IDEAS
FIXED INCOME /// JANUARY 2018

Markets enjoy low vol, high return through 2017

HIGHLIGHTS

- **Geopolitical risks (North Korea, trade issues, elections in Europe) remarkably contained in 2017**
- **Central bank policy moving slowly: Fed proceeds with balance sheet normalisation and ECB cuts asset purchases**
- **Volatility in France, Spain spreads faded quickly after elections.**
- **High-yielding markets outperform. Emerging bonds and high yield beat investment grade asset classes.**

Investment outcomes delivered by financial assets were extremely favourable in the past twelve months. A synchronized pick-up in activity growth and ample liquidity on account of central banks and share buybacks propelled equity markets higher.

The Dow Jones Industrial Average closed at a record high 71 times last year. Volatility remained at extreme lows throughout the year despite geopolitical risks and exuberance in parts of financial markets. Cryptocurrencies emerged as the latest example of financial mania. In bond markets, trading range was narrow as 10-year note yields (2.41%) ended the year just 4bps below previous year's close. Three Fed rate hikes pushed the term structure of interest rates flatter. US credit outperformed government bonds. US dollar weakened for most of 2017.

In Europe, risk-free bond yields moved up slightly to the 0.40% area on 10-year Bunds. Sovereign spreads generally came in after elections (France, Spain). Corporate bonds were buoyed by ECB purchases.

Contained political risks

- **Markets unmoved by geopolitical noise**

Stellar investment returns occurred last year. Measures of financial risks including bond and stock volatility remained at historical lows. It is most surprising. Trade war, North Korean nuclear threat, dysfunctional GOP-led US Congress and European politics all seemingly had the potential to unsettle markets. But, all turned out to be non-events for markets.

- **Trade friction in North America**

Trade war did not play out with China. Aggressive tweeting did not add to much more than noise. US President Donald Trump largely backed away from campaign promises on trade issues with China. Meanwhile the 19th Party Congress failed to identify a potential successor to Xi Jinping. If anything, President Xi looks set to stay in power for a third term. China's influence is much needed to stem North Korea efforts to enhance its nuclear power. Market reaction to repeated missile launches threatening Japan and US territories was incredibly muted. On trade policy, the US Administration shifted its focus on NAFTA. The US had initially promised to withdraw from the agreement. Tense negotiations continue with Mexico and Canada. The market impact was contained in in CAD and MXN volatility.

- **US tax reform, finally!**

Equities surged after the US Presidential elections on expectations of massive tax cut and market-friendly deregulation of the financial sector. However, the GOP-controlled US Congress failed to agree on tax reform until late December. The level of political conflicts within Congress is unheard of. Differences between bills voted by the House and the Senate were finally ironed out days before the holiday season. Fiscal stimulus will primarily benefit firms. The corporate sector will indeed capture about 80% of tax cuts. Headline corporate tax rate is cut to 21% from 35%. That said, a lot of tax exemptions and loopholes have been scrapped. Pass-through businesses will also gain from a flat 25% income tax. As concerns personal income tax, the number of tranches will remain unchanged but marginal rates have been trimmed. Border tax adjustment, ruled out early on last year, reappeared in a form that seemingly breaches WTO rules. European and Asian officials have already voiced concerns about the latter.

- **Populism retreats in Europe, but mind weak coalition in Germany**

In Europe, financial market participants, pundits and commentators anticipated contagion from the rise in populism seen in votes in favour of Brexit and Donald Trump a year ago. A possible win of Marine Le Pen in the French presidential race was the cause for temporary volatility in sovereign bond spreads. Japanese institutional investors indeed sold heavily ahead of the April-May elections. Instead, Emmanuel Macron was elected President with a wide margin. Italy remains another centre of attention. The main centre-right and centre-left parties in power voted in favour of a new electoral law. The electoral system will foster coalition formation and may prevent a M5S-led government. The Italian general elections have been called early and will be held in March 2018. Angela Merkel's CDU-CSU recorded their worst election result in decades. The far-right strengthened considerably whilst SPD lost further ground. 'Jamaica' coalition talks collapsed. In all likelihood, the next government will be a classic CDU-CSU/SPD coalition. In Spain, Catalonia's illegal bid for independence sparked short-term tensions in Bonos. The October referendum outcome was invalidated resulting in the dissolution of the regional parliament. Regional elections were held on December 21st. Separatist parties retained a majority of seats in the region's assembly. Meanwhile, little progress has been made on the negotiations as the UK prepares to formally leave the European Union in March 2019. However, the divorce bill is not agreed and the Irish border issue is still pending. The principle of a two-year transition after March 2019 has been agreed.

Bond markets: Central banks in driver's seat (again)

- **Fed begins balance sheet normalization**

Janet Yellen's tenure as Fed Chair will end in February 2018. She will be replaced by Governor Jerome Powell. Vacancies at the Board are also being filled albeit slowly. Randy Quarles was nominated vice-Chair in charge of supervision after Daniel Tarullo and Stanley Fischer resigned this year. Marvin Goodfriend will also become Federal Reserve Governor if confirmed by Congress. Chair Janet Yellen decided to raise interest rates three times in 2017 (March, June, December) in line with median dot projections produced by FOMC participants.

But the key policy change is the start of balance sheet normalization announced in September. Fed assets had grown to top \$4.5T in the aftermath of the crisis. Holdings of Treasuries and mortgage-backed securities (MBS) totalled \$2.5T and \$1.8T respectively. The issue is obviously that raising interest rates sustainably requires selling bonds in the marketplace. This is done currently via reverse repos (or temporary asset sales). From October 2017, the Fed will make part of these temporary sales permanent by not reinvesting the full amounts of bond proceeds. Excess bank reserves will hence shrink at a predictable pace. In the fourth quarter of 2017, holdings fell by a total of \$30bn (\$20bn less *Treasuries*, \$10bn less MBS). Balance sheet contraction will accelerate steadily to a pace of \$150bn a quarter in the fourth quarter of 2018. It is important to note that the Fed continues to roll holdings across all maturities at auction. The US central bank therefore continues to assume a large amount of duration. This is the chief reason why the yield curve consistently flattened last year even as Fed rates rose.

- **ECB extends QE into 2018**

In the euro area, the ECB took step to reduce immense monetary stimulus. Monthly bond purchases were trimmed from €80bn to €60bn from April. In October, Mario Draghi announced that the asset purchase program will be extended until September 2018 but although ECB market operations will diminish to €30bn. Thus, net asset purchases will fall from €780bn last year to €270bn in 2018. However, €130bn bond reinvestments between January and November 2018 mean that ECB grow purchases will top €400bn. Unlike the Fed, the ECB ventures into corporate bonds, various public-sector and agency debt and asset-backed securities. The market presence of the ECB is unprecedented and certainly raises issues as regards free capital allocation in the economy. Buying of corporate debt further blurs the distinction between fiscal and monetary policies. The ECB is committed not to sell securities even in case of downgrade to sub-investment grade status. This is uncharted territory for monetary policy, which should be about lending against the best collateral.

In Japan, the BoJ exited QE and introduced yield curve control (YCC). YCC policy aims at keeping 10-year JGB yields close to 0%. Purchases required to keep bond yields in check turned out to be about half the pace of the last batch of quantitative easing (80T yen a year). The BoJ also buys loads of equities through ETFs. In total the central bank owns 3% of the Japanese equity market. The policy will likely be amended sometime in 2018.

- **More monetary madness in Sweden**

Elsewhere, monetary experiments continue in Sweden. The Riksbank announced that it would end QE in December 2017 but will bring forward bond reinvestments from 2019 starting in January 2018. It makes little sense in an economy at full employment and with inflation about target. Outsized monetary stimulus instead sparked a housing bubble, a recipe for financial disaster in years ahead. In the UK, Mark Carney finally reacted to rising inflation by lifting rates a quarter percentage point to 0.5%. BoE policymakers had warned markets months in advance of the November hike. Down under, Australia and New Zealand contemplated hiking rates although currency appreciation is to be avoided according to policymakers.

Crypto-mania and low volatility

- **Bitcoin surge is a bubble and the flipside of excess money growth**

One of the surprises of 2017 is skyrocketing cryptocurrency prices. Bitcoin prices increased nearly 1300% in 2017 to $14300. Currencies are generally defined as a means of exchange and a store of value. For the time being, few goods or services can be bought using crypto-money. In addition, excessive price volatility makes it an unreliable store of value. The launch of a future contract on Bitcoin immediately ignited a sharp correction in prices in December. Nor is it legal tender and its use may be tied to illegal activities. It is allegedly a way for Chinese investors to circumvent restrictions on capital flows out of China. Nevertheless, the cryptocurrency bubble is telling us something about central banks' own abuse of their monopoly power of issuing currency. For years, monetary authorities have issued unprecedented amounts of currency against collateral of questionable value. Instead, cryptocurrency is in limited supply much like precious metals (although the number of potentially tradeable cryptocurrencies is not). It bears interest of zero percent compared with negative rates on deposits in EUR, SEK, DKK or CHF. The marginal cost of mining coins is increasing putting a theoretical floor on Bitcoin prices. But Bitcoin's price pattern is undoubtedly indicative of a bubble. And bubbles burst. Always. Furthermore, there is a real regulatory risk hanging over Bitcoin markets. Exchanges can be closed. Convertibility into legal tender can be suspended, as had been the case for gold in early 1970s.

- **Low volatility is *not* low risk**

The other unusual feature of financial markets in 2017 is persistent low volatility. Short volatility strategies have produced large excess returns. VIX (implied volatility on S&P 500) and TYVIX (implied volatility on 10-year note future) indices have remained about their all-time low readings through 2017 expect for short-lived volatility spikes around French elections and in early July. Much like carry strategies, short volatility benefits from economic stability and monetary policy predictability. The absence of volatility was such that reports of North Korea's nuclear tests barely moved bond yields after all. However, market calmness may be artificial and traceable to Central Bank's unprecedented presence across financial markets. A false sense of comfort has been introduced by continuous CB intervention.

High returns in fixed income space

If history is any guide, upside surprises on economic growth tend to be conducive of higher bond yields and outperformance of growth-sensitive asset classes. Equities, credit, high yield or emerging market bonds did very well indeed. However, 10-year benchmark yields remain firmly in control of Central Banks.

- **Overview of fixed income performance**

For euro-based investors, exposure to higher-risk securities paid off nicely thanks to monetary conditions and a strong growth environment. Pan-European high yield generated total returns of in excess of 6% in line with that of 2016. Low default rates, a high number of rising stars underpinned the asset class. Furthermore, ECB buying pressure on investment grade spreads forced investors into high yield. Likewise emerging bonds in hard currency returned more than 8% (hedged to euros) in line with the 2016 outcome. Broad stability in US long-term yields enabled investors to capture carry. In investment grade markets, euro corporate bonds beat the sovereign asset class by more than 200bps.

- **Flat year for euro sovereign bonds**

The euro sovereign asset class had a slightly positive return in 2017. ECB purchases continued as planned despite bond scarcity in core markets. Ten-year Bund yields have evolved within a historically narrow 0.15-0.50% range for the bulk of 2017. Mario Draghi's speech in Sintra triggered a correction around mid-year with yields peaking at 0.63%. Looking at the full year, Bund yields increased from 0.20 to 0.42%. The amount of purchases was kept roughly stable but actual net purchases drifted away from the ECB capital key allocation. Holdings of French and Italian securities have risen more than the ECB capital key would suggest. The curve steepened early as the deposit rate floor applied to QE purchases was removed. The 2s10s spread hit a high in March at 130bps before plummeting to 86bps in late June. The spread oscillated about 110bps in the second half of the year. Core sovereign spreads were generally tighter on the year rallying after elections in the Netherlands and France. Value has evaporated in core sovereign bonds. Spreads on 10-year DSLs ended the year at a paltry 10bps. The yield gap on French 10-year OATs was 35bps after a peak at 79bps in February. Future selling and Japanese cash bond sales had sent spreads wider reflecting the risk of a Le Pen Presidency. Italy bonds were generally wider in the aftermath of the 2016 referendum and the resignation of Matteo Renzi. A surprise upgrade from S&P in October fostered buying of BTPs mainly against Spain's Bonos. BTP spreads hit a multi-year low at 134bps on 10-year maturities in early December. Bonos took a hit following the illegal Catalan referendum for independence. Spread widening was modest to the tune of 20bps. Portugal stands out as the star performer in euro sovereign markets. Cyclical upswing, further improvement in public finances prompted S&P and Fitch to assign investment grade ratings to Portugal. Spreads have thus come in sharply to around 150bps by year-end compared with 388bps at the peak in February 2017.

In inflation-linked markets, breakevens started to move up slightly in the second half as oil prices picked up.

- **Investment grade credit review**

The asset purchase program of the ECB puts on lid on bond yields and spreads. The ECB bought €81.5bn worth of corporate bonds last year and close to €40bn of covered bonds net of redemptions. Spreads on euro investment grade bonds shrank by 37bps to 85bps over Bunds last year. Credit stress stories have remained spotty. Financials' yield premiums narrowed resulting in outperformance of bank and insurance debt. Agencies and covered bonds tightened by about 20bps vs. safe German debt securities.

In parallel, subordinated bank debt had a great run (AT1 notably) ending the year in double-digit return territory. Likewise, hybrid bonds had a quite decent year outperforming equivalent senior debt.

- **Euro high yield takeaways**

The growth environment was a boon for this asset class. With valuations already stretched early on last year, markets look priced for perfection. Fundamentals improved further with a high number of rising stars last year. Euro high yield issuance hit the €100bn mark (record 231 deals). In net terms, supply (€19.8bn) was however lower than each year from 2010 until 2015. Risky PIK/toggle issuance amounted for €2.8bn. Favorable supply conditions, improved credit fundamentals and demand from institutions seeking yields narrowed spreads. Looking at sector performances, energy, industrials and utilities outperformed the broad high yield market.

- **Emerging bonds provided excess returns**

Hard-currency debt spreads tightened early on last year and remain tight throughout the rest of the year. Higher commodity prices, including crude, helped Russia bonds stay within 200bps of US Treasuries. Mexico rallied considerably after the initial negative reaction to Trump Presidency. Noise around NAFTA talks has at times proven unhelpful but overall spreads average about 250bps over the second half of the year. IMF support was the main factor behind the sharp narrowing in Ukraine debt spreads from over 650bps in 1Q17 to 457bps at year-end. Sentiment improved considerably on Brazil despite fiscal challenges, political woes and slow progress on pension reform. The yield gap on USD Brazil bonds came in from 300bps at the start of the year to 220bps in December. Argentina issued a 100-year bond in USD. Demand was such that yield at issuance was less than 8%.

Conclusions

Many things could have gone wrong in the past year from Fed policy to North Korea and politics in the US and Europe. Instead volatility has remained exceptionally low amid continued easy money. Bitcoin surge made headlines. Markets rewarded risk with high-yielding assets outperforming government bonds in 2017.

As at January 8th, 2018.