J. SAFRA SARASIN
ASSET MANAGEMENT

Cross-Asset Weekly

15 February 2019

Hunting for yield in euro area government bonds

Now that interest rate hikes have been put on the back burner in developed markets, fixed income investors are again casting their nets wider in the hunt for yield. This is particularly the case in Europe, where comfirmation that the euro zone economy managed only meagre growth in the fourth quarter of last year means that a first interest rate hike by the ECB is a long way off and German Bund yields will remain extremely low for the foreseeable future. As a result, European investors will also have to look to peripheral markets for better rates of return. We do not believe that the spreads of Italian bond yields over Bunds offer enough compensation for the broad range of risks that investors face. Instead, we prefer Spanish government bonds, since economic fundamentals have improved substantially in recent years, and should continue to do so even if there is a snap election. Irish bonds are also appealing. However, there may be better entry points further down the line if the market begins to fear a hard Brexit as the UK's withdrawal from the EU draws nearer.

The perennially low rates of return on offer from bonds in developed markets have seen investors return to the emerging world. But even here yields may grind lower, as recent declines in inflation add a dovish tilt to the outlook for monetary policy. This is particularly the case in Asia, and the market may soon begin to price lower interest rates more aggressively.

This week's highlights

European Fixed Income 2
Opportunities in euro area non-core bond markets

Emerging Markets 5
Low inflation adds a dovish tilt to EM monetary policy

Economic Calendar 8
Week of 18/02 – 22/02/2019

Market Performance 9
Global Markets in Local Currencies

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European Fixed Income

Opportunities in euro area non-core bond markets

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With core euro area yields close to zero and generally tight credit spreads, opportunities for a yield pick-up are scarce. We find that in the non-core euro bond markets Spanish and Irish government bonds are the most attractive. Both countries have made significant progress since the euro crisis, offer higher yields and steeper curves than core bond markets. Both markets are confronted with (political) events in 2019. In the case of Spain, elections are unlikely to have significant impact, while the fear of a 'hard Brexit' still hangs over Ireland. Spain continues to be our preferred market in the non-core government bond space, while we would wait for a better entry point into Irish bonds.

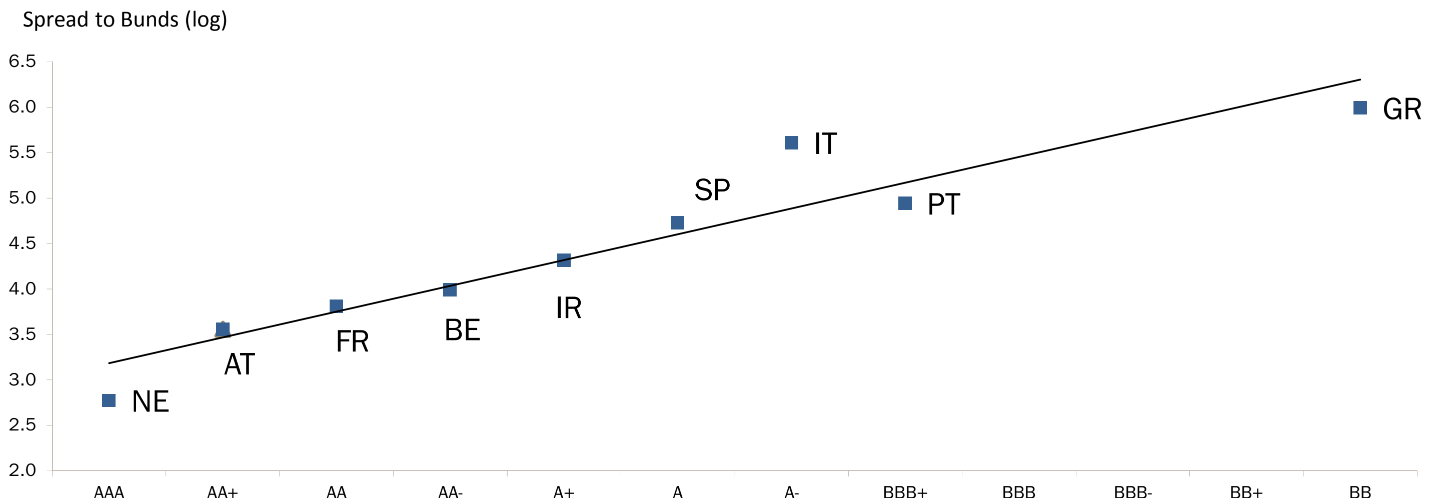
Significantly higher yields in non-core euro area government bond markets

With core euro area bond yields hovering at very low levels and hence delivering mediocre expected returns, investors have turned to higher yielding instruments, namely corporate and non-core euro are government bonds. This week, we explore potential opportunities in non-core government bond markets to generate higher returns. We already made a case for Spanish bonds as a clear overweight to German government instruments, while expressing reservations about Italian bonds (see our Cross Asset Weekly, "*Italian spreads indicate sub-investment rating*", 21st September 2018). In view of the fact that the euro area will have to contend with lower growth rates, our main focus continues to be centred on issuers which have implemented policies that will support sustained structural improvement. Although Italy has the highest yields apart from Greece, we still have reservations as the policies of the current government do not address the structural deficiencies.

Ireland, Spain and Portugal are showing significant signs of improvement

Ireland, Spain and Portugal suffered severely during the financial crisis as the credit-inflated bubble burst. All three countries had to undergo a painful adjustment process during the euro crisis in 2012 resulting in a significant improvement in fundamentals. From a valuation perspective, however, Portugal looks too expensive leaving us with the next two higher yielding markets: Spain and Ireland (Exhibit 1).

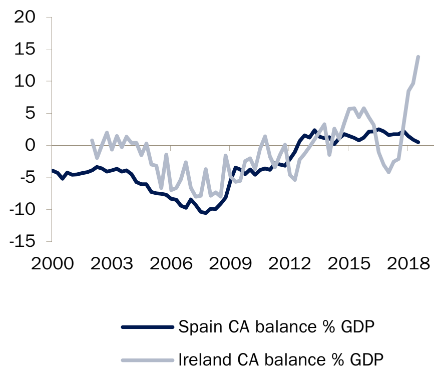
Exhibit 1: Current spreads to Bunds for Ireland and Spain are in line with (S&P) rating category, Portugal looks too expensive



Source: Macrobond, J. Safra Sarasin, 13.02.2019

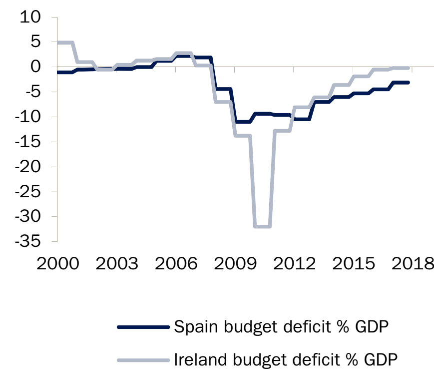
The progress achieved by Ireland and Spain since the global financial crisis is most visible in clear improvements in their current account balances. Ireland shines with a significant reduction in overall government debt/GDP levels and strong GDP growth. The improving credit profile should make Ireland a candidate for a rating upgrade.
Spain is clearly the strongest of the peripheral countries having implemented meaningful structural reforms that have led to above average GDP growth in Europe.

Exhibit 2: Current account deficit have improved significantly



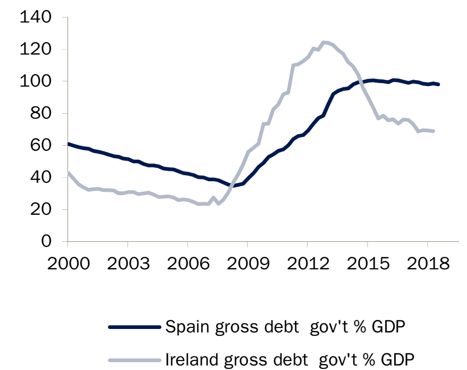
Source: Macrobond, J. Safra Sarasin, 13.02.2019

Exhibit 3: Budget deficits are narrowing



Source: Macrobond, J. Safra Sarasin, 13.02.2019

Exhibit 4: Debt to GDP levels have stabilised and are contracting



Source: Macrobond, J. Safra Sarasin, 13.02.2019

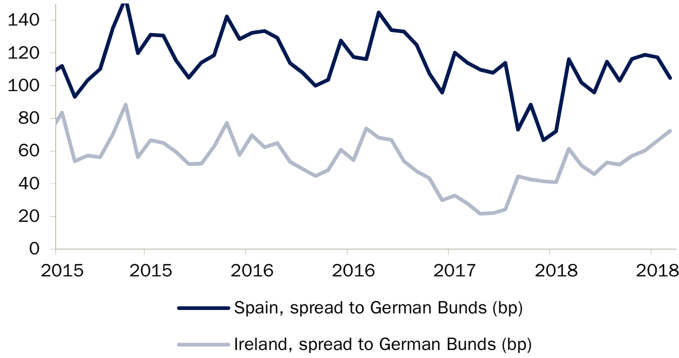
Political risks looming in 2019

Spread levels for the two countries are tight by historical standards. They reflect the structural improvement of the countries as well as the extraordinary support by the ECB in the form of asset purchases and ultra-low interest rates. In Spain, the minority government has failed to pass the budget and will likely have to face new elections. We believe this will result in centre-right coalition that will continue the current fiscal consolidation hence we would not expect significant a significant performance impact.
In Ireland, a ‘hard Brexit’ would have a more serious impact on the growth outlook, given its close economic ties with the UK. Roughly 12% of Irish exports are destined for the UK hence an ‘uncontrolled Brexit’ would have negative short-term effects on Irish bonds. The spread to Germany has already widened by 50bp since the lows registered in October 2017 (Exhibit 5) and we would expect the spread to widen more in the short term as Brexit negotiations near the endgame.

Steeper yield curves add to returns

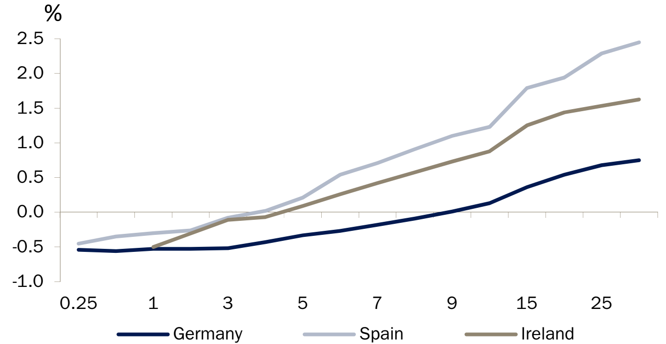
Apart from carrying higher yields to maturity, Ireland and Spain also offer steeper yield curves than in core markets allowing for better roll-down returns. These returns are generated by the fact that with upward sloping yield curves, the yield to maturity falls as the term to maturity becomes shorter. As the bond ‘rolls down the yield curve’ it can generate significant capital gains. It is thus an important, although frequently overlooked performance driver that becomes more prominent with longer investment horizons (6 - 12 months).

Exhibit 5: Spreads are at tight levels, Ireland is widening on 'Brexit' fears



Source: Macrobond, J. Safra Sarasin, 13.02.2019

Exhibit 6: Steeper yield curves than in Germany – higher yields and more attractive roll-down



Source: Macrobond, J. Safra Sarasin, 13.02.2019

Prefer Spanish bonds, wait for better entry points in Ireland

We find that Spain and Ireland are the most promising of the non-core bond markets. Both countries have implemented policies that have led to significant structural improvements. They offer higher yields and steeper yield curves than core euro bond markets and should generate significantly better returns over a 12 month horizon (Exhibits 7-9). With 'Brexit' negotiations heating up until the March deadline, we expect Irish bonds to underperform in the short term. So we would wait for a better entry point. Spanish bonds continue to be our preferred market in the non-core space.

Exhibit 7: Ret. analysis 7-10y German Bund

Change in yield	Investment horizon in months 3	6	12
-0.3	2.6%	2.7%	2.9%
-0.15	1.4%	1.5%	1.8%
0	0.2%	0.4%	0.7%
0.25	-1.8%	-1.6%	-1.1%
0.4	-3.0%	-2.7%	-2.2%

Source: Macrobond, J. Safra Sarasin, 13.02.2019

Exhibit 8: Ret. analysis 7-10y Spanish bonds

Change in yield	Investment horizon in months 3	6	12
-0.3	3.0%	3.6%	4.6%
-0.15	1.8%	2.4%	3.5%
0	0.6%	1.2%	2.4%
0.25	-1.4%	-0.7%	0.6%
0.4	-2.5%	-1.8%	-0.5%

Source: Macrobond, J. Safra Sarasin, 13.02.2019

Exhibit 9: Ret. analysis 7-10y Irish bonds

Change in yield	Investment horizon in months 3	6	12
-0.3	2.6%	3.3%	4.7%
-0.15	1.4%	2.1%	3.5%
0	0.2%	1.0%	2.4%
0.25	-1.8%	-1.0%	0.6%
0.4	-2.9%	-2.1%	-0.5%

Source: Macrobond, J. Safra Sarasin, 13.02.2019

Emerging Markets

Low inflation adds a dovish tilt to EM monetary policy

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Emerging Market (EM) inflation has generally fallen short of expectations in recent months as lower oil prices have reached consumers. Food inflation is likely to rise, but with energy inflation set to remain low and some pull-back in economic activity set to ease core price pressures, it might not be long until some central banks, particularly in Asia, begin to lower interest rates.

The consensus has been too hawkish on EM inflation

Of the 17 major EMs that have reported January inflation data so far this month, the latest readings came in significantly below expectations in 11 of them. Nowhere was that more obvious than in India, where the consensus had been for a large increase in inflation last month whereas our projections were broadly in line with the further decline that was reported. (See our Emerging Markets Weekly, "*Indian rate cut raises eyebrows*", 11th February.) Indeed, only the Czech Republic saw inflation come in much higher than expected.

Energy inflation likely to remain low

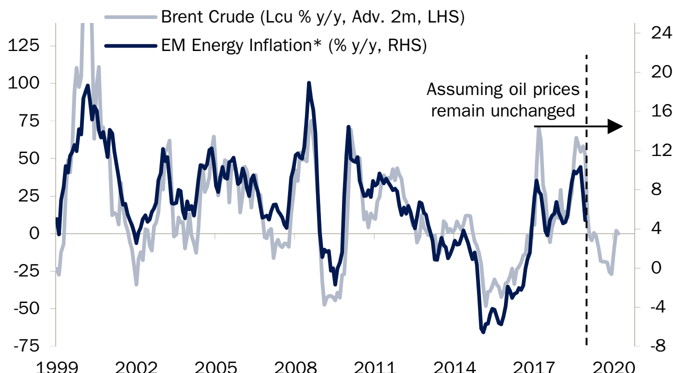
When viewed from the top-down, it becomes clear that a sharp fall in energy prices has been the major driving force behind the recent decline in EM inflation. Oil prices have been broadly flat in the past month, but it is the annual rate of change that matters for inflation and this has plummeted (Exhibit 1). In the absence of a major shift in oil prices in the months ahead, the adjustment in energy inflation has a little further to run, and should be a slightly disinflationary force during the course of 2019.

Food inflation to rise, but unlikely to get out of control

Food inflation has also been a bit softer in the past couple of months, having risen from low levels. It is not easy to analyse food inflation from a very high level, since shifts in global commodity prices affect food inflation with very different lags across the EM spectrum. In India and Mexico there is a long lag between changes in commodity prices and consumer prices, whereas in other countries the lag is much shorter. When looking at the outlook for food inflation, we convert global agricultural prices into local currency terms. By allowing some lag it seems that food inflation is likely to rise in the months ahead (Exhibit 2). The important point, though, is that food inflation is unlikely to spike to the levels seen a decade ago.

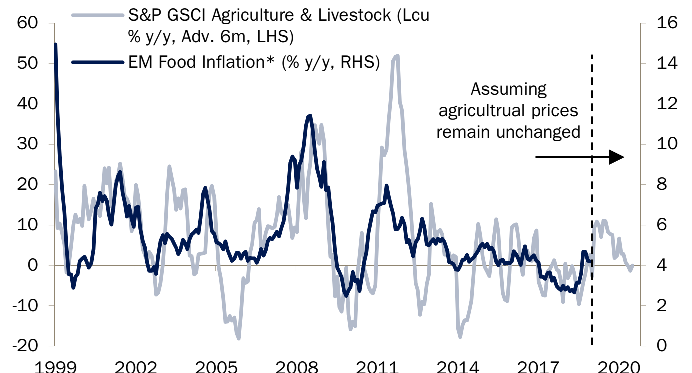
All of that being said, though, the outlook for core inflation is most important, and it has risen a little during the past year. One reason might be the sell-off in EM currencies last year, as higher import prices may have been passed on to consumers.

Exhibit 1: Energy inflation is likely to fall further...



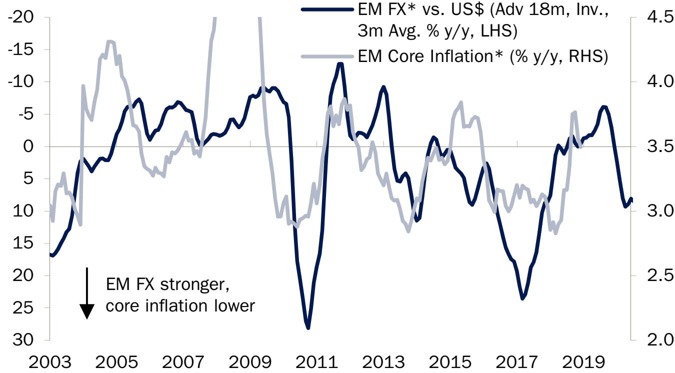
*Simple Average of Major EMs Source: Datastream, J. Safra Sarasin, 13.02.2019

Exhibit 2: ...but food inflation will probably rise



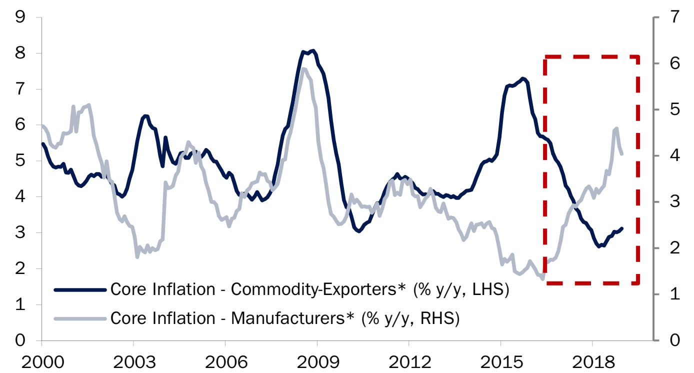
*Simple Average of Major EMs Source: Datastream, J. Safra Sarasin, 13.02.2019

Exhibit 3: The lagged effect of weaker currencies may push core inflation higher, but the relationship is not strong



*Simple Average of Major EMs Source: Datastream, J. Safra Sarasin, 13.02.2019

Exhibit 4: Core inflation is still heading in opposite directions in manufacturing- and commodity-based EMs



*Simple Average of Major EMs Source: Datastream, J. Safra Sarasin, 13.02.2019

Currency movements may lift core inflation in the near term…

However, the relationship between currency movements and core inflation is far from perfect. Taken at face value, the lagged effects of weaker currencies could boost core inflation to some degree in the near term (Exhibit 3). But even if this does materialise, the recent rally in EM currencies will soon begin to help ease imported inflation.

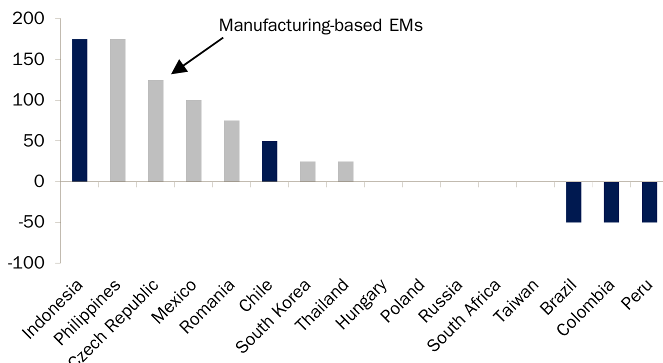
… but supply and demand dynamics are more important for underlying inflation

More fundamentally, core inflation is driven by the relative balance of supply and demand; when demand outstrips supply, core inflation usually rises and vice-versa. One year ago we argued that capacity pressures in manufacturing-based EM economies would cause core inflation to rise and result in gradual rate hikes. (See our Cross Asset Weekly, "*Taking stock of inflation developments*", 2nd March 2018.)

Slower growth in manufacturing-based EMs opens the door to interest rate cuts

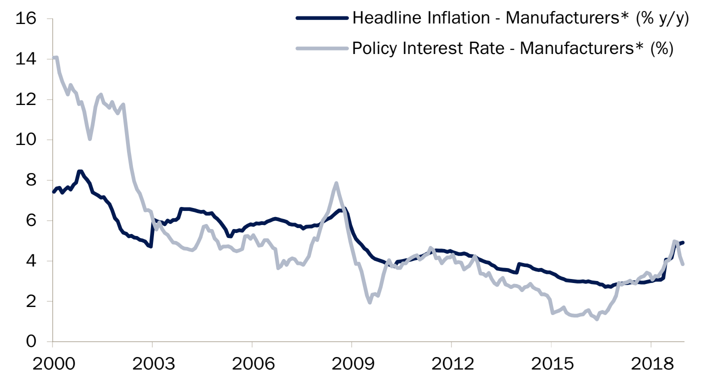
This generally played out (Exhibits 4 & 5), and the lingering effects could still be seen in the latest data from Central and Eastern Europe (CEE), where higher core inflation in the Czech Republic, Hungary and Romania suggests that interest rates will rise in the months ahead. This makes the reduction in market-pricing for rates since the start of the year hard to understand. However, in most other manufacturing-based EMs, particularly in Asia, economic growth is likely to be slower this year than it was last year and labour market dynamics will soften – for example unemployment rose sharply in South Korea last month. All of this will curb the need for tighter monetary policy, and perhaps allow some rate cuts. History shows that manufacturing-based EMs rarely maintain significant positive real interest rates, not least because current account surpluses mean they do not need to attract capital (Exhibit 6). The market has not yet priced this scenario (Exhibit 7), and expectations of rate cuts could support local currency bonds.

Exhibit 5: Change in Policy Rates Since End-2017 (bp)



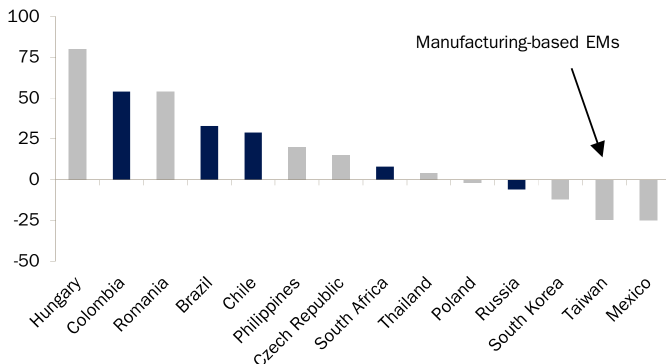
Source: Datastream, J. Safra Sarasin, 13.02.2019

Exhibit 6: Manufacturing-based EMs keep real rates low



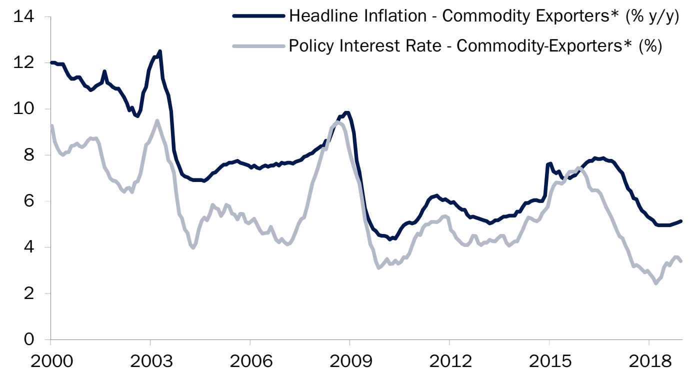
*Simple Average of Major EMs Source: Datastream, J. Safra Sarasin, 13.02.2019

Exhibit 7: Market-implied change in policy rates in next 12m (bp)



Source: Bloomberg, J. Safra Sarasin, 13.02.2019

Exhibit 8: Commodity producers maintain high real rates



*Simple Average of Major EMs Source: Datastream, J. Safra Sarasin, 13.02.2019

The era of low interest rates in commodity-exporting EMs may be coming to an end…

We also argued last year that commodity-producing EMs enjoyed the *opposite* dynamics. Most economies had substantial spare capacity, which ensured that both inflation and interest rates remained lower than was generally expected. The main exceptions to this were Indonesia and Russia, where cautious central banks raised rates to ward-off the effects of external shocks on the rupiah and ruble. On the whole, though, the spare capacity that kept inflation low last year has been used up and core inflation has begun to rise. The pause in Fed tightening reduces the need to raise rates in the near term, but central banks in commodity-producing EMs are most likely to tighten monetary policy in the months ahead. Again, in contrast to manufacturing-based EMs, commodity exporting EMs tend to maintain high real interest rates (Exhibit 8).

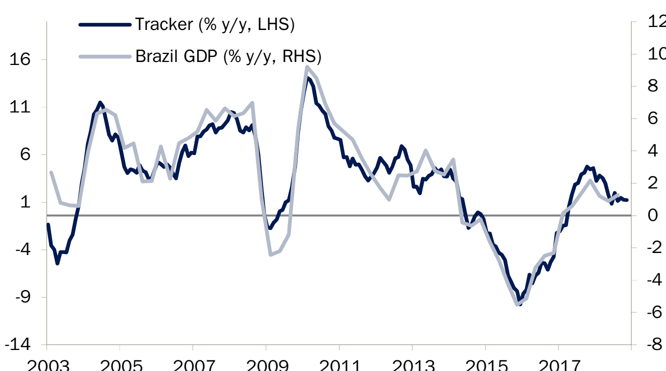
… except in Brazil

The key exception is Brazil. Brazil's economy is yet to really experience a meaningful recovery from the deep recession in 2015/16 (Exhibit 9). As a result, the economy still has plenty of spare capacity that leaves room for a period of faster, non-inflationary growth. Inflation and interest rates are already around multi-year lows, and the monetary policy committee (COPOM) has rarely left interest rates unchanged for long periods of time. However, the benchmark Selic rate has already been at 6.50% for almost a year, and the economic backdrop may enable it to remain there for another year.

Mexico has room for large rate cuts

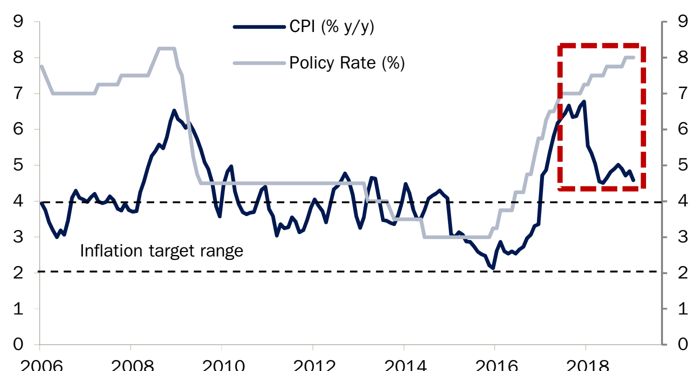
Finally, elsewhere in Latin America, policy rates in Mexico are too high when compared to the outlook for inflation (Exhibit 10). Concerns about the political environment have forced the central bank to run a tight monetary policy to support the peso. However, if President AMLO is "less bad" than expected, there could be large rate cuts ahead. The market currently prices only one cut in the next twelve months.

Exhibit 9: Brazil's economy still has plenty of spare capacity



Source: Datastream, J. Safra Sarasin, 13.02.2019

Exhibit 10: Mexican interest rates are much higher than inflation



Source: Datastream, J. Safra Sarasin, 13.02.2019

Economic Calendar

Week of 18/02 – 22/02/2019

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 18.02.2019						
JP	00:50	Machine Orders	Dec	yoy	+9.7%	+0.8%
UK	01:01	Rightmove House Prices	Feb	yoy	-	+0.4%
Tuesday, 19.02.2019						
CH	08:00	Exports Real	Jan	mom	-	-5.0%
	08:00	Imports Real	Jan	mom	-	+3.7%
EMU	11:00	Construction Output	Dec	yoy	-	+0.9%
	11:00	ZEW Expectations	Feb	index	-	-20.9
DE	11:00	ZEW Expectations	Feb	index	-	-15.0
UK	10:30	Avg. Weekly Earnings	Dec	3mts/yoy	-	+3.4%
	10:30	ILO Unemployment Rate	Dec	3mts	+4.0%	+4.0%
	10:30	Employment Change	Dec	1 000	-	141
	00:00	CBI Trends Total Orders	Feb	index	-	-1.0
US	16:00	NAHB Housing Market Index	Feb	index	59.0	58.0
Wednesday, 20.02.2019						
EMU	16:00	Consumer Confidence	Feb	index	-	-7.9
DE	08:00	PPI	Jan	mom	-	-0.4%
US	13:00	MBA Mortgage Applications	Feb 15	%	-	-3.7%
Thursday, 21.02.2019						
DE	09:30	PMI Services, prel.	Feb	index	-	53.0
US	14:30	Durable Goods Orders, prel.	Dec	mom	+1.7%	+0.7%
	14:30	Capital Goods Orders, prel.	Dec	mom	+0.2%	-0.6%
	15:45	Economic Expectations	Feb	index	-	44.5
	15:45	PMI Manufacturing, prel.	Feb	index	55.0	54.9
	15:45	PMI Services, prel.	Feb	index	-	54.2
Friday, 22.02.2019						
CN	02:30	New Home Prices	Jan	mom	-	+0.8%
EMU	11:00	CPI	Jan	mom	-	0.0%
DE	08:00	Private Consumption	4Q18	qoq	-	-0.3%
	08:00	Government Spending	4Q18	qoq	-	+0.2%
	08:00	Capital Investment	4Q18	qoq	-	+0.8%
	10:00	IFO Business Climate	Feb	index	-	99.1
	10:00	IFO Expectations	Feb	index	-	94.2
	10:00	IFO Current Assessment	Feb	index	-	104.3

Source: Bloomberg, J. Safra Sarasin, 15.2.2019

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	-0.28	3	-3	0.7
German Bund 10 year (%)	0.10	1	-14	1.4
UK Gilt 10 year (%)	1.15	0	-13	1.1
US Treasury 10 year (%)	2.65	1	-4	0.6
French OAT - Bund, spread (bp)	43	-2	-4	
Italian BTP - Bund, spread (bp)	273	-14	23	

	Spread over govt bonds	Change in credit spread		Credit index
Credit Markets (bp)		Δ 1W	Δ YTD	TR YTD in %
US Investment grade corp. bonds	65	-2	-23	2.6
EU Investment grade corp. bonds	72	-2	-15	2.1
US High yield bonds	354	-7	-95	4.6
EU High yield bonds	311	-7	-42	2.8

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	9'143	14.9	1.2	8.5
DAX - Germany	11'090	12.0	0.6	5.0
MSCI Italy	671	9.9	1.5	7.9
IBEX - Spain	8'953	11.4	0.2	5.4
DJ Euro Stoxx 50 - Eurozone	3'183	12.6	1.0	6.4
MSCI UK	2'079	12.5	1.7	7.3
S&P 500 - USA	2'746	16.4	1.6	9.8
Nasdaq 100 - USA	7'022	19.4	1.8	11.1
Nikkei 225 - Japan	20'901	15.1	1.3	5.6
MSCI Emerging Markets	1'039	12.0	-0.2	7.7

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	1.01	6.0	0.5	2.4
EUR-CHF	1.13	4.9	0.1	0.8
GBP-CHF	1.29	11.0	-0.5	2.9
EUR-USD	1.13	6.5	-0.4	-1.6
GBP-USD	1.28	11.7	-1.0	0.5
USD-JPY	110.3	6.8	0.5	0.6
EUR-GBP	0.88	10.8	0.7	-2.1
EUR-SEK	10.50	5.8	0.0	3.4
EUR-NOK	9.78	6.3	0.0	-1.2

Commodities	Level	3M realised volatility	1W in %	YTD in %
BBG Commodity Index	80	10.8	0.1	4.5
Brent crude oil - USD / barrel	65	26.6	4.3	21.3
Gold bullion - USD / Troy ounce	1'316	8.4	0.1	2.6

Source: Bloomberg, J. Safra Sarasin, 15.2.2019

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