Daiwa Capital Markets

Fixed Income Markets: Interest and exchange rate outlook Q2 2016

End period	24-May-16	Q216	Q316	Q416	Comment
Fed Funds Rate	0.25-0.50	0.25-0.50	0.50-0.75	0.75-1.00	The April FOMC meeting minutes indicated that the FFR will be hiked again, perhaps as soon as June, if certain conditions are met. Members will be looking for a pickup in the economic growth, continued improvement in the labour market, and confidence that inflation will return to the 2% target in the medium term. Recent evidence suggests that a case can be made for tighter policy although it is not watertight. According to the advance estimate, US GDP growth slowed in Q1 from 1.4%Q/Q annualised to just 0.5%Q/Q. Weakness principally reflected the largest drop in business fixed investment since Q209 while net trade again subtracted from growth but private consumption remained supportive. While we expect to see a modest upwards revision in due course, Q1 GDP growth was still likely the softest in a year. Consumption appears to have had a stronger start to Q2 and economic growth appears to have accelerated close to 2%Q/Q annualised. The April labour market report was mixed, with non-farm payrolls up 160k, maintaining the 3- and 6-month averages at 200k or more. The unemployment rate remained unchanged at 5.0%, and average hourly earnings were up 2½%Y/Y, near the top of the range of the past 6 years. Inflation has picked up since the autumn, but recent data were more subdued with the Fed's preferred core PCE deflator falling to 1.6%Y/Y in March. As several FOMC members have suggested that the June meeting is 'live', we would not be surprised by a rate hike then. But with the evidence equivocal and officials planning to move gradually, we look for a hawkish statement in June that sets the stage for a rate hike in July.
Asset purchases ($trn)	4.2	4.2	4.2	4.2	
BoJ rate on excess reserves	-0.10	-0.10	-0.20	-0.20	The first estimate of Japan's Q1 GDP surprised on the upside, with growth of 0.4%Q/Q supported by stronger consumption, spending by overseas visitors and net exports. But this merely reversed the contraction at end-2015. With the annual growth rate zero, GDP appears to be oscillating around a broadly flat trend. And surveys suggest that GDP will fall back again in Q2. While the labour market looks to be the tightest since the early 1990s, wage growth remains modest and this year's spring settlement round proved disappointing. Not least due to lower energy prices, headline inflation recently slipped back into negative territory for the first time since 2013. Admittedly, some measures of underlying price pressures have risen e.g. CPI excluding prices of fresh food and energy has remained above 1%Y/Y since August. But given recent yen appreciation, and despite the pickup in the oil price, the BoJ's expectation that CPI will rise to the 2%Y/Y target in FY17 seems unlikely to be met. So, Japan's economy appears in need of another shot in the arm. Having kept its main policy tools unchanged since the introduction of the negative interest rate in January, we expect the BoJ to cut the rate on excess reserves again in July when it might again revise down its economic forecasts. Eventually we expect to see more fiscal stimulus too via an additional spending package. And it would be no surprise to see the consumption tax hike currently scheduled for April 2017 put on ice too.
JGB purchases (¥trn)	316*	325	345	365	
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	The euro area economic recovery continued in Q1 with GDP up 0.5%Q/Q, the most in a year, seemingly driven by consumption and fixed investment but with net trade still a restraint. Spain again saw the strongest expansion (0.8%Q/Q) with German growth at a 2-year high (0.7%Q/Q) and most member states firmer. We expect euro area growth in Q2 to slow to 0.3%Q/Q, and remain close to that rate over the remainder of the year. In April, CPI slipped back to -0.2%Y/Y with core CPI down to 0.7%Y/Y, the lowest in a year. As the impact of past shifts in energy prices fades, we expect CPI to rise gradually from the summer to about 1%Y/Y around the turn of the year. But we expect it to remain no firmer than 1½%Y/Y over the forecast horizon. Having announced in March a range of easing measures, including a further 10bp cut in the deposit rate to -0.40% and a €20bn increase in monthly asset purchases to €80bn, in June the ECB will commence purchasing corporate bonds and launch the first of a new series of targeted longer-term refinancing operations (TLTRO II). Not least given stronger Q1 GDP growth, the higher oil price and a desire to assess the impact of the latest measures before deciding its next steps, the ECB will feel in no hurry to ease again. But in order to avoid a harmful premature tightening of financial conditions, we expect the ECB by the end of this year to extend the asset purchase programme by a further six months to end-September 2017 at the earliest.
Asset purchases (€bn)	975*	1078	1318	1558	
BoE Bank Rate	0.50	0.50	0.50	0.50	Uncertainty surrounding the 'In-Out' referendum on EU membership scheduled on 23 June currently dominates in the UK, weighing on economic activity. GDP growth eased in Q1 by 0.2ppt to 0.4%Q/Q, matching the slowest pace of increase since the end of 2012. Surveys suggest that growth has softened further in Q2 too. While employment continued to rise in the three months to March, average labour earnings growth remained weak. And despite the weakening of sterling over past quarters and increased oil price, inflationary pressures look set to remain subdued. Indeed, the pickup in headline CPI in March to its highest rate since 2014 was reversed in April to leave it at just 0.3%Y/Y. And with core CPI having edged back down to 1.2%Y/Y, we expect headline inflation to remain below the 2% target over the coming two years. As such, assuming that the referendum confirms the UK's membership of the EU – which opinion polls suggest has become increasingly likely – we see the BoE leaving rates unchanged over that period with non-negligible risks of easing. And with the MPC having judged that a vote to leave would hit demand, quite possibly weaken long-term GDP growth, and have large adverse effects on asset prices, a rate cut would be a near-certainty.
Asset purchases (£bn)	375	375	375	375	
10Y UST	1.88	1.85	1.95	2.05	UST yields fell sharply in early 2016 as the oil price slumped and concerns about the global economic outlook intensified. And while financial markets subsequently stabilised, the oil price rose, and, most recently, shorter-dated USTs fell in response to hawkish sounds from the Fed, 10Y UST yields remain well down on their end-2015 levels. Given the likelihood that the FFR will rise only gradually and peak this cycle at a level far lower than in past cycles, longer-dated UST yields seem likely to rise only slowly over coming quarters.
10Y JGB	-0.10	-0.10	-0.15	-0.15	The BoJ's decision to cut the interest rate paid on excess reserves to negative territory has resulted in a marked downward shift in JGB yields across the curve, with roughly three quarters of the market now yielding a negative rate. Given a tight supply-demand JGB balance this year and prospects of further rate cuts, JGB yields might continue to edge lower over coming quarters.
10Y Bund	0.18	0.20	0.35	0.50	After the ECB eased policy in March, 10Y Bund yields briefly fell below 10bps close to their record low, but have subsequently traded within the range of 10-30bps. Given ongoing large-scale bond-buying by the ECB and limited net new issuance, we expect yields to remain very low and only rise gradually as inflation picks up over coming quarters.
10Y Gilt	1.47	1.55	1.65	1.75	Gilts benefited from heightened global uncertainty earlier in the year, with 10Y yields falling to a record low of 1.30%. They have since trended higher while moving in a relatively wide range. With the inflation outlook weak, assuming victory for the 'Remain' camp in the EU referendum we expect Gilt yields to move higher only gradually over coming quarters.
USD/Euro	1.12	1.11	1.10	1.10	The euro has been broadly immune to the ECB's negative deposit rate. But having reached a nine-month high of $1.15 in early May, it subsequently slipped back as expectations of near-term Fed tightening increased. Moves will be limited by the large euro area current account surplus and near-term ECB inertia, and we expect only modest depreciation over coming quarters.
JPY/USD	110	110	110	110	Despite the surprise rate cut in Japan, the yen has maintained a steady appreciation against the dollar, rising through ¥106.5/$ in early May. Despite our expectation of Fed tightening and further modest BoJ monetary easing, scepticism regarding negative rates and concerns about global economic developments should keep the yen elevated.
JPY/Euro	122	122	121	121	The yen has maintained an appreciation trend against the euro this year, earlier in May moving briefly through ¥122/€ to its strongest level since 2013. Going forward, however, we expect the yen to move broadly sideways against the euro as both the ECB and BoJ merely tinker around the edges of their monetary policy tools.
USD/GBP	1.46	1.52	1.49	1.45	Having fallen to a near-seven-year low in February as the UK's economic slowdown and Brexit concerns weighed, sterling has subsequently recovered some of the lost ground as opinion polls suggested increased public support for the UK to 'Remain' in the EU. A 'Remain' referendum victory would give sterling a further boost, but we expect that subsequently to reverse.
Euro/GBP	1.31	1.37	1.35	1.32	In early May, sterling depreciated to its weakest level against the euro in two years. But having since appreciated on referendum optimism and we expect that trend to continue for a while to come, the diminished vigour in the UK economic recovery is likely to weigh on sterling once the vote is out of the way.

**Latest published data. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

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