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February 2015

# 11.5 million

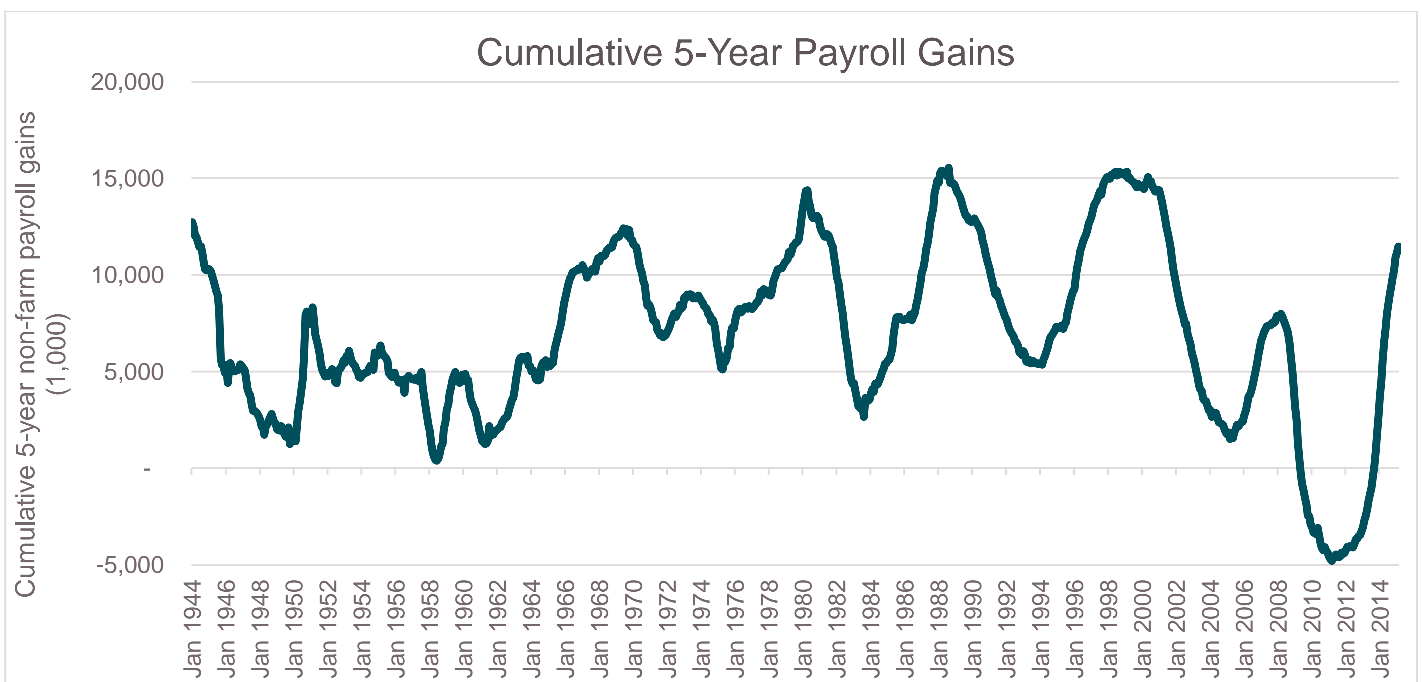
- US job gains over the past 5 years
- Obamacare enrolees
- Total employment in Australia[1]
- 2014 compensation in GBP of Lloyd's CEO[2]

Mixed global economic news over the past few months has kept bond yields in a fairly narrow range as markets balance prospects for a US recovery and eventual Federal Reserve rate hikes against further evidence of deterioration in Europe and Asia.

The positive global story remains focused on the US, where job growth continues to exceed expectations – we saw 295,000 additional jobs in February and a 5.5% unemployment rate, the lowest in about 7 years.

US payrolls have increased by more than 200,000 jobs/month for 12 straight months, the longest run of 200,000+ jobs/month growth in 20 years.

**The US has now added 11.5 million jobs over the past 5 years, a level of job growth not seen in 13 years.**



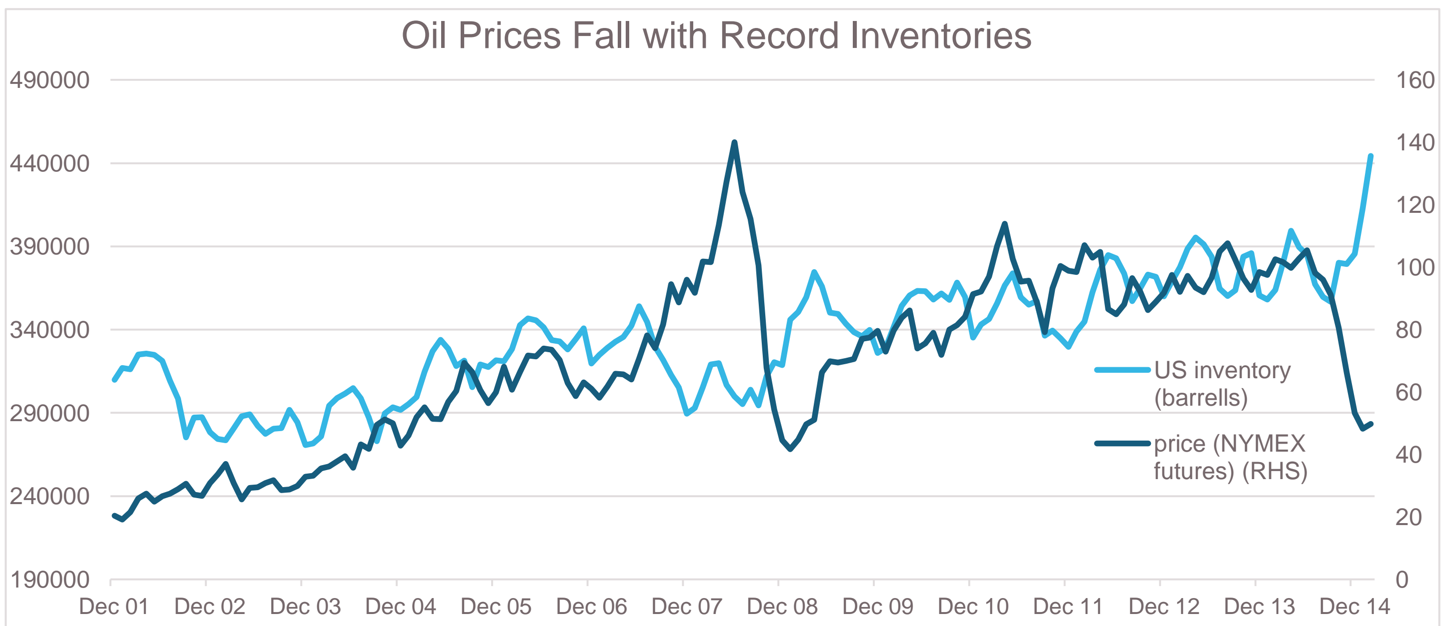

Nonetheless, wage inflation - in our view the key precursor to general overall inflation and eventual Federal Reserve rate hikes - remains well contained, with average hourly earnings up only 2% over the past year. In fact, hourly earnings have only increased at an annualised 2% since the beginning of the current recovery in 2009.

That said, many economists argue that historical evidence shows that wages *almost always* rise in the months following significant job growth so it makes sense to hike rates on the expectation (err hope/prayer?) that wages will rise.

[1] It's really 11.66 million but we didn't want statistics to get in the way of a good theme.
[2] Following a £20 billion taxpayer bailout in 2008

Amidst the improving economic story, the USD has continued to rally toward new record levels, helping to keep a cap on inflation. It recently reached an 11-year high against a global basket of currencies and there are no signs of it reversing its trend.[3]

The European slowdown as well as weakening Asian growth has continued to support USD strength, especially amidst continuing easy global monetary policy and quantitative easing. We remain bullish on the USD, however we believe Federal Reserve rate hikes might be further away than markets anticipate as inflation remains well contained. Helping to ease inflation concerns has been the fall in oil prices, down 50% in USD terms as production and inventory reach record levels.




[3] The Bloomberg Dollar Spot Index tracks the performance of a basket of 10 currencies whose weight is rebalanced annually based upon international trade and f/x liquidity.

The Federal Reserve's preferred measure of inflation, the Personal Consumption Expenditure (PCE) deflator, is only up an annualised 0.2% while core inflation (excluding food and energy) remains well below 2.0%, at 1.3%.

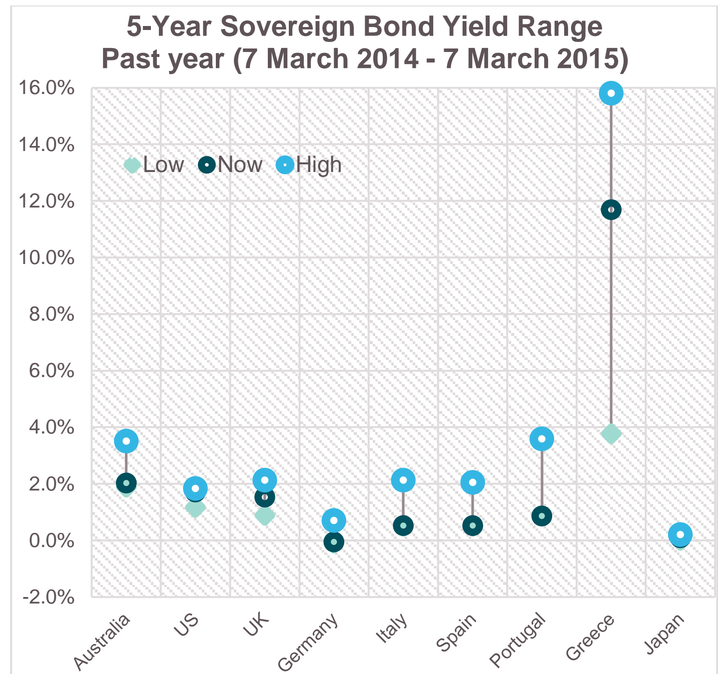
We believe the Federal Reserve will remain careful in its approach to normalising rates. Inflation has remained contained and the global growth story continues to deteriorate. Any rate increase will impact jobs, consumers, investors and markets around the world. While a rate increase should signal a vote of confidence for the US economy, it is important that policy missteps are avoided so as to not impact the global landscape. In our view, Europe remains the biggest threat to progress.

As delusion amongst Greek lawmakers continues to grow – they've moved from demanding German WWII war reparations in efforts to pay their ballooning deficits to a new agenda of blaming Portugal, Spain and Italy for their current woes. While we increase our pessimism over the political will and ability to avoid default, despite the European Central Bank's (ECB) quantitative easing efforts, we believe an eventual Greek default will have little impact on the wider Euro economy.

We expect the ECB's expanding balance sheet will provide support for the remainder of 2015, papering over the deteriorating Greek situation. However, a lack of structural reform in product and labour markets means another Greek default is on the cards, eventually.

To a somewhat lesser extent, the lack of structural reform in other peripheral European economies will remain the key hindrance to growth in the region for the foreseeable future as only moderate progress has been made over the past few years. We expect negative core European yields to remain over the next few years.

**But what are current bond market yields telling us?**




Looking at 5-year sovereign bond yields and their trading ranges over the past year, we find global markets forecasting a somewhat divergent story amongst one another.

With US Treasury 5-year yields at 1.70%, near their 1-year highs, markets are forecasting a favourable economic story - continuing recovery in jobs, eventual inflation and Federal Reserve rate hikes. Markets have increased their expectations for rate hikes in June, with 2 hikes priced in by year-end.

However, in core Europe, with German 5-year yields still negative, markets continue to forecast little to no growth, no inflation and no prospect of ECB rate hikes for many years. But with Portuguese, Italian and Spanish yields at record lows, markets expect continuing ECB quantitative easing and government bond purchases for the indefinite future. There is no default risk in the peripherals ex-Greece given the ECB's role as the buyer of last resort.

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In Greece, markets remain concerned over a potential default, but in our view, sub-12% yields still place a lower probability than we believe exists.

UK yields of 1.52%, the middle of the range of the past year, signify market uncertainty over the UK economy's direction. Nonetheless investors are preparing for higher yields amidst increasing wage pressures, employment and manufacturing. Similar to its cricket team, UK bonds have delivered the globe's worst performance so far this year.

With Australian 5-year yields at 1.87%, near the bottom of the trading range, markets are forecasting further Reserve Bank of Australia (RBA) rate cuts with little inflationary prospects despite the 20% fall in the AUD over the past year.

We remain sympathetic to at least one more RBA cut (as there was little point in just one cut). However, we believe the RBA can afford to wait for longer than markets expect given a surprisingly strong domestic economy; employment, growth and inflation. In the longer-run, the transition from mining investment to manufacturing/export sectors will take time and require an even lower Australian dollar. We foresee terminal rates at 2.0% with the RBA maintaining low rates as limited wage growth stems inflationary pressures which will provide continuing support for the housing market.

Japanese sovereign bonds have traded within a narrow range, close to 0% for a long period of time, signifying an unchanged view of low/no expectation for growth or inflation over the longer-term. We see little opportunity for bond investments in Japan.

Overall we believe the theme of low global central bank rates and more liquidity will continue, compelling investors to hold risk assets. We foresee a continuing currency war as global central banks position for export growth amidst deteriorating domestic environments. The US will remain the only developed market not playing the currency game as prior structural and banking reform promote greater growth prospects.

But then again does any of this really matter? 11.5m happens also to be the size in square miles of the largest recorded ozone hole. That's the same size as the African continent. Even if economic growth continues to range between chilly and lukewarm, global warming is here to stay.

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