Heartwood
Investment Management

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Investment Insight

Weekly Insight

Reflation sets the tone for bond markets

Reflation has been the opening gambit in financial markets at the start of 2018. While global equity sentiment remains well supported by the stronger fundamental backdrop, the long-end of the US treasury market is turning increasingly bearish. It is telling that even after a disappointing January payrolls report, the thirty-year US treasury yield continued to edge higher, illustrating investors' rising confidence in the US inflation outlook.

The key event to shift the bond market narrative is the Trump administration's tax cuts, which received Congressional approval at the end of December. Reductions to corporate tax rates represent a large fiscal boost to the US economy, albeit temporary, and will significantly add to the US government debt burden. These measures come at a time when the US domestic growth is already benefiting from near full employment and rising capital expenditure.

With or without US tax cuts, we have held the view for some time that cyclical inflation pressures are rising. Higher oil prices are expected to have an inflationary impact on headline measures, as well as the feed through from the likely higher import costs arising from a weaker US dollar. More important, though, will be the culmination of several months of strengthening global momentum feeding into prices across developed economies. In our view, inflation is a lagged response to growth since stronger demand should translate into higher spending and, ultimately, higher prices. Specifically in the US, business surveys and regional bank surveys indicate that upside price risks are developing. Admittedly wage growth has been disappointing so far, but we expect that tighter labour market conditions will eventually feed into higher wage setting. Moreover, the recently approved tax legislation has incentivised companies to use their tax windfall to boost wages and/or distribute bonuses.

Adjusting to a more 'normal' cycle?

All that said, we are not suggesting that the US economy will see significantly higher levels of inflation as seen in prior periods of history. However, the nature of the current extended cycle of low interest rates and low inflation is changing, and this trend is now being acknowledged by bond investors. As we enter a more 'normal' cycle, we expect central banks in developed economies to stay on a journey of withdrawing emergency levels of monetary stimulus and lifting interest rates. In this regard, the US Federal Reserve is ahead of the European Central Bank and the Bank of Japan. It is worth noting that despite five interest rate rises since the Fed began its tightening cycle in December 2015, financial conditions in the US have actually eased over the last year {Source: Chicago Fed National Financial Conditions Index}, so there is still some way to go, especially if inflation rises as we anticipate.

Looking forward, we should also consider the US treasury market's vulnerability to supply and demand pressures. US treasury selling in the last few days was further prompted by media reports that the Chinese authorities may reduce its buying of US treasuries. While these reports have since been denied, the US treasury market's reaction is nonetheless indicative of its sensitivity to supply factors. This is particularly noticeable in an environment where we are seeing a regime shift among global central banks from quantitative easing to quantitative tapering. Reduced global market liquidity is likely to receive more market attention as the year progresses. With the Fed already reducing its balance sheet, the European Central Bank will end its asset purchase programme in September. Furthermore, this week the Bank of Japan announced that it will reduce longer-dated Japanese government bond purchases, contributing to

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both a stronger yen and higher domestic and US treasury yields at the start of January.

As central banks step back from supporting financial markets, we expect to see more bond market volatility in 2018. Shorter-dated US treasury yields had already moved meaningfully in the final quarter of 2017, but longer-dated bonds were still fixated to the low interest rate and low inflation backdrop. Evidently this view is now shifting, and we believe that our long-standing underweight duration position in developed sovereign markets remains the most prudent stance.

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