OFFSHORE BONDS

ANCHOR

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We are expecting a gain of 1.6% on US 10-year treasury bonds over the next twelve months. This is comprised of interest income of 2.4%, being offset by capital losses of 0.8%. Over the period, we also expect yields on US treasury bonds to increase from 2.37% to 2.45%.

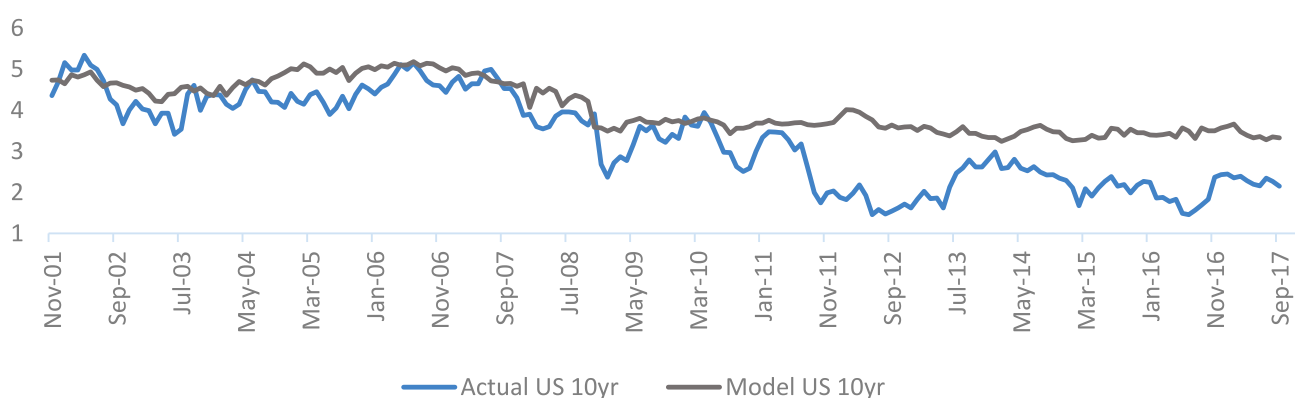
Our regression of US bond yields against a combination of short-term rates, core inflation, the manufacturing index and curve steepness, continues to show that US bonds are unattractive, with an implied fair yield of 3.33% being significantly more than the 2.37% that is on offer in the market.

Our estimate of the long-term fair yield for US bonds of 3.33% is in-line with that of 3.31% last quarter. US economic data that have been released have not lived up to the expectations of a growth acceleration, whilst inflation has continued to disappoint at levels below the Fed's 2.0% target. We also believe that the recent hurricanes in the US will extend the softness of these data to at least the beginning of 2018.

The bond yield can deviate from the regression model for a long period of time. There are a number of factors that might cause such a deviation in the yield of bonds from their fair value. Currently, the most important of these factors is the massive amount of global stimulus that has been injected into the market by central banks. The aggressive buying of government bonds by global central banks has resulted in an artificially low bond yield in the markets.

The US Fed recently announced that it will start reducing its holding of fixed-income instruments, effectively unwinding the QE that took place in the aftermath of the GFC of 2008. This will begin with a negligible reduction in the balance sheet holding of bonds. The quantum of the balance-sheet reduction will increase over time until about three years from now when the Fed's balance sheet is normalised for the size of the US economy.

Figure 8.1: Modelling US 10-year bond using macro fundamentals



Source: Thomson Reuters

We have stated before that we expect this to have a negligible impact on bond yields in the near term, owing to the insignificance of the amounts by which the balance sheet is being reduced.

The European Central Bank (ECB) has continued to support the market by buying bonds onto its balance sheet. We anticipate that the ECB will announce a slowdown of these purchases during the first half of 2018. We would expect that these events will remove some of the support for bonds from the market and will also narrow the gap between our modelled fair yield and that on offer in the market. We don't expect the ECB to cease buying bonds, rather we anticipate that the pace of purchases will slow down from the current EUR60bn per month towards EUR40bn. In our view this will cause moderate upward pressure on global bond yields.

We look at the real yields (yields above inflation) as priced-in by the US 10-year inflation-linked bonds. We highlight that real yields compressed from an average of 2% before the 2008 GFC to a level of -0.50% at the height of QE. The Fed's announcement that it would stop buying bonds in 2013 resulted in a 1% increase in real yields. These are currently at 0.38%. We anticipate that the reduction in stimulus in Europe will have a smaller impact than we saw with the US tapering and we have modelled for an increase of 0.40% in real yields towards 0.75% for a complete termination of EU QE. In-line with our expectation that European QE is only reduced by about a third, we expect that real yields will rise by c. 0.15% resulting in a real yield of approximately 0.55%. This is supportive of our target US 10-year bond yield of 2.45%.

Our yield estimate has declined from 2.55% at the end of 2Q to the projected 2.45%. This reflects the lacklustre performance of the US economy, along with the dearth of inflation. Whilst we believe that some economic acceleration is to be expected, it appears that this is likely to be less than we had originally been hoping for. Inflation is also likely to remain subdued for the near term.

The risks to our view are of a political nature in that the ability of US President Donald Trump's administration to deliver on its fiscal stimulus remains to be seen. The market has been sorely disappointed and the uncertainty from Trump's administration has weighed down the economy without a counterbalancing stimulus. We think that some positive surprises are due and Trump must surely be able to deliver something. This lines up well with our view that rates are likely to increase a little over the period.

The market is currently pricing in two interest rate hikes for the next twelve months - in line with our expectations. Therefore, we are finding that the yield curve will likely shift upwards on a parallel basis over the next year. We acknowledge that, as the US economy moves into the late stage of its economic cycle, the number of risk factors to our forecast is particularly high. This is likely to be the year where active management of risk will be of the greatest importance to your investments.

Figure 8.2: US 10-year TIPS real yields over time

Source: Thomson Reuters

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