TCW

INSIGHT

GLOBAL FIXED INCOME UPDATE

Preemptive Rate Cuts

MARCELA MEIRELLES | 17 MAY 2019

Marcela Meirelles, PhD, CFA
Managing Director
Fixed Income

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.

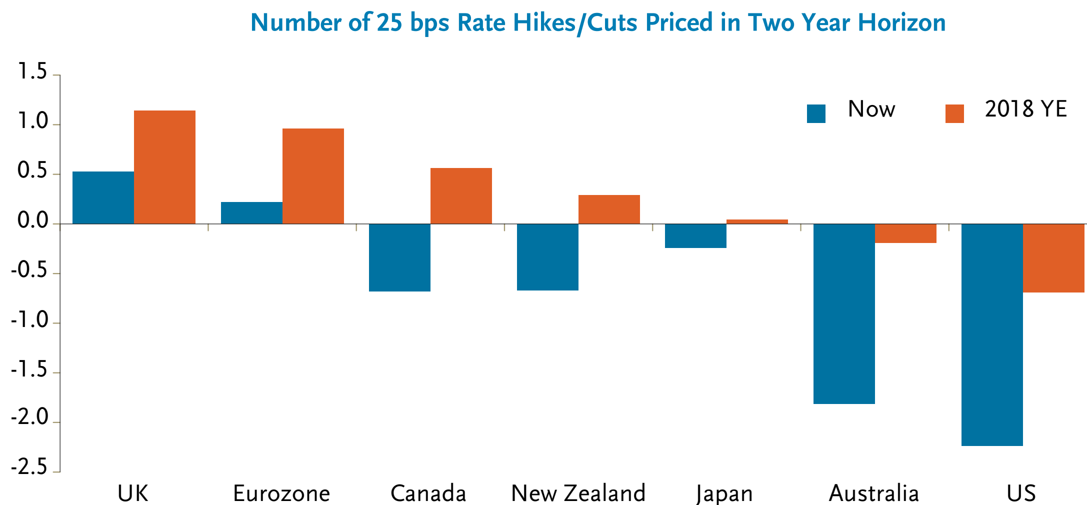
Continued monetary policy normalization has by and large been priced out in global bond markets. The recent negative turn in the U.S. and China trade disputes is just the latest development in a series of blows to the thesis that the world economy can continue just humming along, gradually digesting its leverage issues and opening up space for central banks to hike rates, even if it has to be in a gradual manner. This scenario is not entirely ruled out, but odds are that the road ahead will be very bumpy, especially for those more export-oriented economies that depend on trade openness, low friction in global production networks and healthy business sentiment.

Faced with this level of uncertainty, central bankers have already chosen to err on the side of being cautious. Caution may imply cutting rates in a preemptive manner, before it is too late to have to deal with a more adverse economic scenario that requires deeper rates cuts, but constrained by the lower bound (zero) for interest rates. The **Reserve Bank of New Zealand's** decision to cut its policy rate by 25 bps to 1.5% in early in May fits this description. Years ago, RBNZ's latest decision to cut rates would have been considered highly unusual, given the committee's assessment that inflation is currently only "slightly below the mid-point of the inflation target, and that employment is broadly at the targeted maximum sustainable level"[1] . The policy statement included the now common reference to uncertainty generated by trade wars. It also referenced the downside risks that protracted trade disputes impose on New Zealand's largest trading partners, Australia and China. Committee members also mentioned slowing household demand, influenced by soft housing prices.

The **Reserve Bank of Australia** is expected to follow suit, with two rate cuts (50 bps total) now fully priced over the next six months. The move toward rate cuts is not exclusive of developed markets. In Malaysia, taking into account subdued headline and core inflation, and also citing the headwinds brought by trade disputes, **Bank Negara** policy committee members decided to cut the policy rate by 25 bps to 3%. The **Bank of Indonesia** could be next.

1 Reserve Bank of New Zealand, monetary policy decision statement, May 8 2019.

TCW



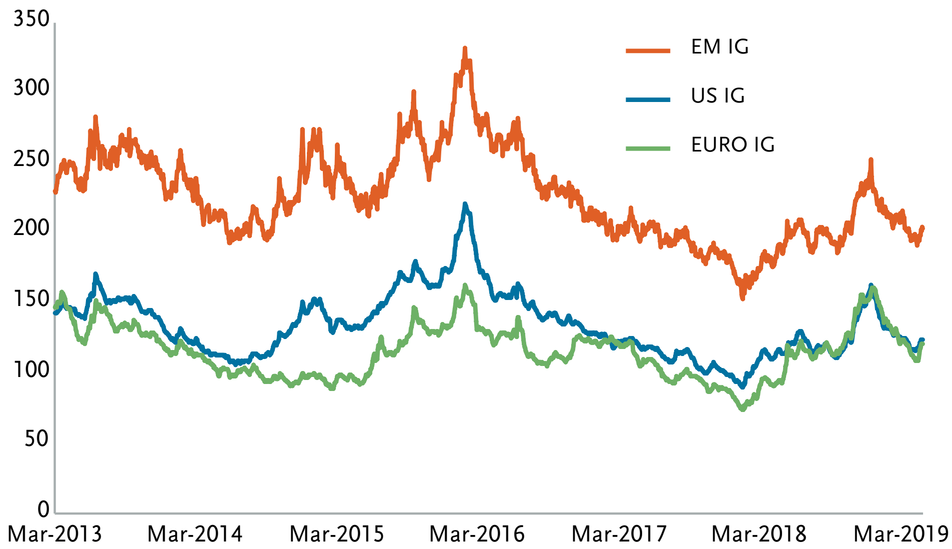
Source: Bloomberg. Data as of 05/16/2019.

Very few central banks are expected to hike rates over the next two years. The **Bank of England** (BoE) is one of them, with a (modest) 25 bps hike (to 1%) still fully priced. That may not last very long, given the dismal lack of progress in finding a framework for an orderly withdrawal from the European Union (EU). The upcoming EU Parliament elections will most likely, and quite ironically, elect UK representatives that in large part come from the recently formed “Brexit Party” led by Nigel Farage. This will cement the fear that any exit solution, once it is finally reached, will not be one in which the UK retains close commercial ties with the EU and also respects the seamless Ireland-Northern Ireland border, whose importance goes well beyond trade.

The market assessment is that policy normalization in the **eurozone** is pretty much off the table over the next two years. This is certainly a very dovish scenario, but developments keep piling on in a manner that strengthens the case against a rates-normalization liftoff. One of the factors is, of course, the risk associated with trade wars. In addition to the direct impact through the trade channel, the sudden deterioration in U.S.-China trade talks sparked unwinding of euro-funded carry trades. A stronger (trade-weighted) euro is potentially bad news for eurozone inflation and inflation expectations. Last but not least, the Italian sovereign debt issue still lingers in the background. This is another topic that could develop in a market-unfriendly manner after the European Parliament elections. Italian BTPs already price (at least in part) a benign scenario in which Matteo Salvini’s Lega Party outperforms in the elections, paving the way for the dissolution of the current government and the eventual formation of a new one, led by business-friendly Lega. But one must recall that one of the pillars of Lega’s growing popularity is a nationalistic platform where criticism of EU rules takes center stage, particularly those related to fiscal austerity.

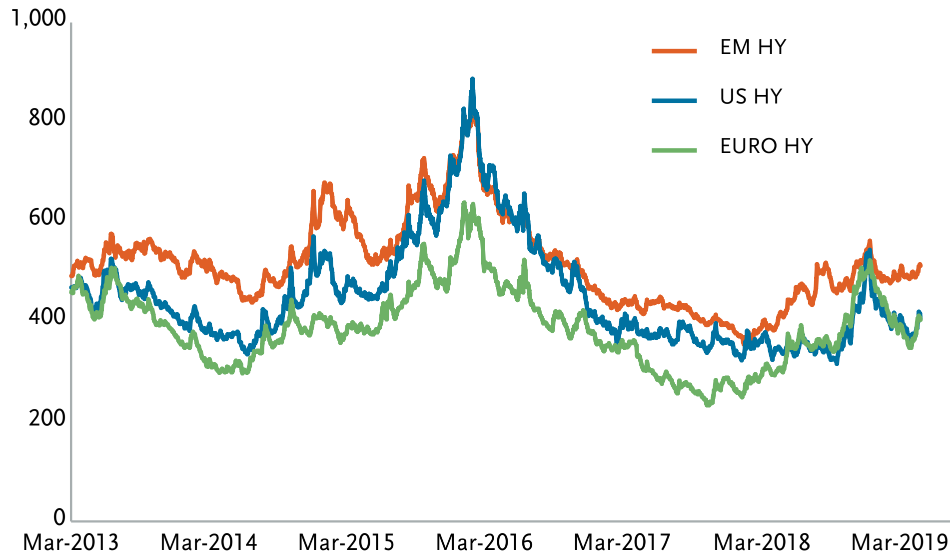
Despite no shortage of concerning news that has prompted central bankers to implement increasingly more dovish policy and communication, credit spreads remain firmly in a much tighter range compared to 2018 wides. Spreads have risen since U.S. and China trade talks broke down and each side imposed retaliatory tariffs, but so far investors’ reactions display an underlying belief that ultimately a deal or lasting truce will be reached.

Global IG Spreads (bps)



Source: Bloomberg, based on BAML (US and Eurozone corporate credit spreads) and JP Morgan (EM corporate credit spreads). Data as of 05/15/2019.

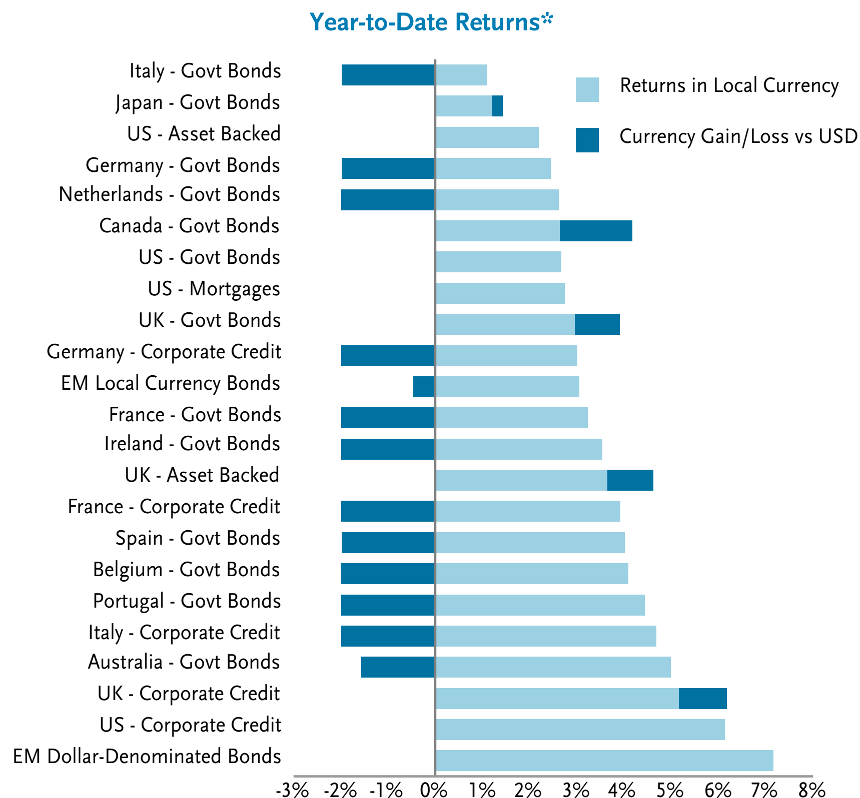
High Yield Spreads (bps)



Source: Bloomberg, based on BAML (US and Eurozone corporate credit spreads) and JP Morgan (EM corporate credit spreads). Data as of 05/15/2019.

TCW

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



*As of May 15, 2019
Source: Benchmark returns based on JP Morgan EM indices and Bloomberg Barclays Global Aggregate Index

This material is for general information purposes only and does not constitute an offer to sell, or a solicitation of an offer to buy, any security. TCW, its officers, directors, employees or clients may have positions in securities or investments mentioned in this publication, which positions may change at any time, without notice. While the information and statistical data contained herein are based on sources believed to be reliable, we do not represent that it is accurate and should not be relied on as such or be the basis for an investment decision. The information contained herein may include preliminary information and/or "forward-looking statements." Due to numerous factors, actual events may differ substantially from those presented. TCW assumes no duty to update any forward-looking statements or opinions in this document. Any opinions expressed herein are current only as of the time made and are subject to change without notice. Past performance is no guarantee of future results. © 2019 TCW

865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | @TCWGroup