suggesting there are other pressure points in the economy.

On the political front, three key risks remain – Italian politics, Brexit and European parliamentary elections. While the Italian government revised its planned 2019 budget deficit to avoid sanctions from the European commission, Italian politics remain volatile and a confidence shock here remains a risk for the euro area. The nature of the UK's departure from the European Union remains unresolved despite the looming 29 March exit (at the time of writing). And European parliamentary elections in May are expected to result in large gains for populists.

OVER THE MEDIUM TERM WE EXPECT CONVERGENCE TO RESUME

Ultimately, we expect a degree of convergence in both policy rates and longer-term bond yields to happen over the longer term. Most likely, both European and UK rates will begin to rise and close the gap with the US in the process. While this is our base case, it is contingent on several factors: the global economy growing at a moderate pace, Europe succeeding in narrowing its output gap while labour slack continues to diminish, and an orderly end to the Brexit negotiations. It is also within the realm of possibility that tightening financial conditions in the US results in slowing domestic growth, or potentially tips the economy into recession, prompting the Fed to reverse course and cut rates, leading to ECB-Fed policy convergence.

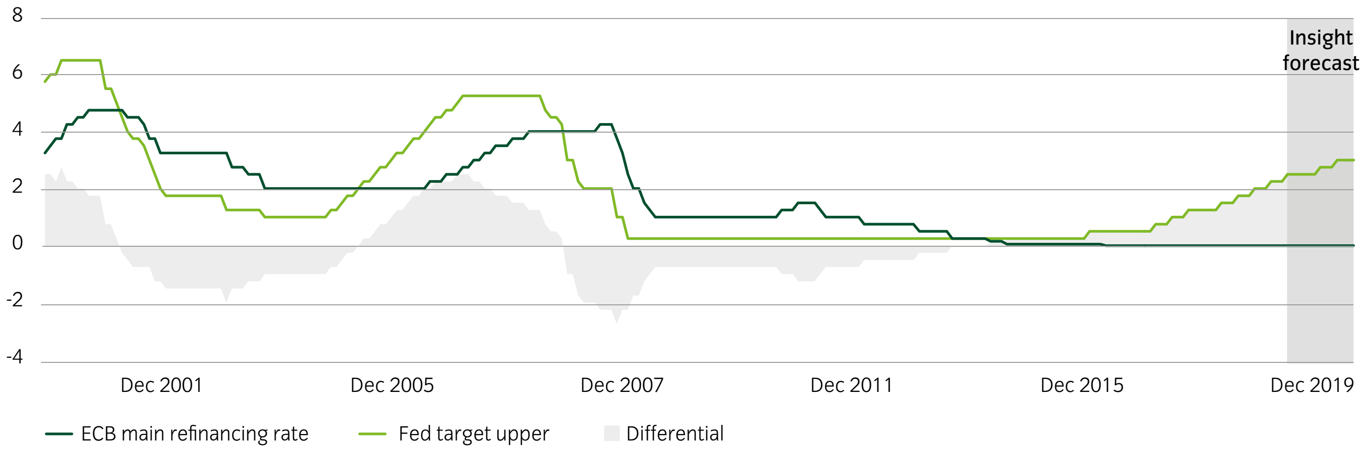
WHERE ARE THE OPPORTUNITIES AND THREATS?

ASSUMING OUR BASE CASE OF NEAR-TERM DIVERGENCE AND MEDIUM-TERM CONVERGENCE, ACTIVE GLOBAL FIXED INCOME INVESTORS HAVE A NUMBER OF OPPORTUNITIES THEY CAN EXPLOIT – AND THREATS TO FACE.

OUR BASE CASE: SHORT-TERM DIVERGENCE AND MEDIUM-TERM CONVERGENCE

Assuming our base case scenario of short-term policy rate divergence – with the Fed hiking a further two times in this cycle and the ECB remaining on hold – the differential between these two policy rates is likely to reach 3% by the end of this year (Figure 8).

Figure 8: Divergence between US and eurozone rates set to continue[8]



[8] Source: Insight, Bloomberg, March 2019.

Short-term divergence

Global monetary policy divergence is an opportunity for investors in global fixed income mandates, where investors are able to diversify their exposures and implement active investment decisions in markets that are repricing the future path of interest rates relative to those markets that are not.

Opportunities

- **Relative yield-curve shapes**: Yield curves typically flatten as the end of the hiking cycle approaches, while typically steepening when rates are expected to remain on hold. These positions can be actively managed to seek to take advantage of investment opportunities. Divergence can also create a more attractive carry-and-roll environment, provided market expectations don't change.
- **Outright duration positions**: Where markets are pricing too much or too little in the way of near-term rate expectations, outright duration positions can take advantage of this price misalignment.
- **Sector positioning across regions**: Differing monetary environments present relative corporate sector opportunities across regions. For example, eurozone banks continue to struggle with negative policy rates and to earn their cost of capital, while US banks have generally benefited from the rising rates environment.
- **Different investor behaviour across regions**: Low and negative yields in the eurozone continue to force investors to 'reach for yield', while in the US flat yield curves are encouraging investors to shorten duration for a limited drop in yield.

Threats

- **Prolonged divergence:** The biggest threat to the above narrative resides in Europe – the risk here being that Europe becomes, in effect, another Japan. Many countries in the eurozone are undergoing profound demographic change as life expectancy continues to lengthen while fertility rates have declined. This in turn has caused Europe's working-age population to shrink and this demographic decline has longer-term implications both for growth and the bloc's ability to generate structural inflation. Should these trends become entrenched (in the absence of sufficient immigration for example), we could see a situation where the ECB remains on hold for the next 10-15 years, as the Bank of Japan has done, ensuring the current divergence in short and long maturity rates persists.

Medium-term convergence

The likely return of convergence over the medium term will also present global fixed income investors with opportunities to capitalise on and threats to navigate.

Opportunities

- **Cross-market**: At the point at which we feel that divergence in base rates has reached its peak, cross-market relative strategies should present potential opportunities. Given that convergence is likely to mean German bund, UK gilt and Japanese government bond yields rising to close the gap on the US Treasuries, this would involve taking a long position in the US versus short positions in Germany, the UK and Japan.

Threats

- **US tightening spill-over**: Continued Fed tightening may force other central banks to ultimately tighten in relative sync. In such an environment it may become difficult to envisage materially different default environments across regions, leaving global spreads highly correlated.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

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Speak to an Insight contact about our global fixed income strategies if you would like to learn more about how to get exposure to these opportunities.

FIND OUT MORE

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14434-03-19