GLOBAL RATES 2017 YEAR AHEAD: TECTONIC SHIFTS

"First came Brexit, then came Donald Trump's election as the president of the most powerful country in the world. Policy will be increasingly shaped by populist pressure, and the history of populism is one of fiscal largesse. Furthermore, with limited scope for additional monetary easing, fiscal easing is becoming the last and only resort for policymakers. It seems reasonable to assume that the combination of these two factors will soon usher in a period of easier fiscal policy that will result in higher yields for government bonds."

– David Woo, head of Global Rates, FX, and EM Fixed Income Strategy and Economics

Our view

Monetary easing will give way to fiscal easing

This year's Republican trifecta – winning control of the presidency, the Senate and the House of Representatives – means that the impact of fiscal easing will be felt most in the U.S. in 2017. The reason is simple: During the 18 years since 1965 that one party controlled both the presidency and Congress, the U.S. structural budget balance as a share of potential GDP deteriorated on average by 0.4 percentage points a year. In short, history tells us that a clean sweep is usually followed by fiscal stimulus.

Fiscal easing not yet priced into the belly of the curve or real rates

Fiscal easing will not be kind to the Treasury market. A bigger budget deficit would increase the risk premium. Moreover, fiscal easing at this late stage of the economic expansion would likely lead investors to demand a higher inflation risk premium. Finally, fiscal easing probably would place pressure on the Federal Reserve to normalize rates more quickly.

Since the election, U.S. rates have backed up quickly, driven largely by a repricing of inflation expectations. With long-term inflation break-even points closing on their historical averages, the next phase of the rates move is likely to be led by the belly of the curve. The market is pricing in only a one-and-a-quarter rate hike in 2017, and another one-and-a-quarter hike in 2018, with the Fed Funds futures implying that the Fed Funds rates will be at only 1.25 percent at year-end 2018. We see a new equilibrium where the Fed's dot plot goes from a ceiling to a floor for the market.

Not all reflation trades are born equal

Reflation trades have skyrocketed since the U.S. election, with commodities, mining stocks, commodity currencies and inflation-indexed bonds outperforming. However, investors should be cautious about indiscriminately buying inflation-linked assets, because the general theme is not always supported by the fundamentals in every market.

Although the inflation party has started around the globe, it appears that Europe did not get an invitation. The eurozone 10-year/20-year inflation break-even has jumped recently, nearing the European Central Bank's (ECB) "below but close to 2 percent" target. However, there is a risk that the December meeting of the ECB could disappoint either by not extending quantitative easing beyond next March or announcing tapering prematurely.

The trades

The five-year part of the curve offers the best risk-reward trade-off for investors to remain short with a three- to six-month horizon to position for a more aggressive Fed. As our proprietary leading indicators suggest, global growth momentum is set to pick up in the first quarter, further supporting this view.

For investors with a one- to three-month horizon, we recommend shorting 10-year real rates. This trade would benefit from higher rates in general, but, more importantly, also would benefit from a sudden risk-off that could render vulnerable reflation trades that have gone a very long way since the election.

Key calls

- **Short U.S. 5-year rates** – Two-and-a-half Federal Reserve rate hikes priced by the rates market for 2017–18 are not consistent with the aggressive fiscal easing promised by President-elect Trump.
- **Short U.S. 10-year real rates** – After the violent repricing of inflation break-even points, real rates offer a better risk-reward to position for higher rates.
- **Sell eurozone 30-year inflation break-evens** – Investors should take advantage of the recent rally to sell into the December European Central Bank meeting, which could disappoint.