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Monetary turnaround and more expansionary fiscal policy push yields upwards

Author
Sebastian Becker
+49(69)910-21548
sebastian-b.becker@db.com

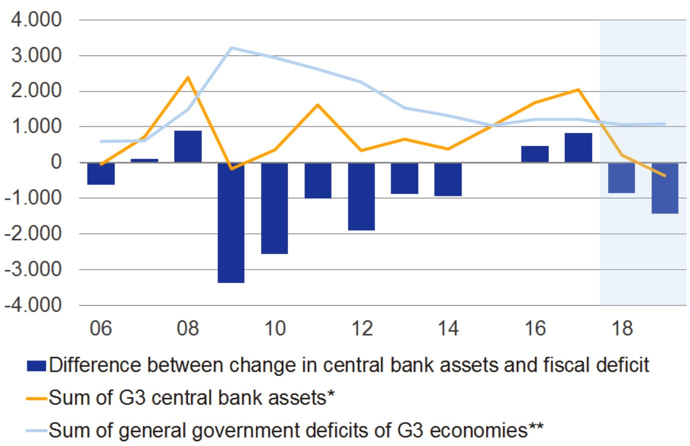
www.dbresearch.com

Deutsche Bank Research Management
Stefan Schneider

Since the beginning of the year, both short-term and long-term government bond yields have risen considerably in the developed markets (i.e. the US, the euro area and the UK; Japan is an exception), even though they are still low.

Fiscal deficits to exceed change in central bank assets

Annual change, USD bn



G3: USA, Euro Area and Japan. * 2018/19: DB Research projections.
** 2018/19: Latest IMF projections (as of October 2017).

Sources: Deutsche Bank Research, Fed, ECB, BoJ, IMF, Haver Analytics, WEFA, IHS Global Insight

For example, 10Y US Treasury yields climbed from c. 2.0% in September 2017 to above 2.9%, and meanwhile 10Y Bund yields rose to more than 0.8% and are now trading at roughly 0.7%, i.e. significantly higher than in December 2017 (0.3-0.4%) – and remember that they were still negative in October 2016. Japan is the only country where 10Y government bond yields are still near zero. This is clearly due to the ultra-expansionary monetary policy, which targets, among other things, a 10Y yield of 0%.

The yield increase is driven by expectations of a less expansionary (future) global monetary policy, as economic growth in major developed and emerging markets is currently quite strong and synchronised. In addition, financial market participants increasingly expect robust economic growth to be supported even further by a more expansionary, and thus pro-cyclical, fiscal policy, in particular in the US, but also in Germany. With capacity utilisation above the average (and excess utilisation rising) in many economies, wages and, in turn, inflation are likely to pick up more significantly.

The gradual withdrawal of (global) monetary stimulus is largely due to the fact that the Federal Reserve will continue to hike its key rate, the Fed funds target rate, this year and slowly reduce its huge holdings of Treasuries and mortgage-backed securities (MBS). We forecast four rate steps of 25 bp each for 2018, which will bring the Fed funds target rate to 2.375% by the end of the year (currently: 1.375%). In addition, the Fed plans to stepwise increase the amount of maturing securities which will not be reinvested to c. USD 50 bn per month by October 2018. As a consequence, the balance sheet total is likely to decline prospectively by c. EUR 600 bn each year. While the euro area is still far away from a balance sheet reduction, the ECB will probably terminate its increasingly controversial bond purchasing programme this year. We believe that the ECB will extend the programme one last time beyond September, but then stop it by the end of 2018. In

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fact, we expect the bond purchases to be reduced to EUR 10 bn per month in the final quarter of 2018 (from currently EUR 30 bn). Moreover, the ECB will probably hike its main refinancing rate by mid-2019 for the first time since 2011. In the UK, too, the Bank of England stopped purchasing gilts in March 2017; it has since raised its key rate from 0.25% to 0.5% due to increased wage pressures. Only in Japan will the Bank of Japan (BoJ) stick to its extremely expansionary course and boost the central bank's balance sheet further.

Overall, central bank liquidity provision is certainly declining again, and the aggregate balance sheet volume of the G4 central banks (US, euro area, Japan and UK) will probably reach its peak this year. The combination of less monetary stimulus and an increasingly expansionary fiscal policy has driven up yields recently. In fact, this year the aggregate budget deficit of the three major developed economies (US, euro area and Japan) might exceed the total of (net) securities purchases by the central banks for the first time since 2014. A higher supply of (and declining demand for) government bonds, persistently healthy growth and expectations of rising inflation should continue to exert upward pressure on long-term yields in the US and Europe. We expect 10Y government bond yields to rise to 3.25% in the US and 1.25% in the euro area by the end of the year. The most significant risk for such forecasts is obvious: once market repricing has started, it might develop its own momentum, and yields might rise considerably further.

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