RICHES FLORES RESEARCH
GLOBAL MACRO & THEMATIC
INDEPENDENT RESEARCH

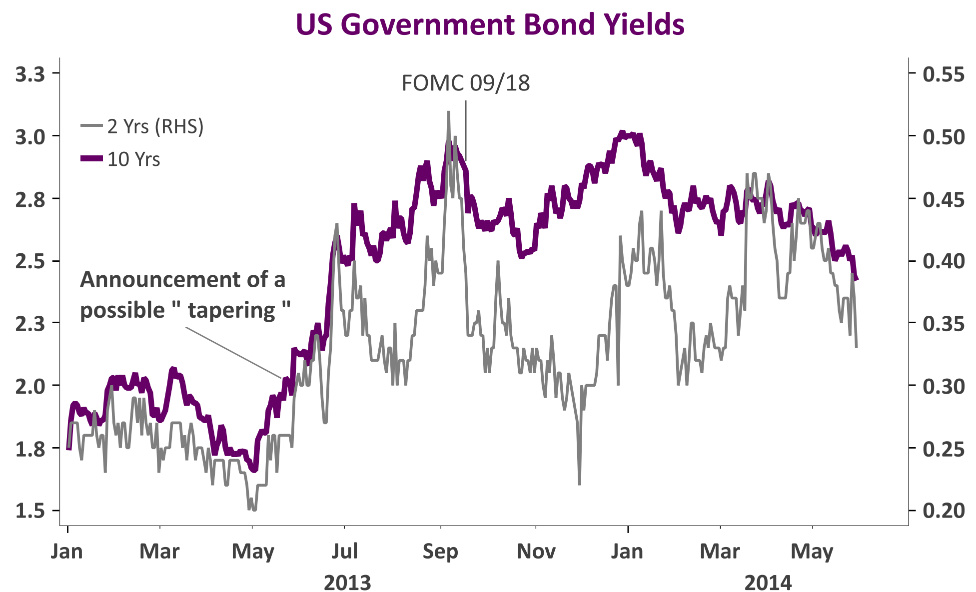
May 30, 2014

GLOBAL MACRO

Three reasons why long-term interest rates will continue to fall

The downwards movement of government bond yields has picked up in recent weeks revealing investors' growing indecision, whereas the consensus had promised them just the opposite. We see several reasons for the drop in long rates which, in our opinion, is not a temporary phenomenon and could, in fact, continue.

US Government Bond Yields



Sources: RichesFlores Research, Macrobond

The market is right not to buy the Fed's outlook

Developments in the U.S. economy are hardly in line with the Fed's expectations. The bank's forecast was in the upper range of the consensus for this year (2.8-3% Q4/Q4), which would be the highest level since mid-2012 and yet growth is a mere 2% at present. In fact, not only has slower growth made the full-year target more difficult to reach but the underlying trends do not point to a pick up starting this summer, as is traditionally expected: the job market outlook is deteriorating (see article *"U.S. jobs, the markets can't see straight"*),

productive investment is stalling, the real estate market has ceased to improve and the export context is hardly uplifting, to say the least (see graphs page 5).

Given the backdrop, it is hard to imagine that the Fed will have the data it needs to continue to fuel anticipations of a possible normalization of its monetary policy on a foreseeable horizon. The lower bond yields helped the tapering strategy initially, but by ramping up, has revealed just how misguided its outlook is. In the end, the gap between the message being sent by the bond markets and the scenario defended by the Fed is becoming embarrassing. It jeopardizes the credibility of the Fed while the low yields and excessive flight-to-safety (into equities) risk weakening the financial environment.

The next few stages of tapering will be harder than the first. We continue to believe the Fed will slow the taper, either by slowing the pace of the reduction in asset buys or stabilizing asset purchases at a low level, the Fed giving itself a safety buffer. If this were to play out, two-year rates would fall to around 0.25% and the 10Y to below the 2.25% mark before the end of the year.

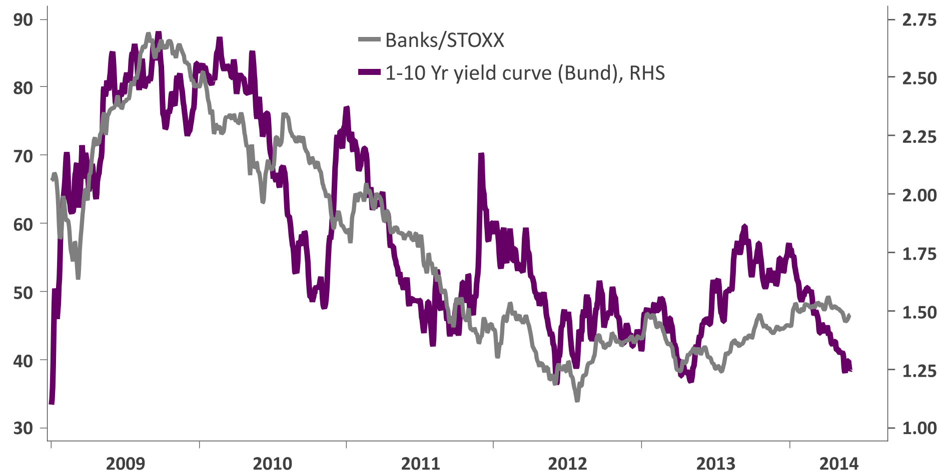
The ECB is beginning a long process of unconventional monetary policy, which, given the growth slowdown, should benefit bond markets more than equities.

It's a done deal. The ECB is poised to take action and is expected to announce, as early as next week, new easing measures, including:
- a drop in the key rate band by 10-15bp with deposit facility rates automatically dropping to below zero,
- the probable unveiling of a special Long-Term Refinancing Operation (vLTRO) with strings attached, targeting the refinancing bank loans to businesses,
- the discussion of a possible extension of unconventional measures to a wider array of assets in the event deflationary risks continue.

These measures have been a long time coming, undoubtedly too late to have any real effect on lending and prices, if the recent downturn in the European economy is any indication. They run the risk of having little impact on economic performance and, by extension, stock markets. We would like to offer a two-pronged rebuttal of the generally-accepted idea that banks will be the big winners of this new ECB action: creeping deflation, which is incongruent with an increase in lending and investment, and the flattening of the yield curve and very low long-term interest rates (in absolute terms), which have a negative impact on the banking profitability.

It is now quite clear that the ECB is about to embark on an extended period of unconventional monetary policy, which stands to benefit the bond markets, first and foremost, especially the German market as these measures are rolled out. We are forecasting for 10Y bunds to therefore fall, to a level we expect in the 1-1.25% range before the end of the year. This would produce a downwards effect

on the rest of the region and spreads with Southern Europe countries would stabilize.

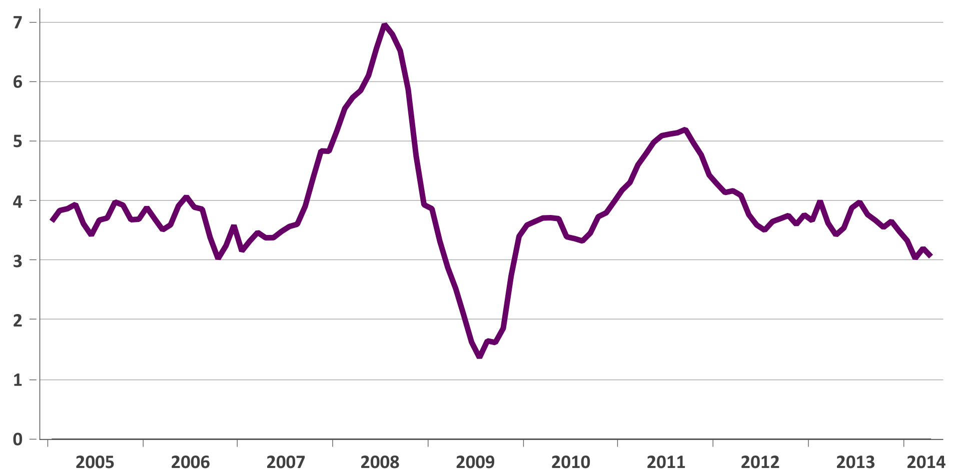


Sources: RichesFlores Research, Macrobond

Global disinflation is gaining ground

The worsening of the global economic situation, as growth sputters, will do nothing to improve these trends. The fresh drop in global trade is particularly worrisome and indicative of the trend.

Moreover, the currency war being waged by China and Japan is spreading deflationary risk to southern Asia and, as a result, to the rest of the world while ongoing inflationary risks in certain major emerging markets (especially Brazil and India) do not have the same ability to 'export' themselves. At 3.1% in April, global inflation hasn't been lower since the 2009 crisis and there seems to be no stabilization in sight.



Sources: RichesFlores Research, Macrobond

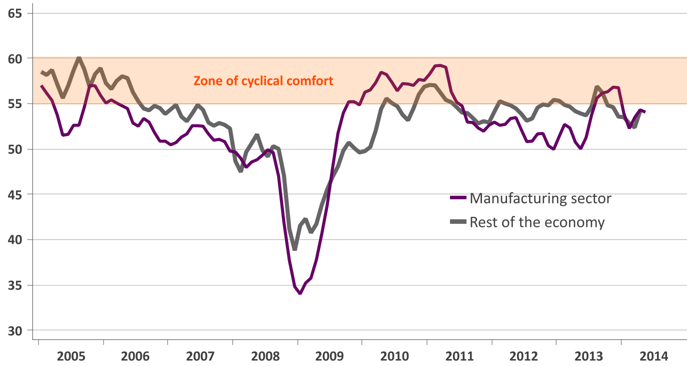
Lastly, wariness over the economic situation of emerging markets has reduced investment flows into these countries. As a result, investment flows into the world's most developed countries have picked up, which contributes to the general movement of falling long-term interest rates.

Looking at the overall picture, it is hard to find arguments in favor of the situation turning around on the bond markets. Yet this has been the baseline scenario for many investors since the spring of last year when Ben Bernanke, the Fed chairman at the time, triggered the 'taper caper'. The situation, which was originally perceived in a positive light as it was feared that the end of QE would send long rates sky high (which could snuff out growth), is no longer relevant as purely monetary-driven recovery plans could fail or at least fall short of their goal.

United States: where are the indicators pointing to growth?

Manufacturing and Non-Manufacturing ISM Indices

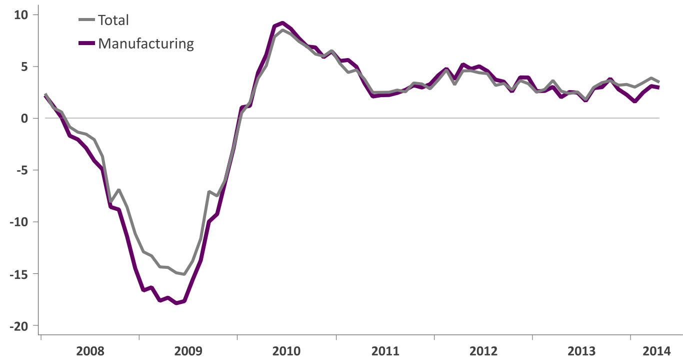
Indice, 2MMA



Sources: RichesFlores Research, Macrobond

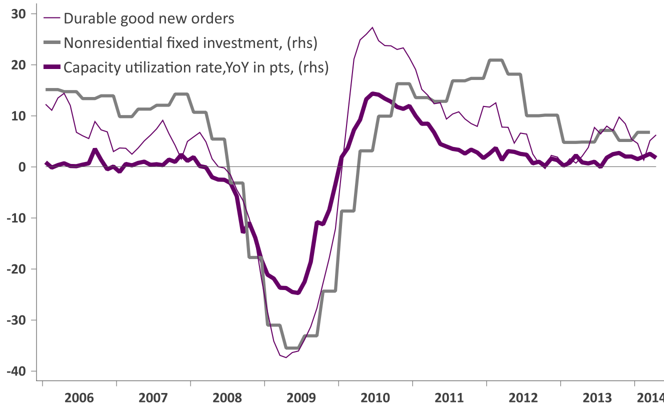
U.S. Industrial Production

YoY in %



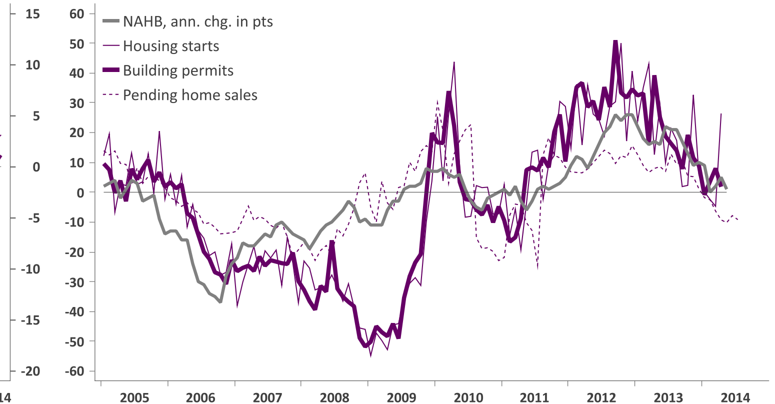
Sources: RichesFlores Research, Macrobond

Business Investment Indicators



Sources: RichesFlores Research, Macrobond

Real Estate Indicators, YoY in %



Sources: RichesFlores Research, Macrobond

Véronique Riches-Flores
contact@richesflores.com

RichesFlores Research is an economic and financial research provider. We produce international economic analysis and forecasts, as well as research on broader short-, medium-, and long-term trends in the global economy.
As an R&D entity certified by the Ministry of Higher Education and Research, RichesFlores Research is eligible for the research tax credit (Crédit d'Impôt Recherche) for the years 2013, 2014 and 2015.
RichesFlores Research is a transparent company, with the databases and information resources we need to remain fully independent and objective. Because RichesFlores Research is not an investment service provider and does not sell financial products, we can offer clients added confidence in the independence and objectivity of our assessments, recommendations, and advice.
This document is provided for information purposes only. It is not and should not be construed as investment advice, or as an offer or solicitation of an offer to buy or sell securities. It contains strictly confidential information intended only for the use of the individual or entity to which it is addressed. This document may not be disclosed to any third party without the express written consent of RichesFlores Research.
This research and its content are the sole property of RichesFlores Research. They may not be reproduced without the express consent of RichesFlores Research and without indication of the source and date thereof.
RichesFlores Research makes no warranty, express or implied, nor assumes any legal liability or responsibility for the accurateness, completeness, or usefulness of the research, conclusions, data, and assessments available on this website.
The content of this website does not constitute a contract and is non-binding. It is not and should not be construed as investment advice or as an offer or solicitation of an offer to buy or sell securities.

Véronique Riches-Flores, contact*@richesflores.com*