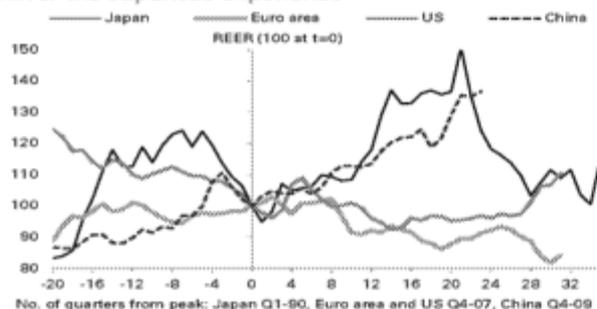




Figure 14: Chinese REER dynamics tend to more closely mirror the Japanese experience



Source: Deutsche Bank Research, Haver Analytics LP, Bloomberg Finance LP, BIS, Bank of Japan, Federal Reserve, ECB, PBoC, CNBS, Eurostat, BEA

Figure 15: Long-term real rates have also increased thanks to a falling deflator



Source: Deutsche Bank Research, Haver Analytics LP, Bloomberg Finance LP, BIS, Bank of Japan, Federal Reserve, ECB, PBoC, CNBS, Eurostat, BEA

*Oil:* Oil prices are exerting a significant impact on global bond markets. First, there is an obvious and very strong correlation between oil prices and the inflation risk premium and the term premium. Second, the ECB has now introduced a strong link between oil prices and monetary policy. The ECB is primarily concerned about a disanchoring of inflation expectations, i.e. the risk that persistently low spot inflation feeds into inflation expectations. In that respect, the ECB is less focused on why spot inflation is low (supply or demand factors, temporary or permanent) and inclined to react if spot inflation remains too low for too long. Given that spot inflation is itself largely determined by oil prices, there is an obvious link between the latter and the ECB's policy decisions. Our oil strategists see potential downside risks to oil prices in the short term, but are more positive for the medium-term outlook from a supply/demand perspective. The turn in oil prices, when it occurs, is likely to signal both a normalization of the term premium in bond markets and underperformance of European fixed income. Conversely, continued decline in oil prices would delay any prospects of an ECB tapering and further slow the pace of rate hikes in the US.

*Fiscal and regulatory policies:* The past few years have been marked by a policy mix which was relying on monetary policy to (over?) compensate for tighter fiscal and regulatory policies. While the regulatory pressures remain strong, there has been a shift in the fiscal outlook. Indeed, not only have fiscal policies in Europe and the US turned neutral, but there are arguably some upside risks over the next couple of years. In the US, the latest budget agreement has incorporated a small fiscal stimulus. The upcoming presidential election could also open the way for a more constructive dynamics between Congress and the Presidency. In Europe, the refugee crisis and the renewed focus on security will also skew the risks towards more fiscal easing, above and beyond what is recognized in the EC's forecasts. The loosening of fiscal policy is likely to be relatively limited in the short term. However, from a medium-term perspective, a shift in fiscal policy would be an important driver behind a reassessment of monetary policy both in the US and Europe.

*US credit cycle:* Under some metrics, the US credit cycle is already quite mature. Credit growth as percentage of GDP has recently averaged 7.5%, in the range seen in the late 1990s (6-10%) prior to the 04-07 credit bubble (10-15%). From this perspective, there are no signs of excess in aggregate, but no clear room for improvement either. Given the significant cumulative accumulation of inflows into specialized credit bond funds over the last few years, there is a clear risk that the policy tightening leads to an unwind of these inflows, which would put pressure on credit spreads and in turn could lead to a decline in credit growth. This could prompt the Fed to slow the tightening process and in an extreme scenario reverse it.