

2019

**Global Market  
Outlook**

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Not Over  
Until It's Over

**Fixed Income Outlook**

# **Time for Bond Investors to Position for Cycle End**

Flattening yield curve and signs of concern in the  
US mortgage market

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Global fixed income investors faced a challenging 2018, as yields moved higher, curves flattened and credit spreads widened. Furthermore, emerging markets currencies and bonds had their worst showing for several years. This price action is indicative of late-cycle behavior as markets feel their way through a monetary hiking cycle and vulnerabilities are exposed. Looking into 2019, we expect a similar dynamic as we move closer to the cycle's end.

While we will know more about further policy moves by the middle of 2019, the US fixed income market cycle going into 2019 already paints a pretty clear picture. US rates are near a cyclical peak, and the yield curve will continue to flatten as the Federal Reserve (Fed) continues hiking. While we do not believe credit poses any imminent threat, pricing suggests caution. The one major segment that looks abnormal is the agency mortgage market, which is why we have reduced our exposure. The rest of the world is simply behind the US cycle, because the US recovery began, and took hold, sooner. It is therefore not surprising that the US will reach the end of the cycle before other developed economies.

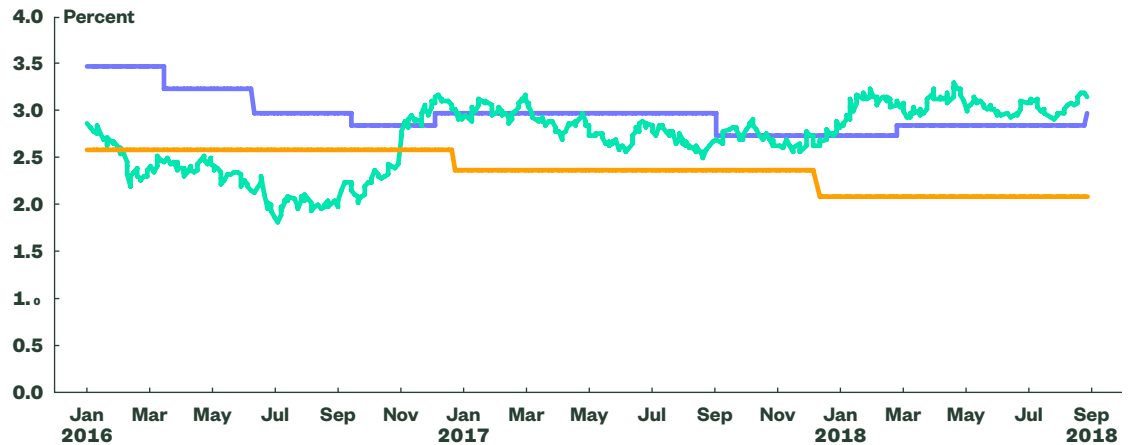
Given this backdrop, investors should seek to balance their overall risk posture, increasingly look to the front end of the US yield curve for opportunities and start to explore select emerging markets bonds and currencies for value.

## Inverting the Yield Curve

While there was a lot of excitement with respect to US interest rates in 2018, as US economic data consistently surprised to the upside, we think key structural constraints on growth and inflation—such as rising debt, aging demographics, low productivity and a lack of capital investment—will provide a cap on real rates (see Figure 1). As the Fed remains committed to its path of gradual monetary policy normalization and secular factors continue to anchor intermediate to long-end rates, the curve will flatten at or around the level consistent with the long-run federal funds rate, and perhaps invert by the end of 2019.

Figure 1  
US Rates Currently Offer Value

■ Fed Long Run Rate  
■ 5y5y  
■ Implied Neutral Nominal Rate



Source: Bloomberg and State Street Global Advisors as of September 30, 2018.

With global rates, the US has been a prominent driver of sovereign bond yield movements over the past two years. As growth and inflation fundamentals in the US and the rest of the world have diverged, the spreads between the regions have followed suit. The spread between the US 10-year Treasury bond and German nominal interest rates is now at its widest level since the euro was introduced. While the current move wider in spreads is reasonable given growth and inflation differentials, the spread between the US 10-year Treasury and the German 10-year Bund is unlikely to persist indefinitely.

While it is too early to expect convergence in policies and rates, we will keep a close eye on how this dynamic plays out, especially in the second half of 2019, as any significant changes will have major ramifications for fixed income investors. In the UK, the uncertainty surrounding Brexit continues to weigh on the gilt market. While economic activity has been relatively resilient, a hard Brexit is expected to have a resoundingly negative impact. The range of possible outcomes, from a hard Brexit, to a more measured one and even the remote possibility of another referendum, means that the direction of travel for gilt yields is still unclear.

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## Focus on Credit Quality

The global credit cycle remains in its later stages, but there are no immediate signs of a turn. Fundamentals remain constructive for the global credit market, especially in the US where tax reform has helped to elongate the current cycle. Key economic indicators within the Conference Board Leading and Coincident Economic Indexes point to the US continuing to make progress, offering further headroom for credit markets over the short to medium term. Coupled with the gradual removal of monetary accommodation on a global scale, tight spreads and favorable market technicals in the form of reduced supply, we feel that the next downturn in the credit cycle does not represent an immediate threat. Nonetheless, it may be prudent to take some, not all, risk off the table. Investors should be tactical with their allocations, opting for quality and moving higher up the credit spectrum in both high yield and investment grade.

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## Reduce Mortgage Exposure Amid Pricing Extremes

Current pricing in the implied interest rate volatility and mortgage-backed security (MBS) markets is extreme. Historically, interest rate volatility has been mean reverting and with the Fed's continued balance sheet run-off and a US economy in the later stages of the economic cycle, investors should position their portfolios to benefit from a repricing of the volatility market.

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## Look for Valuation Opportunities in Emerging Markets Bonds and Currencies

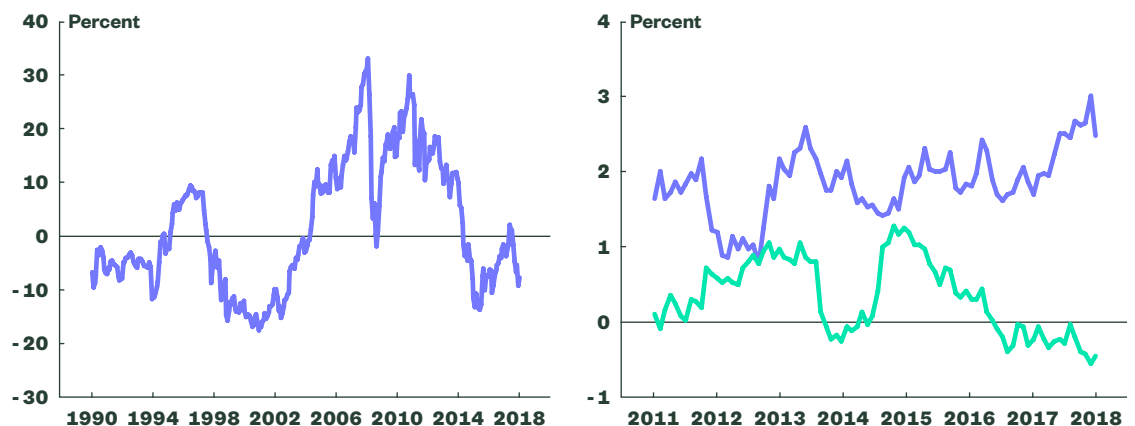
Emerging markets (EM) struggled last year due to idiosyncratic concerns in a few countries as well as increasing global trade tensions, a strengthening US dollar and higher US Treasury yields. However, economic fundamentals remain broadly supportive, inflation is still relatively under control and currencies are undervalued in aggregate. The growth differential between emerging and developed markets is expected to widen over the next few years, while higher commodity prices should bolster EMs in aggregate, and EM yields remain attractive (see Figure 2). As a result, we remain constructive on EM debt, with a preference for local currency bonds, and within EM currencies we favor an increasingly selective approach as the cycle matures.

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Figure 2  
**Emerging Market Bonds  
and Currencies Offer Value**

(Right hand chart)

■ GBI-EM Real Yield Estimate  
■ Global Treasury Real Yield



Sources: Left hand chart: State Street Global Advisors estimate of fair value versus the US dollar as of August 30, 2018. Right hand chart: State Street Global Advisors, Bloomberg Finance, L.P. as of October 11, 2018.

## Glossary

### **Gilt**

A UK government bond

### **Mean**

The simple mathematical average of a set of two or more numbers

### **Fed Long Run Rate**

The Fed's expectation of where long-run real interest rates should be, absent economic shocks

### **5y5y**

The five-year forward expected inflation rate. It reflects the market's inflation expectations of average inflation over 5 years, 5 years from now

### **Implied Neutral Nominal rate**

State Street Global Advisors' estimate of the neutral real interest rate

### **Emerging Market Debt (EMD)**

Bonds issued by governments of developing countries.

### **GBI-EM Real Yield Estimate**

An estimate of real (inflation-adjusted) yield based on the JP Morgan GBI-EM Global Diversified Index weightings (excluding Argentina, Uruguay and Dominican Republic which account for 0.9% of the index) and on an estimate of real yield using approximations of the average maturity for each country.

### **Global Treasury Real Yield**

A measure of cash flow an investor receives for investing in government bonds, expressed as a percentage and adjusted for inflation. Global Treasury Real Yield uses Bloomberg Barclays index weightings as of August 31, 2018 excluding emerging economies and also uses approximations of the average maturity for each country.

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