



Bond Market Strategy: Peak policy divergence

- The divergence between US and European monetary policy may have peaked. Our year-end forecasts have 10Y Bund at 1.1% and 10Y UST at 2.50%.
- In Europe, absent an external shock, the market is likely to focus in H2 on the prospects of the ECB discussing (but not implementing) taper. The curve should steepen as the front-end should remain anchored.
- In the US, the terminal rate priced by the market is arguably too low. However, the hikes priced for 2016 appear close to fair given the downside risks to core PCE due to the lagged impact of the USD.
- There are several key risks to this outlook: the policy response in China, oil prices, fiscal and regulatory policies, the US credit cycle and (geo) political risks.

Peak policy divergence

The end of 2015 was marked by the unusual combination of the Fed likely to tighten policy, while the ECB delivered additional easing (albeit below heightened expectations). There should be some partial policy convergence in 2016. Absent an external shock, conditions could be in place for the ECB to discuss (but not implement) tapering its asset purchase programme in the second half of the year. In the US, the market is close to pricing secular stagnation leaving room for an upward repricing of the terminal rate. However, the pace of rate hikes priced in 2016 looks close to fair given the lagged impact of the USD and commodity prices on core PCE. As a result, we expect yields to remain close to or even below the forwards initially before repricing higher later in the year as (a) the market focuses on the reassessment of the ECB's policy, (b) the factors driving the downside pressures on Core PCE in the US dissipate and (c) the Fed potentially opens the door for a tapering of its reinvestment policy.

ECB: From QE quasi-infinity to taper tantrum

The final ECB meeting of 2015 disappointed overly hyped market expectations but nonetheless added more stimulus. Is this last round of ECB easing just one of many more to come as Europe is turning Japanese? A Japanese-type outcome can be defined as a situation in which private sector deleveraging is slow and is not accommodated by a more aggressive policy response. As a result, the credit impulse (i.e. the pace of deleveraging) never reverses and domestic demand remains under pressure. Ultimately, the economy converges to a situation in which the output gap widens, inflation is negative and real rates are too high. None of that is happening in Europe. In fact, on most of the key metrics, Europe resembles more the US with a ~3-year lag than Japan in the 1990s.

Indeed, as can be seen below³, Europe went through a two-step deleveraging process, but ultimately credit growth turned negative and the pace of deleveraging peaked mid-2013 three years after the US (see Figure 1) To accommodate the deleveraging process, the ECB engineered negative 10Y real rates in 2015 vs. 2012 for the Fed (see Figure 2.) Moreover, ECB policy also led to a more aggressive currency devaluation of more than 15% in real effective terms in 2015 vs. less than 10% achieved for the USD in early 2011 (see Figure 3).

³ In the analysis we compare in event time the behavior of key financial and economic variables in the US and Europe during this crisis and Japan in the 1990s. The reference time t=0 is defined as the peak in credit growth (Q4-07 for the US and Europe and Q1-90 for Japan).