# PRIVATE BANKING INSIGHTS
*Market Update*

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## SUB-ZERO

Temperatures in the North East are not the only thing dipping below zero, so too are sovereign bond yields in Europe. While 0ºF does not actually mean anything (well, it does mean it's really cold out there, -17.8ºC), sub-zero bond yields for sure must tell something about current economic fundamentals. Ten European countries currently have negative 2-year bond yields and sub-zero yields extend to 5-year maturities for 6 countries and all the way up to 7-year in the case of Switzerland.

## HOW DID WE GET THERE?

While the Federal Reserve is still likely to proceed with the highly anticipated lift-off later this year, the massive global monetary easing currently taking place will more than offset any move from the Fed in coming months. This unprecedented wave of liquidity is having a profound impact on bond markets globally. Starting in March, the combined pace of asset purchases by the European Central Bank and the Bank of Japan will amount to around $130 billion per month, significantly outpacing the Fed's most recent QE program ($85 billion per month at its peak). But the flood of liquidity does not end here – so far this year, more than a dozen other central banks have cut interest rates in places like China, India, Australia, Canada, Switzerland, Denmark and Sweden to name a few. Inflation trends are the main factor behind the most recent wave of monetary easing. At the same time, we have to call a spade a spade and realize that a new currency war is being waged. Weakness in the Euro and the Yen is prompting other central banks to act so as to prevent their currency from appreciating further. The Swiss National Bank recently abandoned its policy of pegging the Swiss Franc to the Euro but the removal of the peg came with a move to slash deposit rates down to -0.75% in order to discourage currency speculators. The Danish Krone is seen by many as the next shoe to drop and speculation has intensified that Denmark's currency peg to the Euro will soon break. In order to deter the inflow of hot foreign money, the Danish central bank has been forced to slash rates four times in less than a month, bringing the deposit rate to minus 0.75%. Sweden's Riksbank also moved to impose a negative deposit rate on local banks.

## FROM ZIRP TO NIRP

Central banks in Europe have pushed the big monetary experiment a step further, moving from ZIRP (Zero Interest Rate Policy) to NIRP (Negative Interest Rate Policy). What seemed unconceivable only a few months ago (the so-called "Zero Lower Bound") is now a reality likely to stay with us for quite some time. Charging banks for the privilege of parking their excess reserves at the central bank is a powerful tool amplifying the usual impact of QE on bond yields. The gravitational pull of ECB asset purchases and negative deposit rates is resulting in the current environment of negative bond yields. The upcoming ECB bond purchases will shrink the net supply of sovereign bonds available to the private sector by EUR 300 billion in 2015 alone. A similar situation is also expected in Japan where the pool of JGBs available to the private sector will decline by JPY 50 trillion (roughly $400 billion).

## WHO WILL BE BUYING?

As weird as it might sound, negative yielding European bonds will continue to attract buying interest from several investors. First, QE in the Euro-area will lead to a massive increase in banks' excess reserves, and despite negative bond yields, the incentive for banks to accumulate sovereign bonds will remain due to new regulation (liquidity coverage ratio) and the benefit of owning government bonds with regards to capital requirements (zero risk-weighting). Second, unless one holds these bonds until maturity, purchasing bonds with a negative yield is not a sure and guaranteed strategy to lose money. Indeed, the favorable supply/demand backdrop might push these yields even further into negative territory, thereby providing the opportunity for capital appreciation in the near term. Finally, a 2-year government bond with a negative yield of -0.25% might still provide a positive return in real terms (i.e. adjusted for inflation trends) if inflation is negative over the next 2 years by more than 0.25% on a yearly basis.

At maturity, these bonds will have provided the buyer with an increase in purchasing power. As such, demand for these bonds is a direct consequence of investors' deflation fears.

## DEFLATION FEARS ARE OVERDONE

Negative inflation is likely for several economies in coming months due to plunging oil prices. However, our view remains that a deflationary spiral is unlikely to materialize. In the US, strong labor market gains and a pickup in wage inflation is expected to drive core inflation higher going forward. In Europe, aggressive monetary easing and a weak currency will help stabilize inflation expectations, particularly if the credit cycle continues to recover. Moreover, the impact from lower oil prices will gradually fade even if crude oil stabilizes around current levels. The recent steep decline in bond yields globally was primarily driven by falling inflation expectations while real yields have stayed relatively stable. The deflation trade has probably gone too far but the supply/demand balance remains very supportive for sovereign bonds in the near term. We therefore believe that nominal bond yields are likely to stay broadly flat going forward with rising breakeven inflation rates offset by declining real yields. This is indeed what the ECB (and the BoJ) are targeting – lifting long-term inflation expectations while keeping nominal yields stable (or lower). Lower real rates should lead to increased demand for credit and ultimately translate into stronger economic growth.

## WHAT DOES THIS MEAN FOR US INVESTORS?

The wave of global monetary easing is in stark contrast with the Federal Reserve's plan to lift the Fed funds target rate in the second half of the year. Contrary to previous tightening cycles, we doubt that the Fed's policy decisions will result in higher bond yields at the back end of the curve. In this context, we recommend the following investment strategy for our clients:

1. Don't fear the Fed: overall, monetary conditions are becoming easier, not tighter, irrespective of when and how aggressively the Fed will raise its policy rate this year. The old Wall Street saying "don't fight the Fed" will be challenged by overseas developments. Foreign investors, lured by attractive yields and potential currency gains will remain large buyers of US Treasuries.
2. Duration and credit exposure: while bond yields are depressed everywhere, US yields remain attractive in relative terms. Supply/demand factors will offset the upward pressure on yields (improving economy, Fed tightening) and we therefore advise against being too short bond duration. Spread products (corporate bonds, high yield, EM debt) offer a significant yield pickup and should directly benefit from central banks' QE purchases as private investors are gradually forced out of sovereign bond markets.
3. Stay fully invested in equities: the combination of abundant global liquidity, extremely low bond yields and gradually improving global growth will likely push stock prices higher in coming months.
4. The path of least resistance for the USD is still up. A stronger dollar will provide a further boost to international equities, which we expect to outperform. Hedging foreign currency exposure (in particular in Japan and Europe) still makes sense.

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