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THE RECEDING PROSPECT OF GLOBAL TIGHTENING

If you are waiting for the next global tightening cycle, don't hold your breath.

Among the world's major central banks, the U.S. Federal Reserve (Fed) had been leading the global charge to raise rates. But the Fed, the European Central Bank and the Bank of Japan have put rate hikes on hold—with each signaling an increased likelihood of easing. A global tightening cycle—which was on the near-term horizon a year ago—now looks to be at least 12–18 months away at the earliest. However, even this is not certain.

Preconditions to rate hikes

We think three economic and financial conditions must be met before central banks can even begin thinking about hiking rates again. What's more, how and when these conditions are met will have significant implications for global bond markets and fixed income investment strategies.

The first is that we will have to see a stabilization in economic growth, particularly in China, core Europe and the U.S. Only when growth has plateaued in these economies will we begin to see wage inflation stoking consumer inflation. But with global growth heading downward, the bottom of this cycle still looks some way off. And until we reach the bottom, rates are not going to start climbing again.

The second precondition is accommodative financial conditions. At the end of 2018, market volatility caused credit spreads to increase, as equity markets plummeted. This increased the cost of borrowing for corporations and households, while also reducing their confidence in investing.

Although conditions improved in the first quarter of 2019, there needs to be tighter credit spreads and stronger equity markets to give the economy a boost via improved borrowing and investment conditions. As of mid-June, spreads on investment–grade corporate bonds in the U.S., for example, were around 1.25%. This is well above the tighter 0.85% spread seen in 2018. With economic conditions shaky, lower borrowing costs could help encourage companies in areas such capital expenditures and hiring.

Finally, we need to see inflation rise above 2% for a sustained period, probably for a few quarters. With U.S. inflation currently at 1.9%, this perhaps looks more likely in the U.S. than in Europe where eurozone inflation is 1.5%.

Clearly, the goalposts have moved for central banks in the past year and meeting these conditions has become more, not less, challenging. We think, therefore, that it is going to take several more quarters before central banks can even begin to consider tightening again.

Then what?

When the next global tightening cycle eventually comes, caution will be essential, as companies with more leveraged balance sheets will find that environment more challenging.

If it’s a coordinated cycle, investors could consider shifting their exposure to countries that are closer to the end of their rate-hiking cycle. Based on current cycles, this will probably involve moving from European to U.S. investment-grade bonds.

In the best-case scenario for growth, the next wave of interest rate hikes wouldn’t resume until 2020, but it could certainly take significantly longer for this cycle to begin. And if the growth outlook continues to deteriorate, we see the the Fed cutting rates as soon as the next (July) Open Market Committee meeting. This slowing growth cycle has not bottomed out yet, and interest rates will not start to resume their upward trend until this bottom has been reached.

For the rest of this year, we will be looking for signs that corporate investment and industrial activity—both subdued amid fears of global trade wars—are starting to pick up again. For example, if global air freight data, which has been declining for over a year, starts to stabilize or even rebound, then that will be an encouraging sign.

But with many risks and uncertainties remaining, above all, investors in fixed income markets need to stay watchful and nimble.

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