BNP PARIBAS INVESTMENT PARTNERS | The asset manager for a changing world

Weekly Intelligence Report

Our views on this week's investment events

22 March 2016

Overview

Guy Williams
Chief Investment Officer, Institutional Business
guy.williams@bnpparibas.com

Global financial markets continue to be driven by surprises in central bank policy and rhetoric. In last week's Weekly Intelligence Report, we argued that markets had under reacted to the significant policy measures announced by the European Central Bank on March 10th. The subsequent firming of European corporate bonds and equities has tended to support that view. The market's reception to the March 17th Federal Open Market Committee statement and Yellen testimony was less ambiguous; the overall communication package was widely viewed as dovish, and supportive of growth and risk assets. Market price action has reflected this.

Steve Friedman's analysis of last week's FOMC can be read in "March FOMC: Global risks come to the fore" and reflected this. In the first of our articles in this publication, Steve explores the conundrum posed by the continuing **unusual flatness of the US yield curve**, and warns that the current suppressed levels of term risk premia may not persist.

Adnan Akant, Head of Currencies, examines the recent **consolidation of the US dollar,** which has been reinforced by last week's dovish FOMC, and draws some more positive conclusions on the prospects for commodity and emerging market currencies.

Lastly, L. Bryan Carter and Lewis Jones, respectively Head of Emerging Markets Fixed Income and Portfolio Manager, Emerging Markets Fixed Income, turn a spotlight on recent dramatic **political and market developments in Brazil**, and pose the question of whether we are witnessing an inflection point in the crisis.

There will be no edition of the Weekly Intelligence Report next week, given the upcoming holidays. The next edition will be published on Tuesday April 5th.

Happy reading!

What's behind the flattening of the Treasury curve?

Steven Friedman
Senior Investment Strategist
steven.friedman@bnpparibas.com

As the first quarter draws to a close, the New Year has already witnessed a sizeable swing in risk sentiment and the prices of risk assets. Six weeks ago falling oil prices, higher perceived recession risks and concerns that central banks were running short on policy options led to notable declines in global stock prices and a widening of credit spreads. More recently, many of these narratives underpinning negative risk sentiment have reversed, leading to a significant recovery in risk assets.

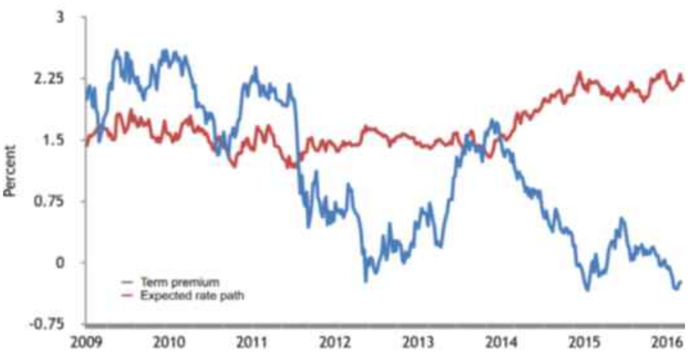
One aspect of market pricing that has not greatly reversed is the slope of the Treasury yield curve, which has remained remarkably stable even as longer-dated yields have risen from their February lows. For example the 2- to 10-year yield curve has re-steepened by less than ten basis points after reaching its flattest level since early 2008. How do we explain the flatness of the yield curve? Do we expect it to persist? Put another way, does it make sense for 10-year Treasury yields to remain below 2 percent, at levels more commonly associated with periods of significant downward growth revisions and major monetary policy easings?

Slope of the 2 to 10-year Treasury curve

Source: Bloomberg

One way to tackle this question is to decompose the 10-year yield into the expected path of short-term rates over the next 10 years, and a term premium, which represents the compensation that investors demand for holding a long-duration asset. As seen in the second chart, one commonly-cited estimate reveals a 10-year term premium that remains in negative territory and near its lowest level of the post-crisis period. A number of factors could be suppressing the term premium at present. These include expectations for reduced net supply of Treasury securities (which can result from either domestic or foreign quantitative easing ("QE")), risk aversion and flight-to-quality flows, or a declining inflation risk premium.

10-year Treasury yield decomposition



Source: Federal Reserve Bank of New York

We can likely rule out the last of these explanations – 10-year breakeven inflation compensation has moved materially higher in recent weeks, and a good portion of this move may reflect a rise in the inflation risk premium. This leaves the impact of QE and risk aversion as plausible explanations for a suppressed term premium.

Is it plausible that flight-to-quality flows or poor risk sentiment continue to suppress the term premium? Although risk assets have performed well in recent weeks, many investors still view the turnaround with skepticism as they still see elevated recession risks for the US and the global economy over the next one to two years, and may still remain overweight Treasuries. In addition, some of the term premium suppression may relate to known upcoming risk events, such as the June referendum on "Brexit" and what is increasingly an uncertain and highly charged US election cycle.

Finally, the impact of QE on the term premium could reflect the recent upsizing of the ECB's bond purchase program, as well as expectations that any additional easing by foreign central banks is likely to take the form of additional bond purchases as opposed to further cuts of short-term rates into negative territory. And of course, investors worried about a US recession may view a return to QE as the inevitable path of monetary policy, particularly given comments from Federal Reserve officials that indicate a reluctance to cut the rate of interest on excess reserves below zero. In addition, as investors discount a flatter policy rate path, they may also be reducing expectations that the Federal Reserve will ever begin unwinding its balance sheet.

In short, there are a number of plausible explanations for the flatness of the yield curve and for 10-year yields that are well below end-2015 levels, even as equity indices have fully recovered their earlier losses. These include continued negative risk sentiment, still-elevated perceptions of recession risk, and yield-seeking behavior as a result of current and anticipated QE. Still, it should be noted that the term premium very rarely persists at such low and negative levels for long. The spring of last year is a case in point. In under two months the 10-year yield rose by well over 50 basis points, driven by a significant snapback in the term premium as global bond markets continued to digest the ECB's first foray into QE.

While a snapback in the term premium poses one risk to the current low level of 10-year Treasury, there are others. One relates to the expected path of short-term rates, which could also adjust higher. At slightly over two percent, the expected rate path seen in the chart above implies very little policy tightening over the next three years and a neutral longer-run policy rate that is a good deal below the FOMC's (Federal Open Market Committee) own estimate. This policy path could be due for a correction if the recent firming of inflation persists, and markets begin to discount a rate path over the next few years that is similar to the FOMC's projections. Assuming no change in the term premium, such an adjustment to the expected rate path during normalization is worth about 10-20 basis points in the 10-year yield[1]. So while the global backdrop continues to hold down long-term Treasury rates and flatten the curve, this trend could come to an end if inflation continues to move higher and the US economy maintains its resilience in the face of slowing global growth.

1. This estimate assumes that investors discount a neutral long-run federal funds rate of 2.50 percent. If instead investors came to expect a 3.25 percent neutral rate, in line with the median FOMC participants' projection, the 10-year yield would be about 100 basis points higher, also assuming no change in the term premium.

Tracking US dollar movements

Adnan Akant
Head of Currencies
adnan.akant@fftw.com

The U.S. dollar has appreciated sharply, by about 20%, since mid 2014 via a series of steps. First came a strong move against the euro bloc from mid 2014 to March 2015. This move was the result of clear monetary policy divergence between the Federal Reserve and the European Central Bank. During this period the Federal Reserve ended quantitative easing and planned a lift-off of interest rates just as the ECB planned and started a program of QE and cut interest rates to negative levels. After March 2015, the euro entered a period of range trading versus the U.S. dollar, while commodity bloc and emerging market currencies continued their decline until early 2016 due to continued fears regarding China and oil prices. The broad U.S. dollar index reached its high point in January 2016 as global equity markets tumbled driven by China's devaluation of the yuan. By early February 2016, market participants and policy makers came to fear downside economic risks and the possibility that central banks around the world had lost effectiveness in supporting the global recovery. Talk of recession in the US, deflation in the Eurozone and Japan, and fears of a Chinese hard-landing became prevalent. Market pessimism as measured by bullish sentiment surveys rivaled the 30-year lows set by episodes such as the Eurozone sovereign debt crisis of 2011-12, the Lehman crisis of 2008-09, the 9/11 terrorist attacks of 2001, the Internet crash of 1999-2000, the Asian debt crisis of 1997-98, and the October 1987 stock market crash.

As the G-20 met in late February, and important central bank meetings, specifically those of the People's Bank of China, ECB, Bank of Japan and the Federal Reserve took place in March, it became clear to many that currency devaluation policies around the world resulting in an ever stronger U.S. dollar were no longer beneficial. The ECB took its focus away from pursuing a weak euro, the PBOC pledged to keep the yuan stable, the BOJ passed on further easing steps to weaken the yen, and the Federal Reserve finally brought its "dots" closer to market expectations after more than a year of extra "hawkishness" by dropping them 50 basis points and removing two previously forecasted increases in the federal funds rate. The Federal Reserve emphasized "global factors", a pseudonym for the effects of a stronger U.S. dollar. This sea-change in central bank policies culminating in the Federal Reserve's decision of March 16 marked a significant turn for the U.S. dollar. The weaker U.S. dollar encouraged a rally in commodity prices and battered emerging market currencies. Global equity markets, anticipating these shifts, have been rallying strongly since the extreme low sentiment point of mid-February. U.S. economic data remain shaky, but on balance have stopped surprising forecasters on the downside: first quarter GDP is expected to register above 2%, a pick up after the fourth quarter's dismal 1% reading.

The question we face now is whether this declining trend in the U.S. dollar that started in late January 2016 is a minor correction of 5% or a durable turn that will last for the medium term. To answer this question we will need to monitor and assess the dynamics of the U.S. and global economic recoveries, including China and other emerging market countries, as well as movements in inflation and further developments in central bank policies. We are optimistic that the U.S. recovery will pick up some speed while U.S. inflation will remain low though rising. This combination of U.S. factors should allow the global recovery to broaden, and support the depressed currencies of emerging markets and commodity producers, in particular. Within the major bloc of G-5 currencies, the U.S. dollar would then most likely weaken to some extent as well, though the likelihood of the U.S. dollar falling sharply in this G-5 group is limited to, in our view, at most a decline of 10% from the recent peak. Commodity and emerging market currencies may have further upside if our prediction regarding global growth acceleration during the remainder of 2016 becomes a reality.

An inflection point in Brazil?

L. Bryan Carter
Head of Emerging Markets Fixed Income
bryan.carter@bnpparibas.com

Lewis Jones
Portfolio Manager, Emerging Markets Fixed Income
lewis.jones@fftw.com

Brazilian assets have rallied strongly this year; perceived improvements in the domestic political arena have reinforced a wider improvement in the market's appetite for emerging markets. While the macro-economic picture remains dismal, a resolution of the current political crisis would be a much needed first step toward an eventual recovery. The Brazilian real is the best performing emerging market currency gaining 12% in total return terms and the average yield on the local curve rallied an astonishing 260 basis points while the sovereign CDS spread has fallen 130 basis points, all over the year-to-date period ending March 18. While at current levels we would argue valuations no longer look particularly cheap, we do see likelihood of potential further positive reaction to headline news on both the political and economic fronts.

The path to the potential removal of President Rousseff from office has taken many twists and turns over the past year but none so dramatic as have been observed this month. First, a high profile member of the ruling PT party, Senator Delcídio do Amaral, agreed to a plea bargain deal with federal prosecutors in exchange for his testimony against former President Luiz Inácio Lula da Silva. Lula was arrested and questioned while several properties linked to him were searched by police attempting to find evidence linking him to the Petrobras 'Carwash' corruption scandal. Subsequently, President Rousseff named Lula to a ministerial post in an attempt to shield him from prosecution, with the details of the plan being made public by the release of wiretap recordings between the two.

These events have been seen by many Brazilian followers as signaling the final death knell for the ruling PT party as members and coalition partners leave and the government's approval rating remains mired in the single digits. There are now three potential mechanisms for a change of leadership in play. Firstly, Rousseff could resign: with a fractured party, a strong opposition and the corruption scandal investigations getting closer, governability has reached new lows at a time when deep structural reform is needed. Second, she could be removed through the impeachment process: the required Lower House Committee has been formed and polls show 68% voters approve of impeachment. Congress could hold a vote as soon as April, which if successful, would force Rousseff to step down for 180 days while the process is taken up by the Senate. Thirdly, there is the possibility that the Electoral Court invalidates the 2014 election due to breaches of campaign financing rules which would trigger new elections within 90 days of such a ruling. If this was delayed until 2017, an interim president would be elected by Congress rather than voters. With such an array of obstacles against her, it is becoming less and less likely that the President will finish her term.

The market has taken a very constructive view of the PT's demise, and we think the headline effect of Rousseff actually leaving power would be further market positive. Rousseff's administration has coincided with a period of slow growth, high inflation and abandonment of monetary and fiscal "anchors", and a change of government increases the probability of a U-turn in economic policy. The likely outcome in any scenario of Rousseff dismissal would be a temporary period of leadership under Vice President Michel Temer of the PMDB party, which has embraced a more conservative economic platform.

Economic news may improve on its own in the meantime. A stronger Brazilian real this year and the roll-off of year ago effects from the devaluation will show a lower inflation number in coming months: current inflation has already peaked and is falling from last month's 10.7%. Due to the economic downturn, trade and current account balances have turned up decisively. To its credit, the central bank employed strong counter-cyclical monetary policy, hiking interest rates during the inflation acceleration, and stands poised to complement the recovery with substantial easing once the fiscal situation is addressed. For 2015, interest payments totaled 7% of GDP on top of the primary deficit of 1.9%. This year should be slightly better on its own, particularly with the currency impact which effectively results in profits on the central bank's outstanding US dollar swaps position. We think the real could strengthen to 3.5 to the USD before the unwinding of these positions absorbs financial inflows and curbs appreciation. The carry is attractive relative to other emerging market currencies and we expect further flattening of the curve in the belly as inflation drops back into single digits. Credit spreads remain elevated both by historical standards and relative to Brazil's ratings peer group, even after recent compression. Despite the recent sharp turn for the better in market sentiment, we do not think that Brazil has run out of good news just yet.

Lastly, a word on institutional development and the long-term view for Brazil. Let us not lose sight of what has developed in Brazil over the past two years. Yes, the corruption case has laid bare to the world that Brazilian politicians are not immune to misconduct. It has also made plainly clear that Brazil boasts surprisingly strong institutions that transcend any one government or any one politician: an independent judiciary, that has investigated and prosecuted the case without hindrance; strong rule of law, free from dictatorial infringement; freedom of the press, and a healthy and vibrant civil society; and once again, peaceful change of leadership following a democratic process according to its constitution. There's no question this display has been messy but it is unmistakably democratic. How many other emerging markets can you name where democracy is this strong?

More of our thoughts on the market

Papers

Choices to address foreign currency exposure
by Momtchil Pojarliev, CFA, Senior Portfolio Manager
22 March, 2016

FFTW weekly commentary
by Timothy Johnson, Head of Total Return Multi-Sector
21 March, 2016

Weekly strategy update
by Joost van Leenders, CFA, Chief Economist
17 March, 2016

March FOMC: Global risks come to the fore
by Steven Friedman, Senior Investment Strategist
16 March, 2016

Asset allocation monthly
by Joost van Leenders, CFA, Chief Economist
March 2016

ECB: Trying the big bang
by Reinhold Knaus, Senior Economist
10 March, 2016

How much has China repaid its foreign corporate debt?
by Chi Lo, Senior Economist Greater China
9 March, 2016

Central Bank Watch
by Richard Barwell, Senior Economist
and Steven Friedman, Senior Investment Strategist
2 March, 2016

Will inflation divergence resurrect policy divergence?
by Richard Barwell, Senior Economist
and Steven Friedman, Senior Investment Strategist
1 March, 2016

Webcasts & podcasts

Replay

Opportunities in the current environment for bank and energy stocks
featuring Geoff Daily, CFA, Senior Equity Resarch Analyst
and Eric McLaughlin, CFA, Investment Specialist
17 March 2016

ECB and Fed policy outlook discussion
featuring Richard Barwell, Senior Economist
Daniel Morris, Senior Investment Strategist
and Steven Friedman, Senior Investment Strategist
3 March 2015

Global Emerging Market Equities Small Caps
featuring Rick Wetmore, CFA, Deputy CIO, Global Emerging Market Equities
and Christine McQuillan, CFA, Investment Specialist
17 February 2016

Absolute Return
An Alternative Fixed Income Strategy
featuring Alex Johnson, Head of Absolute Return, FFTW
27 January 2016

Factor investing: going beyond active and passive management
featuring Etienne Vincent, Head of Model Driven Global Quant Management,
19 January 2016

Download Insights - our mobile application

insights

Insights by BNP Paribas Investment Partners provides quick and easy access to the thought leadership content for the institutional investor including regular commentary, trending topics and research papers via various formats including articles, videos and webcasts.

Follow us

Disclaimer