The Yield Report.

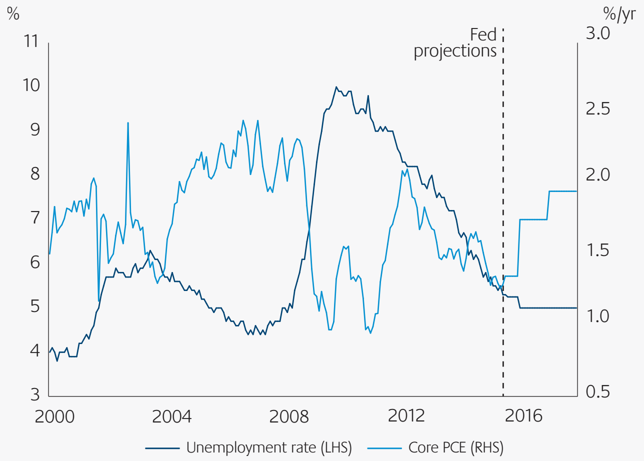
Economic Overview

The Fed looks forward, but China risks grow.

The Chair of the US Federal Reserve (the Fed), Janet Yellen has indicated that the monetary policy normalisation process should get underway before year-end 2015.

The minutes of the July Federal Open Market Committee (FOMC), released 19 August, indicated that, at that time, the Fed did not yet have enough information or confidence to make the decision to begin raising interest rates. However, the Fed was clear that the economy was heading in the right direction.

The move to begin normalising interest rates is supported by the Fed's forecast that the unemployment rate will move to 5% or lower in coming months, while inflation (as measured by the Core Personal Consumption Expenditure (PCE) Index) will trend back towards 2% over the medium-term (see chart 1). The Q2 15 Gross Domestic Product (GDP) report, showing growth of 3.7% seasonally adjusted annualised rate (saar), is also supportive of higher interest rates.



Source: Bloomberg and FOMC. Data to 31 July 2015 for unemployment rate, 30 June 2015 for Core PCE. Fed projections as at June 2015.

However, since the release of the minutes of the July FOMC meeting, global financial markets have seen a significant increase in volatility. This has been driven not only by uncertainty around the expected trend to higher interest rates in the US, but also by concerns over the pace of economic growth in China and the ability of the authorities to support economic growth, equity market volatility and the depreciating currency.

Our view for quite some time has been that the monetary policy normalisation process in the US would get underway at the 16-17 September FOMC meeting. We acknowledge that the recent significant volatility in global financial markets has reduced the likelihood of the first move being in mid-September.

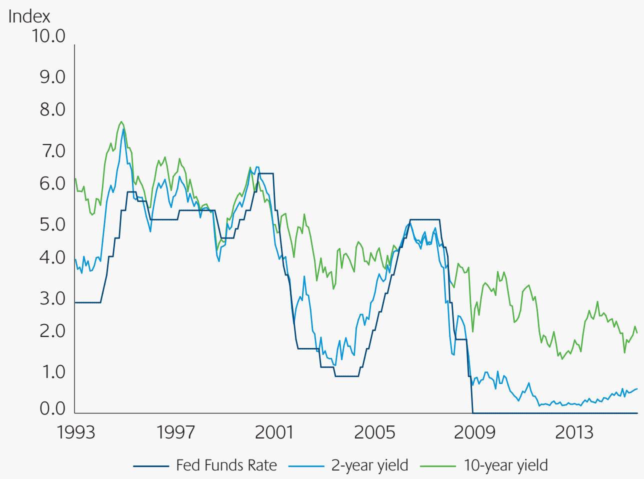
If the Fed was to delay the first rate hike, it will have two more opportunities to increase interest rates this year – at the 27-28 October FOMC meeting and/or the 15-16 December meeting.

Note that we expect the first rate hike from the US Fed will be a 25bp increase, taking the Fed Funds target rate from the current 0%-0.25% range up to 0.25%-0.5%. This interest rate range or 'corridor' is expected to be bound by the Reverse Repo rate at the lower end and the Interest on Excess Reserves rate at the upper end.

After the first rate hike from the Fed, we would then expect this move to be followed by 25bp rate increases every second meeting after that. Our base case would be, therefore, for a rate hike before the end of 2015, followed by further moves in March, June, September and December 2016.

As demonstrated in chart 2, once the US Fed starts raising official interest rates, bond yields usually tend to follow. From current lows around 2.2%, the US 10-year government bond yield could be expected to trend higher in the year ahead, and indeed, this is our expectation.

This trend to higher longer-dated bond yields in the US is likely to have significant implications for financial markets – not just in the US, but around the world.



Source: Bloomberg, First State Investments. Data to 13 August 2015. EMR forecasts to June 2018.

Will tighten really tighten? Maybe not

This 'tightening' cycle by the US Fed may have a very different impact on financial markets than previous rate hike cycles.

While, as stated above, the US Fed looks set to begin raising interest rates this year, it has also made it clear that this rate hike cycle will be very gradual. As noted, recent volatility in global financial markets could act as a catalyst for the US Fed to delay the start of the normalisation process.

We have chosen to reflect the expected 'gradual' approach from the Fed by looking for a 25bp rate hike every second FOMC meeting, i.e. four rate hikes totalling 100bp per year. But it is clear that the US Fed is on no pre-set course and that the path of monetary policy will be data-dependent.

Nevertheless, even the 'gradual' rate hike cycle we expect is more aggressive than that currently priced into financial markets – with the market (as at 27 August) priced for a Fed Funds rate of just 0.265% at year-end 2015 and 0.82% at year-end 2016.

It is important to note that even this gradual approach could itself be altered to reflect financial market developments.

This is expected to limit the risk of a 'blow-out' event in the bond market, or to put it another way, a repeat of the so-called 'taper tantrum' of 2013 is unlikely.

In addition, the possible end point for this tightening cycle is expected to be much lower than previous rate hike cycles by the Fed. This is likely given expectations that the long-run potential growth rate of the US economy has slowed and that economic activity will be more sensitive to higher interest rates after such a long period of very loose monetary policy.

Our own forecasts have the Fed Funds rate at just 2%-2.25% by the end of 2017, i.e. not much different from where US 10-year government bond yields are today, and peaking at 2.5%-2.75% in 2018. This is still well below the FOMC's own assessment of the long-run Fed Funds rate of 3.75%.

For the bond market, therefore, it is not so much when the US Fed rate hike starts that is important, but the pace and the end-point.

On both of these counts it would seem to be most likely that any sell-off in the 10-year US Treasury bond would likely see yields peak at around 2.75%-3% in the year or two ahead.

We would expect that 2-year Treasury bond yields will experience a more aggressive increase in yields, perhaps to around 2% from current levels closer to 0.7%.

This would imply quite a flattening in the US Treasury bond yield curve (2-10 years) over the next couple of years – from approximately 150bp at present to closer to 75bp-100bp in coming years.

Monetary policy – conscious uncoupling

The other significant difference for the coming US rate hike cycle is that it is expected to occur in a very different global context to most tightening cycles.

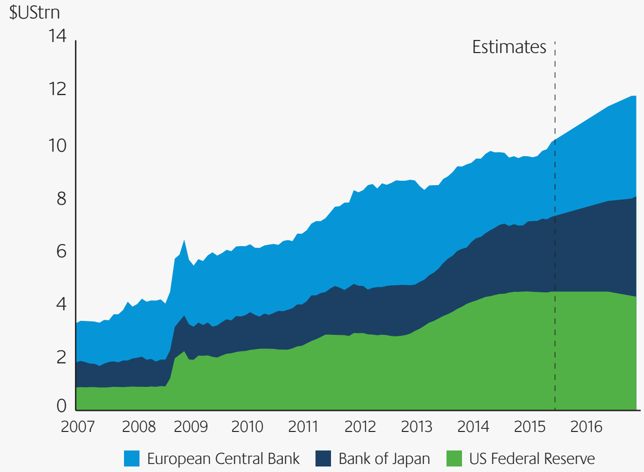
While we do expect the Bank of England (BoE) to start raising official interest rates in late 2015 or early 2016, all other major central banks are not in that camp.

We expect either steady monetary policy or further policy easing in Europe, Japan, China, Canada, Australia and New Zealand in the year ahead. In addition, many other emerging market economies will likely need to ease monetary policy – especially through their currency market.

In this context it is hard to see US or global bond yields selling off aggressively when the total monetary policy position for the global economy is likely to trend towards more easing.

We expect this will be significantly impacted by the ongoing large-scale quantitative easing programs in both Europe and Japan – which could be expected to hold down bond yields in these parts of the world and increase demand for US Treasury bonds from global investors.

Chart 3: European Central Bank (ECB) and Bank of Japan (BoJ) Quantitative Easing to swamp US tightening



Source: Bloomberg and First State Investments estimates to December 2016. Assumes Fed will stop reinvesting in 2H 16 and ECB and BoJ continue at current pace till end 2016.

Scenarios for the US bond market: what could go wrong?

While our base case expectation is a relatively gradual increase in US Treasury bond yields and a flattening of the yield curve, we are aware of some scenarios (see below) that pose a risk to this base case.

Higher yields – behind the curve?

As noted, US Treasury bond yields are starting the monetary policy normalisation process near historically very low levels. Indeed, the current very low level of inflation and term premiums within the Treasury bond market likely means that there is more upside risk than downside risk to yields from current levels.

As financial markets continue, in our view, to significantly under-estimate the pace and extent of Fed monetary policy tightening (even given recent volatility in markets), it would be easy to imagine that the bond market reaches a 'point of panic'. This could occur perhaps after two or three rate hikes, when there is a realisation that that the Fed is serious about raising interest rates and consequently, bond yields need to adjust sharply higher. This could easily see US 10-year Treasury yields above 3.25% or higher.

In addition, any signs of unexpected inflation would also likely prompt a sell-off in the Treasury bond market on expectations that the Fed's 'gradual' approach will leave the Fed 'behind the curve.' An upward repricing of commodities could be a factor to cause unexpected inflation.

The other key factor for the bond market will be the Fed's policy towards its balance sheet. At $US4.5 trillion as at early September 2015, the Fed's balance sheet is significantly larger than the level of just under $US1 trillion that was in place prior to the collapse of Lehman Brothers in September 2008.

The Fed has indicated that part of its monetary policy normalisation process in the years ahead will be returning the balance sheet to a more 'normal' size.

At this stage, it is widely expected that this will occur only through allowing bond holdings to mature and not through active selling of bonds in its portfolio. In this way, balance sheet normalisation would take many years, i.e. some estimates are suggesting out to 2022.

If, however, the Fed was to bring forward the balance sheet normalisation plans in any way (i.e. a more immediate decision to cease reinvestments and/or a potential decision to sell bonds out of the balance sheet), then this would likely result in a sharp spike higher in Treasury bond yields. The Fed could be prompted to undertake this policy if the reaction in the bond market to Fed tightening was muted and was not removing the accommodative conditions as quickly as the Fed had hoped.

Lower yields – lower for longer?

There is also the risk that the Fed's policy tightening process could see longer-dated Treasury bond yields decline. Given that the Fed is expected to start raising interest rates with the Core PCE Index (their favoured measure of inflation) at just 1.2%, there is a risk that the market behaves as if the Fed has made a 'policy error' and there is no chance of inflation returning to its 2% target.

The market could believe instead that inflation is more likely to fall, rather than rise from here. This could occur as a result of either the strong US dollar (USD) and/or further potential declines in energy prices.

A fall in inflation and any signs that the Fed has made a 'policy error' or that the pace of further rate hikes will be reduced significantly, could create an environment where US 10-year bond yields head back towards their cyclical lows of around 1.5%.

Additionally, given the sharp rise in global financial market volatility in recent weeks, the Fed may indeed decide to hold interest rates at their historical lows for a longer period – delaying the policy normalisation process.

If the Fed did delay lifting interest rates into 2016, and commodity prices took another sharp leg lower, this could see US 10-year bond yields continue to rally down to levels well below 2%.

A rally in US Treasury bond yields could also occur if we were to see substantial further monetary policy easing by other major central banks, such as the ECB, BoJ and/or People's Bank of China (PBoC).

Such policy easing could lead to more capital inflow into the US Treasury bonds, both lowering yields and strengthening the USD.

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