# Global bond yields drop on growth concerns and prospect of looser policy

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## Highlights

- **Last month saw global bond yields drop sharply on a combination of soft economic data and expectations that central banks will loosen their policy stances. Oil prices saw their best quarter in a decade mainly on OPEC supply cuts.**
- **US growth was revised down to 2.2% 4Q18 though recent data suggest that concerns of a sharp near-term slowdown are overblown. Futures markets now expect at least one Fed interest rate cut this year.**
- **The economic slowdown appears to be more pronounced in the Eurozone, with German manufacturing gauges now deep in contraction territory. The ECB revised down its growth and inflation forecasts for this year.**

Last month saw global bond yields drop sharply on a combination of soft economic data – especially in the Eurozone – and growing confidence that central banks will loosen their policy stances to provide fresh support. Expectations of a policy shift boosted equity markets, with the US S&P seeing its best quarterly rise in almost a decade, up 13%, albeit partially a rebound from December's heavy sell-off. Amid the broad economic gloom, there was better news on the US-China trade dispute, with the two sides said to be close to a deal that could be signed off later this month. Oil prices meanwhile continued to rally, closing in on the $70/bbl mark amid Saudi-led efforts to reduce supply and a drop in production in some other major oil producing countries.

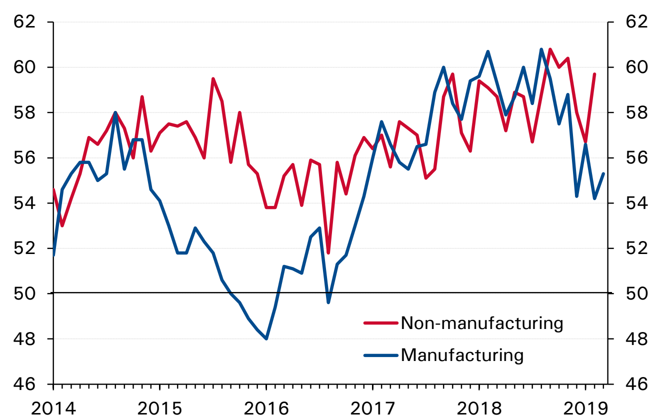
### Mixed signals on US growth, but bond yields dive

US GDP growth in 4Q18 GDP was revised down to an annualized 2.2% from the earlier estimate of 2.6%, driven by weaker but still decent growth in private consumption (2.5%) and investment (3.7%), and a fall in government spending. Growth for 2018 overall was unchanged at 2.9%, just short of President Trump's 3% goal. Given the fading impact of last year's fiscal stimulus, the late stage in the economic cycle, a potentially peaking labor market, trade tensions and the lagged impact of past policy tightening by the Federal Reserve, expectations are that growth will continue to soften this year. But although the downside risks are clear, data over the past month suggest that concerns of a sharp near-term slowdown may have been overblown. The Atlanta Fed's 'Nowcast' is now pointing to growth of 2.1% in 1Q19, much higher than the sub-0.5% performance it signaled less than one month ago.

For example, the ISM manufacturing activity index returned to above 55 in March and appears to have arrested the sharp decline seen in the second half of last year, while the services index rose to a robust 59.7 in February on strong order books. (Chart 1.) Away from industry, consumer sector signals have been mixed. Jobs growth slowed to a 17-month low of 20,000 in February, but the unemployment rate still ticked down to 3.8% while wage growth accelerated to a decade-high of 3.4% y/y. Consumer confidence has also recovered after plunging in January due to the government shutdown. However retail sales fell 0.2% m/m in February following a very poor holiday season, while the disappointing 0.1% m/m rise in the broader consumer spending measure in January points to a weak contribution to GDP growth at the start of last quarter.

**Chart 1: US ISM activity surveys**

(index, 50='no change')




Source: Thomson Reuters Datastream

Concerns over economic prospects have been visible in the bond market, with the 10-year treasury yield sinking from 2.76% at the start of March to below 2.4% near the end of the month and the lowest in well over a year. This briefly triggered a so-called 'inversion' of the yield curve – where some shorter-dated bonds yield more than longer-term ones – which in the past has signaled an impending recession. (Chart 2.) While this yield gap is a technical measure and open to interpretation, it has lent support to the narrative of a weakening economy, to the Fed's recent rate hike "pause" and also possible interest rate cuts later in the year (which futures markets now see as more likely than not). Both President Trump's key economic advisor and his nominee to the Federal Reserve Board have recently argued the case for a 50 bps rate cut, a sign of continued Whitehouse pressure on the Fed to boost the economy. That case has also been enhanced by low inflation, which fell to 1.5% y/y in February on the CPI measure.

**Chart 2: US government bond yield gap**

(% points)

Source: Thomson Reuters Datastream

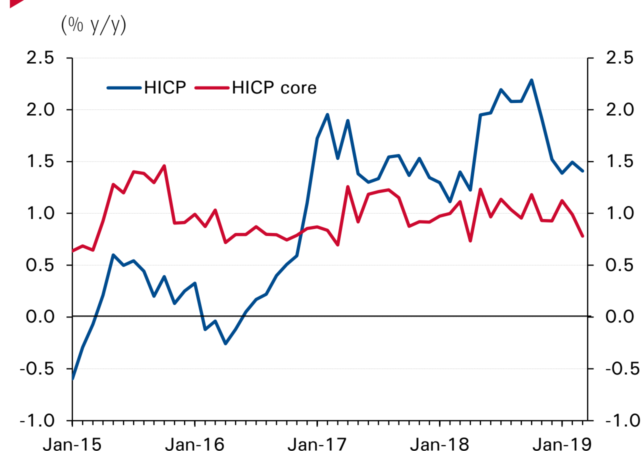
## Europe facing weakening growth and political pressures

There has been more evidence of a worrying economic slowdown in the Eurozone, amid decelerating global growth, trade tensions, regional political uncertainty and the halt to monetary stimulus by the European Central Bank (ECB) late last year. The Eurozone flash composite PMI fell to 51.3 in March, pointing to just-positive growth but with the Q1 average significantly below 4Q18. Key to the downturn is weakness in the manufacturing component, which at 47.5 plunged deeper into contraction territory and to its lowest in six years, with Germany particularly affected. At the same time however, labor market data has continued to improve in most countries, with both unemployment (7.8%) and wage growth (2.3%) now at around decade bests. Although the labor market often lags developments in the rest of the economy, there is hope that this tightening will feed through into stronger consumption to cushion the region from a deeper industrial-led downturn.

Meanwhile Eurozone inflation continues to trend lower, with the headline rate edging down to 1.4% y/y in March from 1.5% in February, while the core rate fell to just 0.8%. (Chart 3.) Both are well below the ECB's goal of "below but close to 2%". The bank revised down both its growth (1.1% from 1.7% in December) and inflation (1.2% from 1.6%) forecasts for 2019 in March, and now projects that inflation will remain below target through 2021. Like the Fed, it has abruptly changed course recently and after having ended its asset purchase stimulus program in December, has now restarted a program of offering cheap long-term loans to banks to boost credit and promised to not raise interest rates until at least next year – around six months longer than previously stated. However with a possibility of a rate *cut* later this year by the Fed now being debated, talk of even a delayed rate hike by the ECB is beginning to sound outdated.

**Chart 3: Eurozone inflation**

(% y/y)



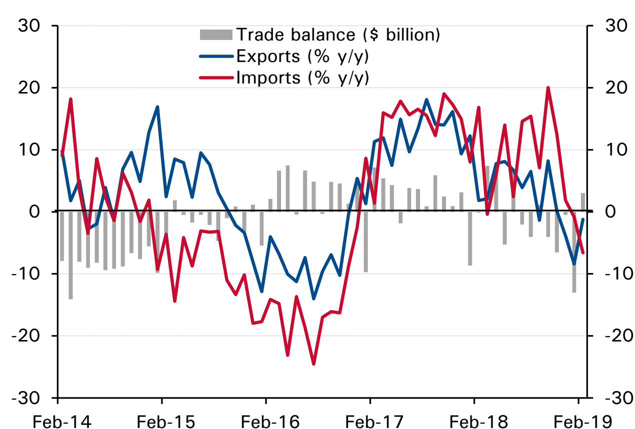

Source: Thomson Reuters Datastream

The UK parliament again voted down prime minister Theresa May's Brexit withdrawal deal with the EU, forcing her to apply to extend the UK's scheduled end-March departure date, now set for 22nd May but still contingent on the deal being passed. In a bid to break the impasse, May has offered to collaborate with the opposition Labour Party on the nature of the future trading relationship with the EU (which will be negotiated after her withdrawal deal passes) or failing that with parliament as a whole, which could end up with a soft form of Brexit such as a customs union or a second referendum. Embattled PM May is under pressure from within her own party to stand down, which could trigger a general election and usher in either a more anti-EU government or the left-wing Labour party, with new Brexit objectives. Brexit-related pressures may be starting to weigh on the until-now resilient UK economy, with the services PMI at 48.9 in March and the manufacturing measure rising to 55.1 but helped by uncertainty-driven stockpiling.

## Japanese weakness leads to stimulus speculation

Ongoing trade tensions between the US and China as well as a softer global economic climate continue to weigh on the Japanese external sector. In spite of a slight improvement, Japanese exports declined for the third straight month in February (-1.2% y/y versus -8.4% in January). Imports also fell, by a sharper 6.6% y/y in February versus a 0.8% drop in January, reflecting continued softness in domestic demand. (Chart 4.) The weakness in Japan's external and domestic sectors has sparked speculation of further stimulus ahead. However, during its policy meeting last month, the Bank of Japan stood pat on its monetary policy and the bank's governor ruled out the possibility of further stimulus in the near term.

**Chart 4: Japan international trade**




Source: Thomson Reuters Datastream

## Chinese stimulus measures may be taking effect

Economic activity in China appears to have hit a trough in early 2019. According to the official and Caixin PMI survey indices, manufacturing activity reversed its decline and climbed to multi-month highs of 50.5 and 50.8, respectively, in March. The improvement was mainly thanks to a raft of policy measures aimed at propping up the private sector. Meanwhile, the official services PMI also witnessed an uptick, rising from 54.3 in February to 54.8 in March. However, export growth remains sluggish amid a softer global economic climate and an ongoing trade rift with the US. Indeed, export growth fell by a sharp 20.7% y/y in February (the timing of the Lunar New Year holiday also weighed on the data). This may prompt the government to implement further expansionary measures to counteract the ongoing weakness in the external sector.

## Oil posts best quarterly performance in ten years

International benchmark Brent crude closed out March with its best quarterly performance since 2009, rising 27% to $68.4/bbl. Prices have been buoyed by signs that the market is tightening. Led by Saudi Arabia, which appears determined to drain excess supplies from the market, OPEC-11 compliance with targeted production cuts reached 106% in February, with production down 812 kb/d to 25.9 mb/d from its reference level of last September/October. Non-OPEC compliance, meanwhile, improved to 52% in February from 25% in January. Russia reiterated that it intends to fully comply soon.

OPEC-11's efforts have been augmented by falling output from Iran and Venezuela due to a combination of political turmoil, mismanagement and US sanctions as well as by lower supplies from Canada and Libya. Even in the US, data has been less bullish of late. While US crude production continues to break new ground, reaching 12.1 mb/d in the week-ending 22 March, the number of oil drilling rigs has fallen for six consecutive weeks. Indeed, in early March the US Energy Information Administration cut its oil production forecasts, by 110 kb/d to 12.3 mb/d in 2019 and by 170 kb/d to 13.03 mb/d in 2020. Drilling in the smaller shale plays has become more circumspect amid a focus on shareholder returns.

**Chart 5: Brent crude oil price**

($ per barrel, end of month)

Source: Thomson Reuters Datastream

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