Daiwa Capital Markets 50 YEARS IN LONDON

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Fixed Income Markets: Interest and exchange rate outlook – October 2014

End period	24-Oct-14	Q414	Q115	Q215	Comment
Fed Funds Rate	0-0.25	0-0.25 *(0-0.25)*	0-0.25 *(0-0.25)*	0.25-0.50 *(-)*	US GDP rebounded in Q214 at a stronger-than-expected annualised rate of 4.6%Q/Q, the firmest since Q411. This partly reflected stock building. But final sales rose 3.2%Q/Q ann. following a drop of 1.0% in Q114. Recent data, meanwhile, point to GDP growth of around 3%Q/Q ann. in Q3. While job growth eased in August, positive momentum returned to the labour market in September taking average monthly non-farm payrolls growth in the past six months to 245k and the unemployment rate down to 5.9%. At its September meeting, the FOMC made little amendment to its economic assessment judging that economic activity was expanding at a moderate pace, with significant underutilisation of labour resources and inflation still running below the FOMC's longer-run objective. As such, it predictably further reduced its monthly asset purchases to $15bn, and reaffirmed that an end to the programme remained likely in October. The FOMC noted again that the timing of the first hike in the FFR would take account of a 'wide range of information' including labour market conditions, inflation pressures and expectations, and financial developments. And while the FOMC was uncomfortable with the wording, it repeated that the FFR is likely to be kept at its current level 'for a considerable time' after the asset purchase programme ends. There were two dissenters from the statement. And the 'dot plots' suggested that FOMC members anticipated a slightly steeper pace of tightening over the next couple of years than before, perhaps implying also that the exit strategy might become more dominant in discussions at forthcoming meetings. Given recent events – including the fall in oil prices, increased evidence of weakness in Europe and market turbulence – we continue to think that the first rate hike will only take place in June 2015, with rates rising gradually thereafter.
Asset purchases ($trn)	4.2	4.2 *(4.2)*	4.2 *(4.2)*	4.2 *(-)*	
BoJ O/N Rate	0-0.10	0-0.10 *(0-0.10)*	0-0.10 *(0-0.10)*	0-0.10 *(-)*	Having surged 1.5%Q/Q in Q114 as households and firms brought forward spending ahead of April's consumption tax hike, Japanese GDP plunged in Q214 by 1.8%Q/Q, the steepest drop since Q109. Consumption and business capex fell more than 5%Q/Q, with only stock-building and declining imports preventing a steeper fall in output. Recent data disappointed, suggesting a sluggish recovery in GDP in Q3. And while largely consistent with expansion, surveys – and a large inventory overhang – suggest recovery will be no firmer than moderate over the near term. After levelling out over the summer, underlying inflation is now easing back, with the BoJ's preferred measure of core CPI (excluding fresh food prices and the consumption tax) down to 1.1%Y/Y in August and oil prices a new downside risk. Assessing spare capacity to be limited, the BoJ's recent assessment was for inflation to rise from early next year to meet the 2% inflation target by end-FY15. We suspect the target will remain out of reach. But while a failure of growth to pick up or a notable decline in inflation over coming months might prompt further easing, and strengthened forward guidance might prove helpful, we think the BoJ will maintain its asset purchases at the current rate through 2015, when the consumption tax is likely to be hiked again.
JGB purchases target (¥trn)	183	190 *(190)*	203 *(203)*	215 *(-)*	
ECB Refi Rate	0.05	0.05 *(0.05)*	0.05 *(0.05)*	0.05 *(-)*	Euro area GDP was disappointingly flat in Q214 as declining investment offset modest growth in consumption and a positive contribution from net trade. Surveys and data suggest that growth might well have remained elusive in Q3 too with Germany unexpectedly weak. Inflation also continues to surprise on the downside, with CPI down in September to a new near-5-year low of 0.3%Y/Y. After market measures of expected inflation declined in August, the ECB agreed further policy easing on 4 September including rate cuts – taking the refi rate to just 5bps and the deposit rate to -20bps – and a new programme to purchase ABS and covered bonds, the latter of which commenced on 20 October. But the first offering of cheap long-term refinancing under the TLTRO programme saw modest take-up, and we suspect that the ECB will struggle to meet its aspiration to expand its balance sheet back to early 2012 levels. And with the ECB likely to have to revise down its forecasts of growth and inflation in December, the Governing Council might well expand its asset purchase programme to include corporate bonds from early 2015.
BoE Bank Rate	0.50	0.50 *(0.50)*	0.50 *(0.75)*	0.50 *(-)*	While UK GDP expanded for the seventh consecutive quarter in Q314, growth of 0.7%Q/Q was 0.2ppt weaker than in Q2 and there appears to be a moderation of momentum heading into Q4. Inflation has fallen further than the BoE expected, to 1.2%Y/Y in September, and looks set to remain firmly below the 2% target over coming quarters. The unemployment rate has also fallen faster than expected to 6.0% in August, down 1.7ppts from a year earlier and the lowest since 2008. But employment growth has eased and regular wage growth below 1%3M/Y over recent months has been the weakest on record. While opinion on the degree of spare capacity in the economy, and the outlook for labour market, remains divided on the MPC, and two members have voted for a rate hike since August, the majority appears unwilling to tighten policy at least before wage growth picks up. Indeed, given recent data and comments from BoE officials, we now expect the first increase in Bank Rate to come in Q315 at the earliest.
Asset purchases target (£bn)	375	375 *(375)*	375 *(375)*	375 *(-)*	
10Y UST	2.24	2.35 *(2.70)*	2.50 *(2.90)*	2.80 *(-)*	Having touched 2.65% in mid-September, 10Y yields trended lower as concerns about weak global growth and inflation mounted. On 15 October 10Y UST yields briefly plunged below 1.90% before rebounding and moving above 2.20% in recent days. We expect them to rise gradually further from here. But with the FFR to stay below 'normal' levels for a long time to come, upwards pressure might be limited. And given uncertainty about the timing of the first hike in the FFR, and the extent of additional tightening thereafter, further episodes of market volatility seem likely.
10Y JGB	0.46	0.47 *(0.60)*	0.50 *(0.65)*	0.55 *(-)*	After rising above 58bps in mid-September for the first time since June, 10Y JGB yields trended lower to fall back below 50bps in the second half of October. With BoJ purchases set to dominate the market for the foreseeable future, and speculation of additional BoJ easing to persist, we expect JGB yields to remain close to present low levels over coming quarters.
10Y Bund	0.88	0.90 *(1.00)*	0.90 *(1.00)*	0.90 *(-)*	After following the global trend to rise to 1.10% in mid-September, 10Y Bund yields fell back and plummeted to below 75bps in mid-October. While they have since picked up to 90bps, 10Y Bund yields seem set to remain well contained by continued fears of deflation, speculation of additional ECB easing, and the extra long-term liquidity to be provided by the TLTROs.
10Y Gilt	2.22	2.35 *(2.70)*	2.45 *(2.90)*	2.70 *(-)*	While Gilts followed USTs during the volatility in mid-October, they have recently underperformed, with markets pricing the BoE to beat the Fed to the first rate hike. We are not so sure, and, while they will tend to move closely together, we see scope for Gilts to outperform USTs over coming quarters.
USD/Euro	1.27	1.25 *(1.28)*	1.25 *(1.27)*	1.24 *(-)*	Since falling close to $1.25 in early October for the first time since 2012, the euro has been volatile, briefly rising close to $1.29 in mid-October before easing back to through $1.27 in recent days. With the ECB likely to consider further incremental easing measures to tackle deflation risks, we see scope for modest further euro depreciation from here.
JPY/USD	108	109 *(109)*	111 *(112)*	114 *(-)*	Having depreciated more than 6% against the dollar from mid-July to touch ¥110/$ briefly in early October, the yen subsequently firmed back though ¥106/$ during the wider market volatility on 15 October. But it has since eased back through ¥108/$ and we expect it to maintain a gradual depreciation trend as the Fed moves closer to tightening and the BoJ continues with QQE.
JPY/Euro	137	136 *(140)*	139 *(142)*	141 *(-)*	In mid-October the yen appreciated close to ¥135/€, its firmest level since November 2013. But we foresee renewed yen depreciation over coming quarters as the BoJ's balance sheet expansion continues to outpace that of the ECB.
USD/GBP	1.61	1.61 *(1.64)*	1.60 *(1.65)*	1.58 *(-)*	Having risen to a more than 4½-year high at the start of July, sterling has trended lower, falling close to $1.61 in recent days. And since we now do not expect the BoE to raise rates before H215, sterling might well have further ground to lose against the dollar over coming quarters.
Euro/GBP	1.27	1.29 *(1.28)*	1.28 *(1.30)*	1.27 *(-)*	With economic conditions in the euro area and UK still contrasting significantly, sterling appreciated to a 23-month high through €1.28 in late-September. And while it briefly slipped through €1.25 in mid-October, the more favourable economic outlook in the UK means that sterling should broadly hold ground with the euro over coming quarters.

Figures in parentheses are previous forecasts. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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