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INSIGHT

MONTHLY COMMENTARY

Global Fixed Income Monthly: Three Lessons From Brexit

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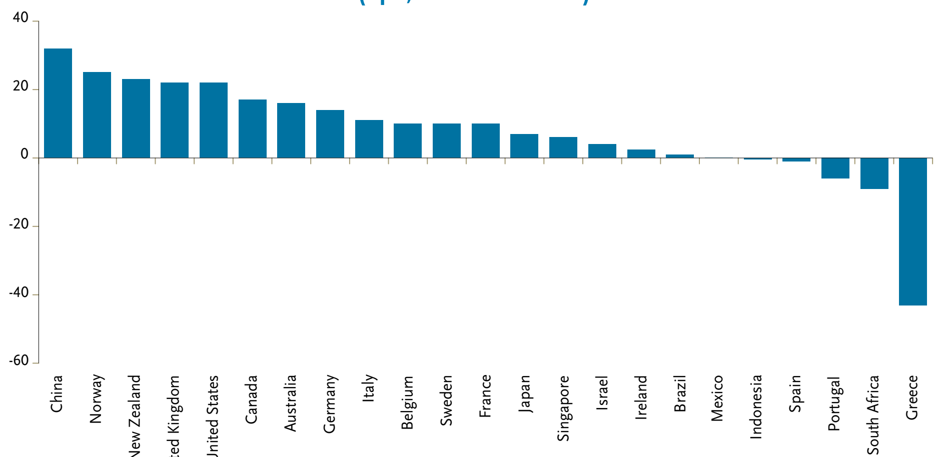
Dr. Meirelles is a Senior Analyst within the Fixed Income group responsible for international nominal and inflation linked bonds; she has been with TCW for over a decade having previously served as the firm's primary Latin America Credit Analyst. She brings the firm strong experience as a former Economist with the Federal Reserve Bank of Kansas City, where she conducted research on inflation targeting and was responsible for the construction of U.S. macroeconomic scenarios. Born and raised in Brazil, Dr. Meirelles was an Economic Policy Advisor for the Brazilian Senate and the Health Ministry of Brazil. Prior to that, she was a Researcher with the Institute of Applied Economic Research (IPEA) in Brasilia. Dr. Meirelles earned her PhD in Economics from UCLA, where her dissertation focused on the optimal design of inflation and fiscal targeting regimes. She holds a Master in Economics from the University of São Paulo and a BA in Economics from the University of Campinas, Brazil. She is a CFA charterholder.

After a first quarter largely characterized by strong global fixed income performance, courtesy of central banks' dovish pivots, the rates rally took a breather in recent weeks with China and core advanced economies giving up some of the recent gains. Higher yielders have been spared so far. In early April, we saw sizable and geographically diversified demand drawn by the Saudi Aramco inaugural bond deal, which was supported by a business with strong cash generation. Meanwhile, Greek bonds continued to outperform by a large margin, with 10-year sovereign bond credit spreads 100 basis points (bps) tighter year to date. These examples illustrate a hunt for yield, but also a desire for diversification of trades away from core Treasury markets, which have become largely a play on the Fed's increasingly dovish policies and communications.

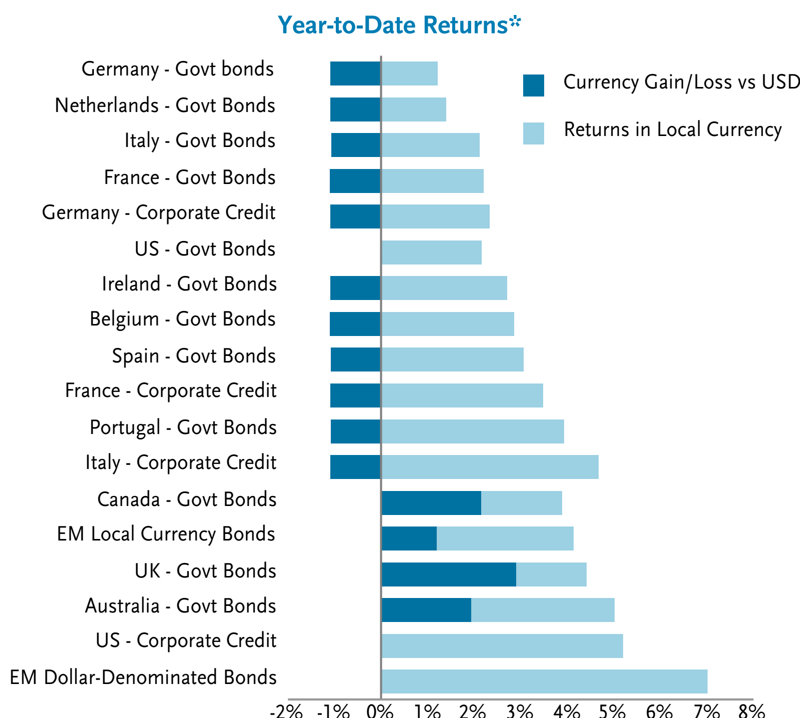
The bond rally in core markets came to a halt when incoming Chinese data started showing better-than-expected figures, with an uptick in manufacturing PMI (including positive data on leading components) and upside surprises in credit growth. China Treasury 10-year yields have sold off 32 bps since late March to 3.39%. This month marks the inclusion of China Treasury and developed bank bonds in one of the main fixed income global indices. When index inclusion is completed, China will represent about 7% of global index capitalization, the third largest country weight after the U.S. and Japan. Other global index managers are also expected to include China in their benchmark by the year 2020.

10-Year Treasury Yield Change (bps, Month-to-Date)



Source: Bloomberg, period covering March 29 - April 16, 2019

Total returns year to date have largely been driven by credit spread compression. Noticeable total return outperformance has been recorded in the U.S. dollar credit curve, with U.S. corporate credit and EM U.S.-dollar-denominated bonds posting the largest gains:



*As of April 16, 2019
Source: Benchmark returns based on JP Morgan EM indices and Bloomberg Barclays Global Aggregate Index

UK gilts have underperformed other G10 markets, as a hard Brexit was priced out, and the Pound has posted one of the best currency performances versus the U.S. dollar year-to-date. Now that the departure of the UK from the European Union has been delayed for another nine months, it is worth pausing to reflect on what we have learned so far from this event.

The first lesson (or reminder) is that the timing of constructive political action – of the type that breaks gridlocks and provides actionable solutions to economic matters – rarely coincides with the time schedule that investors hope for. Individual and partisan political gain calculations unfortunately get too frequently in the way of timely policy action. Add to that a lack of urgency, or the belief that any difficult but necessary solution can be postponed, and the result is the type of paralysis that afflicts so many legislative chambers and executive branches in both developed and emerging markets. To make matters worse, these delays alter the nature and depth of economic problems, rendering a workable solution harder to reach in the end.

The second lesson comes from the example set by the Bank of England (BoE) in 2016. It sheds light on how to think about inflation targeting frameworks in an era when policymakers are quite sanguine about their ability to bring inflation down, but not as confident that they can nudge it up. It also highlights the weight given to the overall economic activity level, even when the policy target is inflation and not economic output. Just two months after the Brexit vote, the BoE cut rates and expanded its asset purchase program. At that time, the unemployment rate had already declined to levels close to historical lows and inflation was undershooting the target, but as BoE had pointed out in the previous inflation report, this was largely due to the impact of a past fall in energy prices and other temporary factors. In its August 2016 policy statement, the bank acknowledged that its actions could stoke inflation, particularly in light of the pound already having sustained significant depreciation. Policy easing could, on the other hand, mitigate some of the economic downside risks posed by Brexit, even if that occurs at the cost of having inflation overshoot the target for a longer period of time. That, the BoE stated, was an acceptable trade-off.

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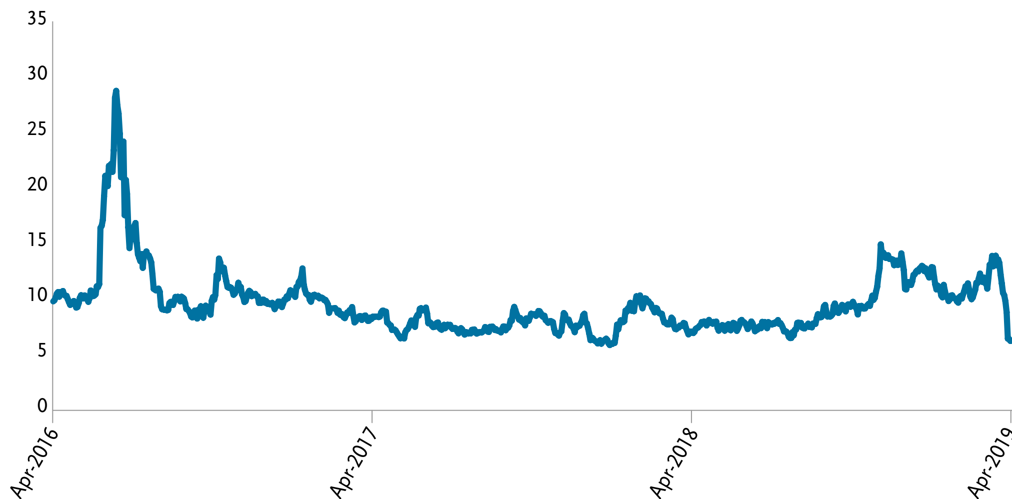

The third lesson is that the market in general is not good at – and is not getting any better at – predicting voter preferences. Investors did poorly when assessing the Brexit risks and more recently overestimated the ability of PM Theresa May to push through Parliament a withdrawal deal that would take the UK out of the EU, but offered limited assurances on the type of trade relationship that would prevail following that withdrawal. Back in 2016, the British pound option implied volatility (which now has plunged again, given the nine month delay of Brexit) had risen during the weeks leading up to the Brexit vote, but was not far off from average historical realized levels (see chart above). Other examples abound. Months after the Brexit vote, the French elections triggered a long-lasting market rally in part because markets had swung to the opposite extreme: that of seeing the election of a non-mainstream, conservative nationalistic group as much more than just a small tail risk. In the fall of 2015, a U.S. -based investment bank conducted a live electronic survey in a room filled with hundreds of knowledgeable investors: most of them predicted Hillary Clinton would be the next president of the United States, closely followed by Jeb Bush.

To be sure, predicting election outcomes has always been a challenging task, only made more difficult by uncertain voter turnout and the reluctance of voters to reveal their preferences to pollsters. But the relevance of demographic, generational and other factors that influence voter preferences is not getting any smaller. This is particularly true given ongoing shifts in electorate views on basic issues, such as questioning what exactly free markets have to offer to them. ■

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