Government Bonds Outlook
Quarter 2 2018

The views represented are those of the Standard Life Investments Rates team. Aberdeen Standard Investments is a brand of the investment businesses of Aberdeen Asset Management and Standard Life Investments.
Everyone is more cautious on the outlook as the developing story of a fiscal growth push, higher supply and (maybe) higher inflation took a sharp knock during March. All of this was a reminder that bond behaviour continues to lean heavily towards a more dovish stance and a belief that capacity pressures will not produce more inflation. We disagree. Meanwhile, the bond supply that will test investor appetite will not arrive until late 2018 – and the ECB continues to tread a very patient path towards tapering its QE programme. We expect steady rate rises from the Fed and inflation to continue to rise – this combination should ultimately undermine bonds.

The BoE monetary policy decision in May is finely balanced following softer growth and inflation data, and recent intervention from Governor Carney. Even if the MPC chooses to persist with its supply-side argument and raise rates, we think it is unlikely it will be able to follow this up with another hike this year. We maintain the view it is too optimistic on the strength of the economy and the path of Brexit negotiations. For us, the distribution of possible Brexit outcomes remains wide and UK economic activity will likely stagnate and continue to underperform other developed economies whilst uncertainty persists. We anticipate using the less supportive technical environment over this quarter to reinstate our strategic bias for holding overweight gilt positions versus other developed markets in the context of a rising yield environment.

Data remain firm in Europe and its strength is broad-based, both in terms of internal and external demand, and is fairly uniform across the bloc. Continued strong growth cannot coexist with ultra-low policy dovishness ad infinitum. The market now expects no movement on policy rates until near the end of Draghi’s tenure (late 2019). Draghi has almost been too successful in suppressing expectations and we expect to see a continuation of the renewed volatility in bunds. Despite unhelpful market positioning, we expect core European bonds to sell off.

Our overall positioning bias remains the same: we prefer underweight exposure to JGBs given the asymmetry around pricing. Despite reasons to believe the inflation trajectory in Japan remains firmly below target, there are features of BoJ policy and the JGB market that suggest asymmetry around an underweight position and curve steepeners. The BoJ’s comprehensive review led to the introduction of Yield Curve Control and a new paradigm of thinking. We think that the explicit desire for steeper curves, and the BoJ’s longer-term willingness and ability to allow long-end yields to edge higher will continue to support this trade. Our base case is not for JGBs to be higher in yield or for inflation to hit target imminently, but we think the asymmetry means the risks for yields are to the upside.

Recent minutes from the RBA meeting reinforced its view that the most likely path for interest rates is up. This comes as no surprise given previous guidance from Governor Lowe around financial stability. More interesting was the reference to tightening financial conditions through higher funding costs for banks. With household leverage a key issue for the RBA and funding pressures coming through from overseas markets acting as a headwind for Australian lending, we continue to feel the RBA will look at weak domestic inflation and wage growth and keep policy rates unchanged. We remain overweight Australian bonds on a cross-market basis.
Trade war fears have emerged as the Trump regime has initiated a tariff 'tit-for-tat' spat with China. The impact on risk markets has been relatively muted overall and Federal Reserve (Fed) chair Jerome Powell’s latest economic assessment paid the issue little attention. Core economic conditions have remained upbeat albeit with some softening in surveys (although these remain at high levels and consistent with 4% annualised GDP). Inflation data continue to suggest a steady increase in the pace of core inflation, but within market expectations. The unemployment rate is dallying with a breach of 4% but hourly earnings have failed to accelerate above 3% as yet.

Investor sentiment remains relatively muted after price action in March that squeezed positioning both outright and through yield curve flattening. This whipsaw move back from February is a reminder that bond behavior has not become more even-handed and still suggests a disbelief that inflation will increase. Protectionist policies on trade combined with higher Fed rate expectations should have led the curve to steepen but flattening remains the consistent response. Positioning has felt more balanced in April; however, pension fund demand remains an influence.

While the Federal Open Market Committee failed to endorse four rate hikes during 2018, bonds failed to react to the uplift in forecasts for 2019/20 and continue to fight the extent of the tightening cycle. Ten-year Treasury yields have settled around 2.80% and are struggling to meaningfully breach this level. Almost the opposite effect is underway at 30-year part of the curve as the long bond keeps getting drawn back to 3% through repeated yield curve flattening. Ten-year yields have broken above their post-Trump election spike while the 30-year yield remains within that range. At the moment, pressure from heavier supply and balance sheet adjustment is not acting as a significant restraint.

Low inflation is embedded across the US yield curve. How tolerant will bonds be of a steady acceleration in core CPI?

High inflation is embedded across the US yield curve. How tolerant will bonds be of a steady acceleration in core CPI?
Fundamentals
The fundamental outlook for the UK remains uncertain. Brexit headwinds continue to weigh on growth relative to peers, with 1.4% GDP growth in 2017 versus an average 2.4% for other developed market economies. The labour market continues to impress with robust employment growth, record high vacancies and tentative signs of wage pressures, providing some justification for the hawkish tone adopted by the Bank of England (BoE) on the basis of diminishing spare capacity. Yet inflation continues to fall faster than anticipated by the BoE, with the most recent headline CPI data printing 0.2% below the MPC's latest forecast. Stronger wage growth and rapidly falling inflation will mechanically ease the negative real income burden on households, but we anticipate the corresponding uplift in consumption is likely to be modest due to lingering Brexit uncertainty.

Sentiment
The agreement of a broadly status quo transition deal has significantly reduced the risk of a cliff-edge outcome to Brexit negotiations and has in turn had a negative impact on sentiment toward gilts. Recent messaging from the MPC has also added to this as it maintains a positive outlook on the economy and continues with hawkish communication despite a weak start to the year for economic activity. However, sentiment towards gilts remains vulnerable to sudden swings in response to volatility in risk markets or Brexit negotiations. We anticipate sharp sentiment swings will continue to characterise the gilt market. This will lead to volatile price action and frequent positioning squeezes.

Valuation, technical & supply
The technical backdrop for gilts has been supportive recently, with a dearth of long-dated supply in the final quarter of the fiscal year coinciding with the largest asset purchase facility reinvestment programme to date, and an improvement in the public finances signalling a light issuance calendar for 2018/19. From a general valuation perspective, gilts remain rich at current yield levels as they retain a Brexit uncertainty premium. We expect to see some retracement to higher yields and a somewhat steeper curve over the quarter as the supply backdrop improves, including nominal curve extension in May. However, any steepening is likely to prove temporary given firmer government regulation on pension scheme behaviour encourages hedging activity and the BoE is committed to raising policy rates in the face of weak potential growth.

Summary
The BoE monetary policy decision in May is finely balanced following softer growth and inflation data, and recent intervention from Governor Carney. Even if the MPC chooses to persist with its supply-side argument and raise rates, we think it is unlikely it will be able to follow this up with another hike this year. We maintain the view it is too optimistic on the strength of the economy and the path of Brexit negotiations. For us, the distribution of possible Brexit outcomes remains wide and UK economic activity will likely stagnate and continue to underperform other developed economies whilst uncertainty persists. We anticipate using the less supportive technical environment over this quarter to reinstate our strategic bias for holding overweight gilt positions versus other developed markets in the context of a rising yield environment.
Europe

**Fundamentals**

While European economic growth is no longer running at 3%, it is still clearly in expansionary mode and sits at odds with the European Central Bank’s (ECB) cautious approach to policy normalisation. As the central bank negotiates the difficult transition from QE to rates forward guidance, this caution has increased. The messaging has been very clear on "persistence, patience and prudence" with regard to policy, which has helped stem the sell-off in rates.

**Sentiment**

Market sentiment remains negative on core European bonds and, in particular, Italy, following the country's inconclusive election. This, coupled with the upcoming cessation of QE, is perceived as a negative combination. However, the key point for us here is that the Central Bank remains robust in its commitment towards stemming any standalone peripheral weakness. Scarcity persists in German bunds, but should dissipate as policy tightens. Sentiment has proved a powerful barrier to bunds weakening in response to stronger data.

**Valuation, technical & supply**

Valuations still look expensive, with 2-year rates 20 basis points below the deposit rate despite very little genuine deflation risk and a clear, albeit gradual, change in language from the ECB around policy normalisation. QE is not quite disappearing yet, meaning scarcity will continue as a driver for now. A continued appetite for relaxing the deficit rules is negative for bonds. In the very short term, net supply is negative, as redemptions dominate. However, this should change over the next three months as opportunistic syndications in bond issuance prevail.

**Summary**

Data remains firm in Europe and is fairly uniform across the single currency bloc. The strength is broad-based in terms of internal and external demand. However, continued strong growth cannot coexist with ultra-low policy ‘dovishness’ ad infinitum. The market now expects no movement on policy rates until near the end of Draghi’s tenure (late 2019). Draghi has almost been too successful in suppressing expectations and we expect to see a continuation of the renewed volatility in bunds. Despite unhelpful market positioning, we anticipate core European bonds selling off.

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**Market Prices & Moves (as at mid-April 2018)**

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<tr>
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<th>3 months ago</th>
</tr>
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<tbody>
<tr>
<td>10-year bund</td>
<td>0.50%</td>
<td>0.63% (-13bps)</td>
<td>0.58% (-8bps)</td>
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<tr>
<td>10-year BTP</td>
<td>1.81%</td>
<td>2.00% (-19bps)</td>
<td>1.98% (-17bps)</td>
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<tr>
<td>EUR/USD</td>
<td>1.24</td>
<td>1.23 (+0.81%)</td>
<td>1.22 (+1.64%)</td>
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**Weightings**

<table>
<thead>
<tr>
<th>Fundamentals</th>
<th>UNDERWEIGHT</th>
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<tbody>
<tr>
<td>Sentiment</td>
<td>NEUTRAL</td>
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<td>Valuation, technical &amp; supply</td>
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<tr>
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**SLI Rates Bund Yield Forecasts – 6-months forward**

[Graph showing 6-months forward SLI Rates Bund Yield Forecasts]

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**5-year German bund yield no longer anchored**

[Graph showing 5-year German bund yield no longer anchored]

Source: Bloomberg
Fundamentals
The economic picture in Japan remains strong, although recent data has been mixed relative to consensus forecasts. Q4 2017 GDP was recorded at 1.6% quarter-on-quarter annualised, the eighth consecutive quarter of positive growth. However, this is expected to fall back towards the ‘potential’ annual growth rate of 0.5% through 2018. National inflation is tentatively ticking up (the headline rate was 1.5% year-on-year for February) but weaker core measures and lacklustre wage pressures both appear to point to a subdued trajectory from here. We continue to believe structural headwinds will limit the Bank of Japan’s (BoJ) ability to reach its 2% inflation target, but underlying economic conditions are more favourable now than in any time in the recent past.

Sentiment
Sentiment is notoriously difficult to quantify or measure, but it is clear that there is an increasingly dominant narrative in the marketplace concerning the growing likelihood of a BoJ policy exit. We think this is overdone. Although we position for a change in policy (such as a shifting of the Yield Curve Control (YCC) target to a shorter maturity or an increase in the 10-year target) such an announcement is not in our base case forecast horizon of 3-6 months. Our underweight position would benefit from such a move, while we do not see much room for yields to rally lower than current levels.

Valuation, technical & supply
YCC continues to anchor 10-year Japanese government bond (JGB) yields. Between -10 and +10 basis points around zero appears to have been established as a range at which the BoJ will intervene on breaches. The cross-currency basis that drove foreign investors to buy front-dated JGBs hedged has moved back from the most extreme levels. This has reduced the spread pick-up, although it remains firmly in positive territory. This structural richness continues to distort rate pricing signals from the front end of the government bond curve. The other side of that basis, the relative cheapness of some foreign bonds (European government bonds in particular) for yen-based investors remains a significant marginal mover of global duration. However, looking at the overnight index swap market, we can see that no further cuts are priced in, and the first hike of 10 basis points is not fully priced in until 2021.

Summary
Our overall positioning bias remains the same: we prefer underweight exposure to JGBs given the asymmetry around pricing. Despite reasons to believe the inflation trajectory in Japan remains firmly below target, there are features of BoJ policy and the JGB market that suggest asymmetry around an underweight position and curve steepeners. The BoJ’s comprehensive review led to the introduction of YCC and a new paradigm of thinking. We think that the explicit desire for steeper curves, and the BoJ’s longer-term willingness and ability to allow long-end yields to edge higher, will continue to support this trade. Our base case is not for JGBs to be higher in yield or for inflation to hit target imminently, but we think the asymmetry means the risks for yields are to the upside.
Australia

Labour market indicators remain robust, with healthy jobs growth and increasing labour force participation likely to support domestic demand. Wage pressures remain elusive and underemployment metrics suggest there is further slack to absorb before we see a significant lift in average pay. This has the potential to expose vulnerabilities with regards to household leverage, which has skyrocketed since the financial crisis as house prices soared. Over the past few years, the Australian Prudential Regulation Authority (APRA) has introduced measures to slowly remove some of the vulnerabilities from the housing market. Awkwardly, it could come under additional pressure as the Royal Commission sets its sights on bank lending standards. Meanwhile, previous APRA measures continue to dampen conditions, although the market seems able to withstand both headwinds for now.

Sentiment
Sentiment towards Australian bonds remains positive as weaker wage growth and inflation prints continue to push back fears of policy tightening by the RBA later into 2018. Despite a more sanguine policy outlook, shorter-dated bonds have suffered under the weight of financial tightening in the US filtering through into Australian funding markets; however, longer-dated bonds are well supported. As always, positioning remains key and year-to-date price action suggests a return of buyers to the Australian market as investors search for highly rated safe havens.

Valuation, technical & supply
Bonds in general are attractively priced given the current mix of policy rates and low inflation. Smaller current account deficits will reduce bond issuance going forward. The Australian Office of Financial Management is likely to continue to target longer issuance as it fills out the bonds curve past 10-years, where we see a significant demand for these relatively higher yielding safe-haven assets. Meanwhile, with just one Reserve Bank of Australia (RBA) hike priced in over the next 12 months and a high bar to easing, we prefer forward structures further out the curve where valuations still look attractive.

Summary
Recent minutes from the RBA meeting reinforced the message that it views the most likely path for interest rates as up. This comes as no surprise given previous guidance from Governor Lowe around financial stability. More interesting was the reference to tightening financial conditions through higher funding costs, which can be seen from the chart below. Although RBA commentary had generally been quite supportive for our ‘on hold’ view as can be seen from overnight index swap curve pricing, three-month bank bill lending rates have increased significantly as higher US funding rates push up global rates. With household leverage a key issue for the RBA and funding pressures coming through from overseas markets acting as a headwind for Australian lending, we continue to feel the RBA will look at weak domestic inflation and wage growth and keep policy rates unchanged. We remain overweight Australian bonds on a cross-market basis.

Market Prices & Moves (as at mid-April 2018)

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<tr>
<td>3-year ACGB</td>
<td>2.14%</td>
<td>2.17% (-3bps)</td>
<td>2.18% (-4bps)</td>
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<tr>
<td>10-year ACGB</td>
<td>2.66%</td>
<td>2.82% (-16bps)</td>
<td>2.75% (-9bps)</td>
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<tr>
<td>AUD/USD</td>
<td>0.776</td>
<td>0.787 (-1.40%)</td>
<td>0.792 (-2.02%)</td>
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Weightings

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Australian funding costs have risen despite RBA dovish guidance

SLI Rates ACGB Forecasts – 6-months forward

Source: Bloomberg

<table>
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<th>3 Month Bank Bills (%)</th>
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<tbody>
<tr>
<td>2.40</td>
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<tr>
<td>2.20</td>
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<tr>
<td>2.00</td>
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<td>1.80</td>
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<td>1.60</td>
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<tr>
<td>1.40</td>
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<tr>
<td>1.20</td>
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<td>1.00</td>
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Source: Bloomberg
Investment involves risk. The value of investments, and the income from them, can go down as well as up and an investor may get back less than the amount invested. Past performance is not a guide to future results.

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