Schroders

Outlook

2014: Global Bonds

Bob Jolly, Head of Global Macro

- The eurozone still faces myriad problems, of which the threat of deflation is probably the most worrying
- Developed market central banks would on balance rather be too late in tightening monetary policy than too early
- Bond investors will need to remain nimble in 2014, this is not a market in which your long-term strategic views are going to make you money every month.

"Europe appears to be at least 18 months behind the US on the road to recovery and it is currently stalling."

In last year's investment outlook we discussed how the world's economies face a long and winding road to recovery. One year on, and some countries find themselves further down the road than others. Those nations who responded most aggressively to the crisis that began five years ago are beginning to see positive results, while those who were more ponderous still face massive challenges.

The European Central Bank is fretting about deflation and is mulling both quantitative easing (QE) and negative interest rates, while – in contrast – the Bank of England (BoE) has already cast QE to the history books and it appears it won't be long until the US Federal Reserve begins to end its greatest ever experiment, 'QE infinity'.

US out in front

The US is furthest along the road, having thrown everything but the kitchen sink at its problems; recapitalising its banking system, slashing interest rates and embarking on QE on an enormous scale.

The one missing ingredient in the US currently is the consumer confidence that Americans normally have in abundance. With the housing market recovering and the stockmarket near record highs, confidence should pickup in 2014.

UK accelerating

Meanwhile the UK is slightly behind the US, although it has seen significant improvements in recent months. It appears to us like a pre-election economic acceleration, caused by government schemes such as 'Funding for Lending' and 'Help to Buy'. These are creative ways the government has used to avoid actually spending money, creating an off-balance sheet liability rather than doing what it should probably really do: build houses. But the UK is also being boosted by small improvements in its main export market – Europe – and by a pickup in lending.

Longer-term impediments

Despite improvements and grounds for optimism in the UK and the US, there are a number of structural headwinds and uncertainties that may impede a longer-term upswing. There remain considerable balance sheet issues that need to be dealt with, on both a government and household level. The US, for example, has never outspent its revenue (outside of wartime) by such a degree as it has in the past five years. The UK, meanwhile, tried to address its balance sheet issues by cutting back on spending and imposing austerity – but the result was a significant loss of revenue.

Furthermore, households also have a long way to go to repair their balance sheets. Having overspent and lived beyond their means for years, the structural adjustment needed won't take weeks or months. Mortgages, for instance, take decades to pay off.

Bob Jolly,
Head of Global Macro

Bob Jolly joined Schroders in September 2011 and is Head of Global Macro in the Fixed Income team, with responsibility for a number of macro and multi-sector portfolios. He was previously at UBS Global Asset Management where he was Head of Global Sovereign, Currency and UK Fixed Income Portfolio Management. Prior to that he spent two decades at Gartmore Investment Management, where his roles included Head of Fixed Income Portfolio Construction and Head of Structured Fixed Income.

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Europe the laggard

Europe appears to be at least 18 months behind the US on the road to recovery and it is currently stalling. Eurozone unemployment is around 12% and is likely to go up rather than down. One of the reasons growth is not accelerating is that banks are unwilling to lend to companies as they fear the risk of defaults and blowing even bigger holes in their balance sheets.

We think there is a strong probability that we see QE from the ECB. The region still faces myriad problems, of which the threat of deflation is probably the most worrying.

The spread of disinflation and deflation is getting broader. When you see headline inflation coming down, often it is just due to the oil price, but when you see disinflation in everything you buy, from food to cars to TVs and household appliances, that is when a central bank's nerves really start jangling. Such a scenario reflects a genuine lack of demand causing corporates to reduce their profit margins to stimulate demand. Europe is much closer to this than it was a year ago. In addition, the output gap or spare capacity of the eurozone's economy (the difference between actual GDP and potential GDP) could grow and add to disinflationary pressure.

Investment implications

Disinflation aggravates debt dynamics by making repayments increasingly hard to meet. One of the only ways the ECB can deal with this is to weaken its currency. This is why we favour short exposure to the euro versus a variety of currencies.

The Fed's decision to delay tapering in September reinforced our view that developed market central banks would on balance rather be too late in tightening monetary policy than too early. Central banks remain acutely aware of the danger of derailing a nascent recovery by tightening too soon; preferring instead to keep policy accommodative for longer and risking a potential inflation problem in later years. The implication of this is that we expect policy rates to remain low until at least 2015.

In Europe we will take opportunities to buy short-dated bonds whenever they selloff. Short-term rates will ultimately be anchored by low base rates and the larger shifts will happen further along the yield curve.

Bond investors will need to remain nimble in 2014, this is not a market in which your long-term strategic views are going to make you money every month, so you need to trade around your core views and take advantage when uncertainty causes mispriced opportunities.