بنك أبوظبي الأول
FAB
First Abu Dhabi Bank

Market Insights & Strategy

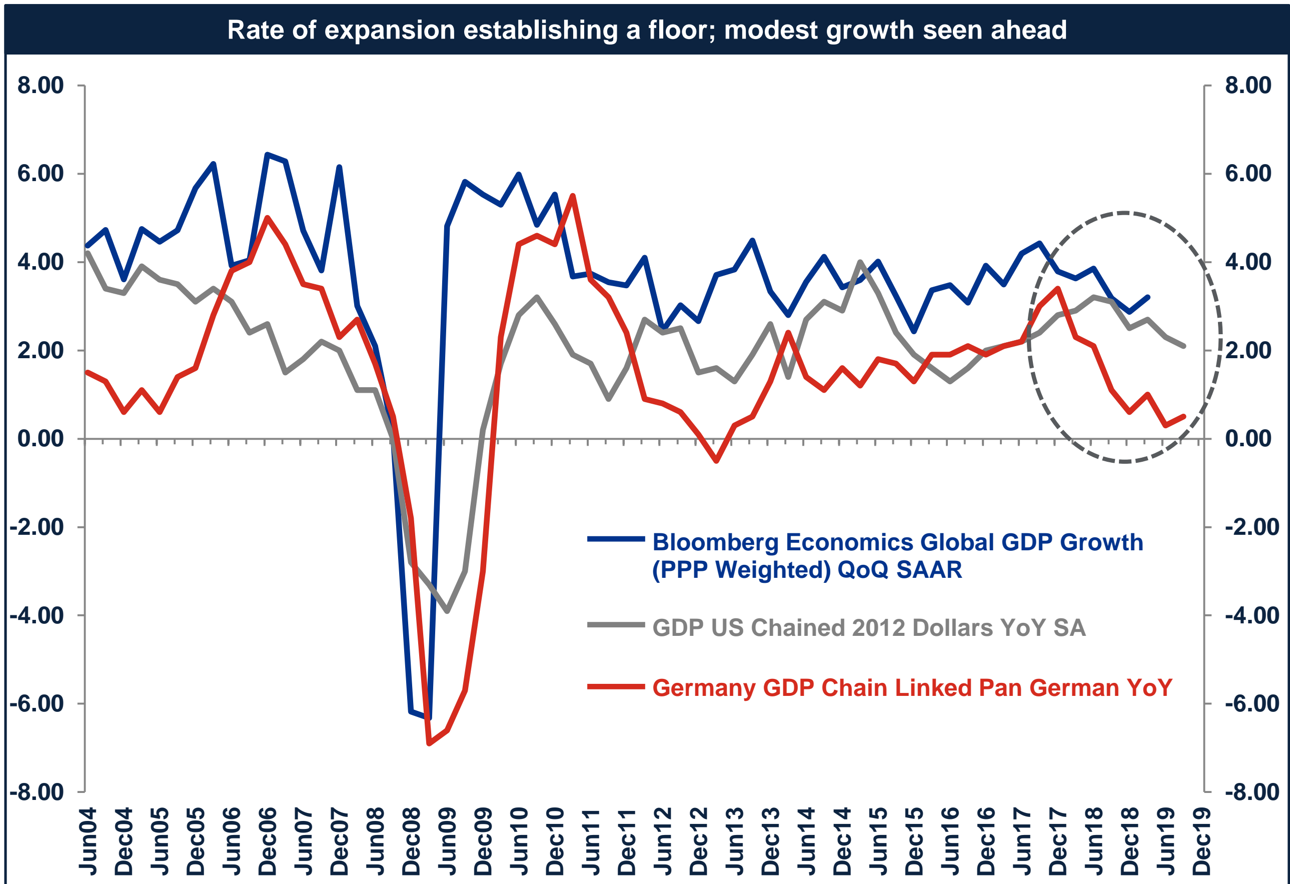
*Please click **here** to view our recent publications on MENA and Global Markets*

Simon Ballard
Chief Economist

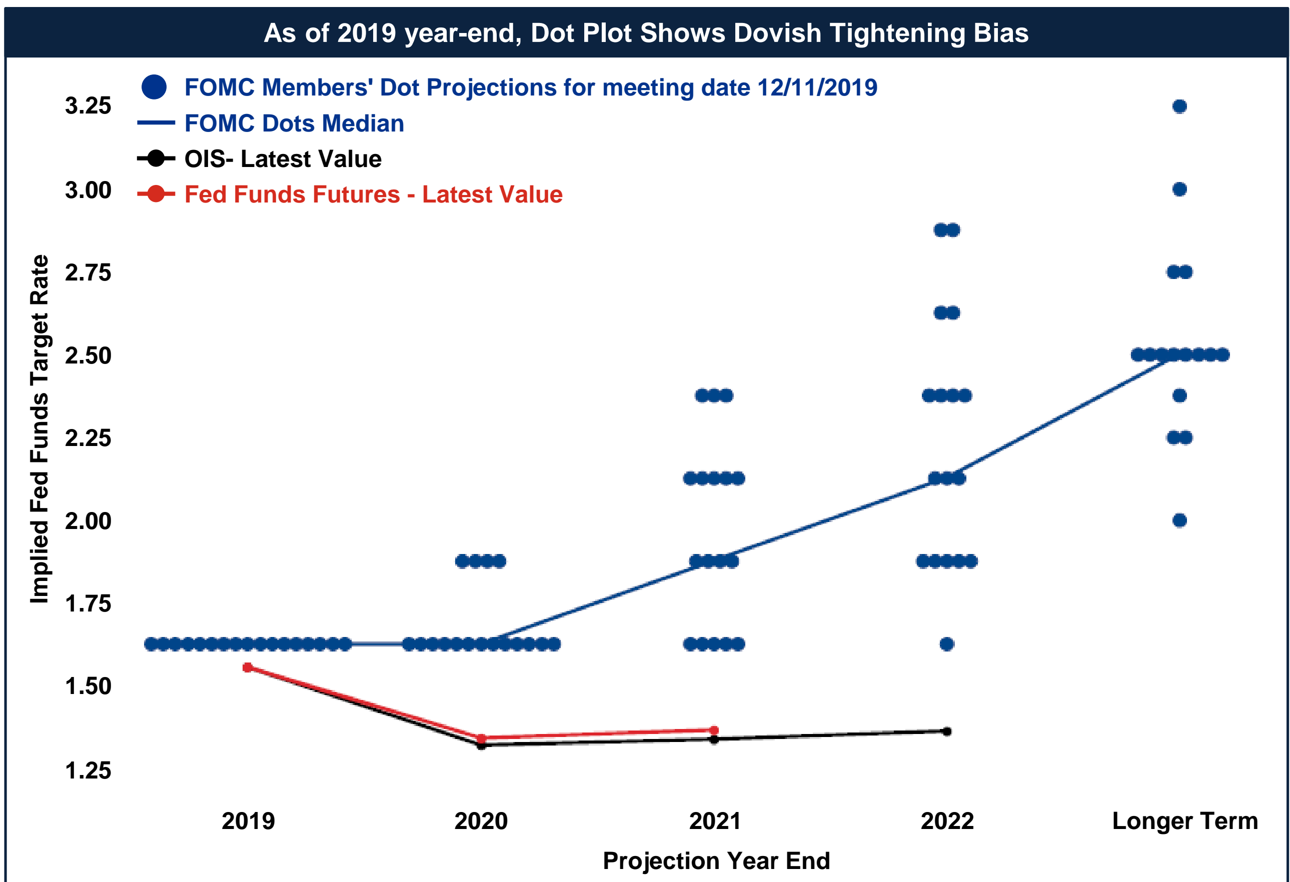
FAB House View: Global Rates (2020 Outlook)

Forecasting Breaks in the Clouds

- The global macro and rates outlook should experience a modest uplift during the course of early 2020, although interest rates themselves seem likely to remain anchored for the time being.
- Amid persistent global macro uncertainties we retain a cautious bias as we head into 2020, which will constrain the Fed hawks. Yes, global market sentiment has been buoyed in December by news of a 'Phase One' U.S./China trade deal being agreed, but upside potential will remain limited until the deal is signed (January's business, if at all?).
- We certainly still do not subscribe to the (U.S.) recession or to the demise of the U.S. dollar stories.
- Global trade tensions should ease over the coming months, based on the assumption that U.S. president Trump should soon begin to scale back his trade tariff rhetoric as he embarks on the process of positioning himself (more favourably and eying a second term) for next November's presidential election.
- Our improving macro rates outlook is also predicated on the Brexit saga now evolving more favourably and a 'hard, no-deal' Brexit outcome being avoided. This all being the case, we would then expect corporate psychology and business sentiment to improve and consumer confidence to strengthen, all of which will buoy economic growth prospects.
- Recent Chinese manufacturing data has also offered evidence of a global macro base for recovery being established, which should help to underpin risk appetite and create an upward bias to rates.
- We therefore maintain our view that the three U.S. Fed funds rate cuts executed this year were 'insurance cuts' rather than anything more dovish. We were among the first to make such an assumption, at a time when many others were suggesting that the macro environment was so weak that the Fed was embarking on a new easing cycle.
- The global macro backdrop will determine if there is a further (final) rate reduction to come during the course of 2020, but generally we believe that the rates outlook from here should be benign.
- Notwithstanding such optimism though, we believe that the rates market will remain reasonably well anchored by the inherent uncertainty in the global trade complex as well as the lingering spectre of a 'hard Brexit' in December 2020. Under these circumstances, interest rates will probably struggle to rise significantly above their current levels during the course of 2020.



Source: Bloomberg/FAB

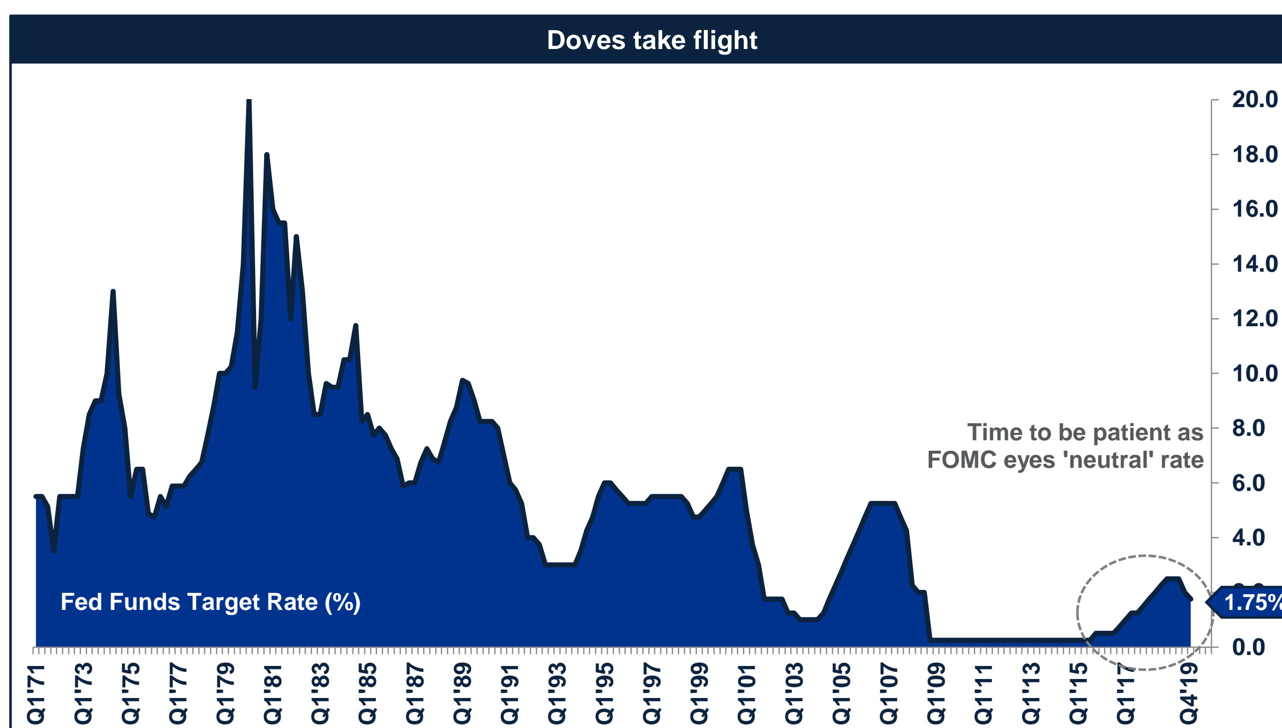


Source: Bloomberg/FAB

U.S. Rates

- **Bottom line: We have long maintained that monetary easing 2019 should be interpreted as 'insurance cuts' not the beginning of an easing cycle. The three rate cuts implemented by the FOMC in July, September and October 2019 were all insurance cuts in our view.**
- **Futures market is pricing in a 100% probability of a further 25bp rate reduction by the FOMC by November 2020, but we believe this could recede as Trump scales back his trade rhetoric, easing dovish expectations.**
- **In the context of the firm underlying conditions of the U.S. economy and optimism of a stabilising global macro outlook, the Fed may now be in a prolonged pause phase through 2020.**
- With the Fed having initiated 9 interest rate increases between December 2015 and December 2018 – putting 'insurance' ammunition back into its monetary policy ordnance – redeploying some of that accommodation was clearly a 'dovish insurance play'.
- We are cognisant though that a more pronounced trade war is probably the key risk to global rates market stability and the outlook for capex over the coming quarters.
- But similarly, the robust nature of underlying U.S. macro data – including a tight labour market and 50 year low unemployment rate of 3.6% – suggests no need to make significant further cuts at this stage.
- Near absence of inflationary pressures will also help to keep rates anchored in the near-term, although inflationary pressures from trade tariffs could bolster the hawks in coming quarters.
- Longer-term, as the macro backdrop stabilises and investor concerns recede, we believe that the (data-dependent) Fed will look to shift back toward a tightening bias, although any actual tightening of policy may not now occur until 2021.
- This should result in a continued gradual re-steepening of the yield curve; led by the longer tenors, with front end yields anchored.
- **We anticipate a stable-to-upward-bias to the U.S. 10y yield and 2s/10s yield curve in Q1 2020. We see the 10y yield in a 1.95%-2.05% range and marginal further steepening of 2s/10s toward 30bps.**
- We do not subscribe to the U.S. recession scenario, but do anticipate that interest rates will remain low for longer across our benchmark regions of the U.S., Eurozone and UK, with negative rates now largely part of global markets' DNA.

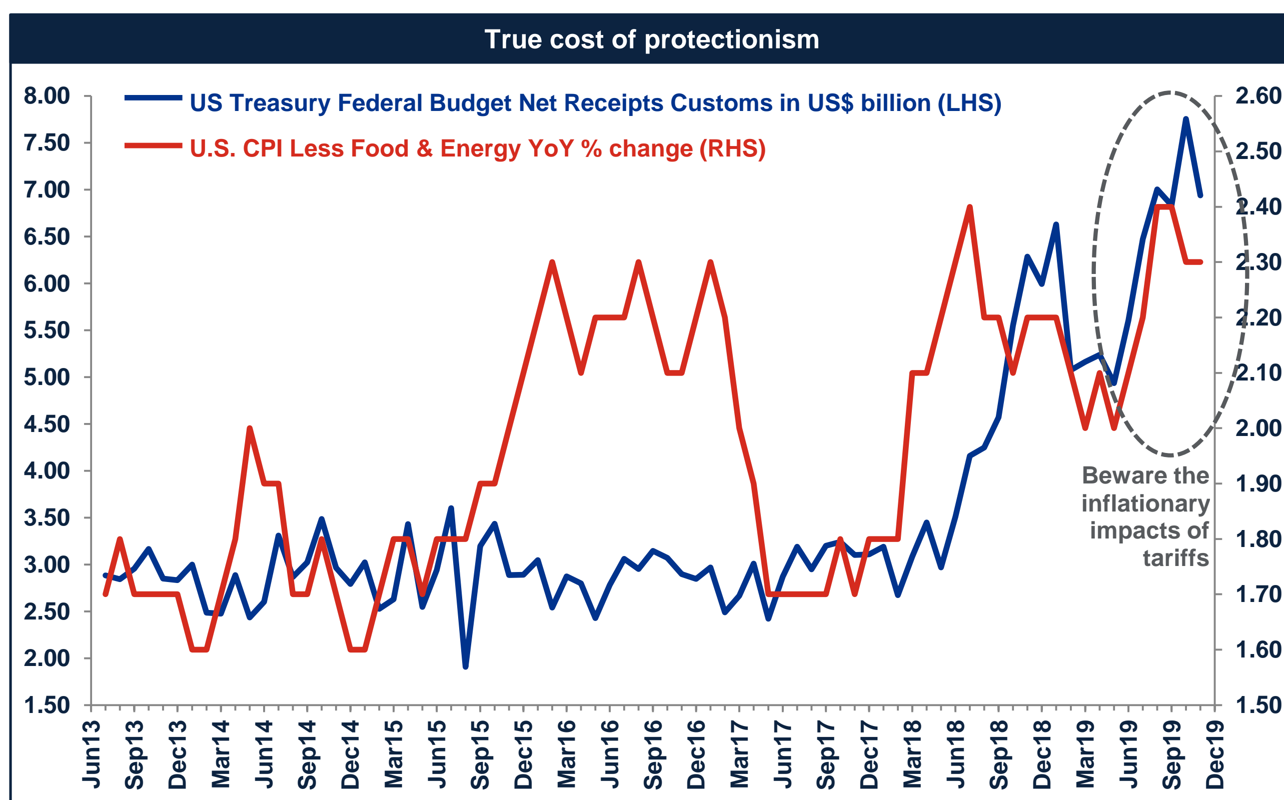
Doves take flight



Source: Bloomberg/FAB

U.S. Rates Analysis

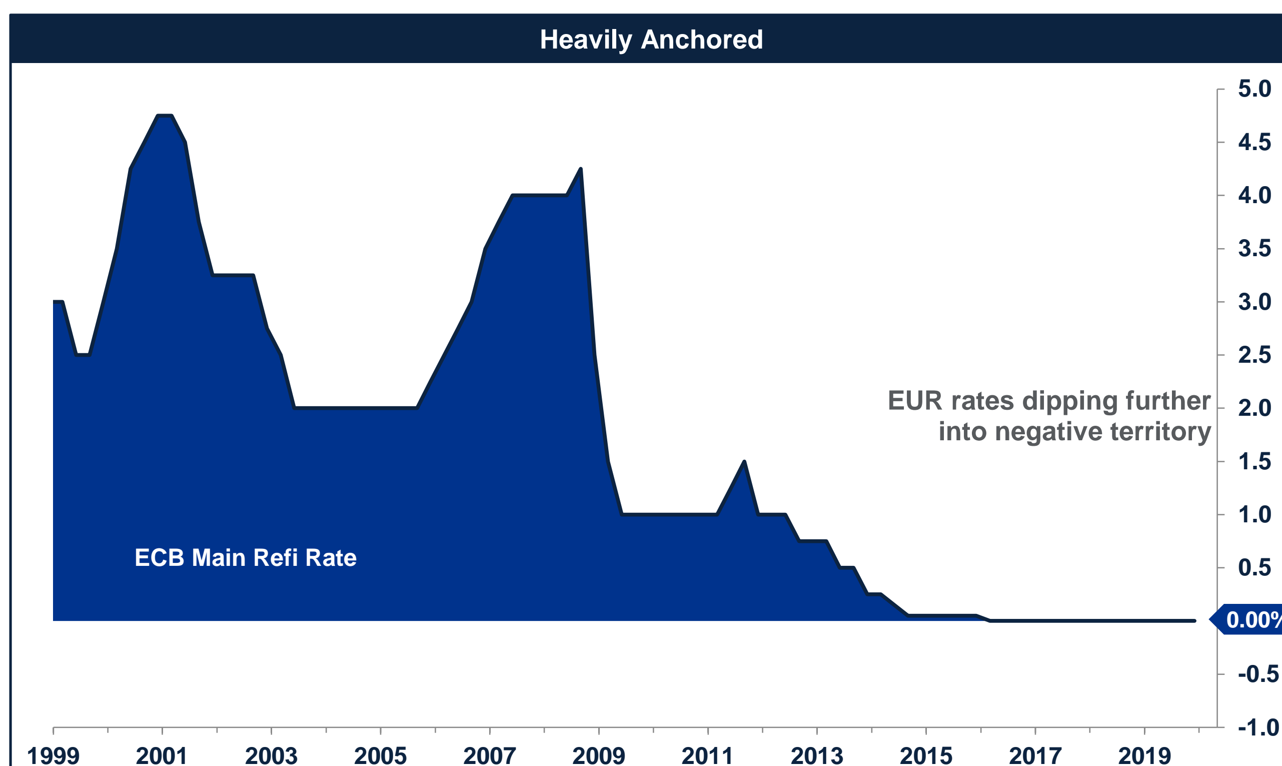
- U.S. economic growth cycle is in its 11th year, but we see few traditional late-cycle characteristics, such as accelerating inflation or rising interest rates.
- Nonetheless, slowing GDP into year-end 2019 is expected to recede further in early 2020. We look for U.S. economic growth to slow toward 2.0% in 2020, albeit clearly avoiding the spectre of recession.
- Tight labour market is beginning to fuel some wage inflation, but paradoxically this further supports the growth outlook due to implied consumer confidence and robust consumption.
- November jobs report blew past consensus and the October figure was revised higher; net jobs gain of 294,000 in November, 114k ahead of expectations.
- The participation rate was pushed lower to 63.2% and the unemployment rate dipped back to 3.5%, the lowest level in over 50 years.
- But investment and trade are being negatively impacted by heightened uncertainty toward tariffs and weak demand from foreign markets, which constrain near-term growth prospects.
- Tariffs on Chinese imports fuel macroeconomic uncertainty and weigh on confidence, business investment and industrial production. Tariffs may also create temporary inflation.
- Even if consumers become more cautious and scale back spending, we would interpret this as a cooling, not a deterioration of growth metrics.
- All adds up to the FOMC now being on hold for the foreseeable future, although the evolution of U.S./Sino talks will be key. Any deterioration in the outlook could see the return of a dovish bias.



Source: Bloomberg/FAB

Eurozone Rates

- **Our bottom line: The ECB seems set to maintain the Main Refinancing Rate at zero (0.00%) for the foreseeable future, and certainly throughout 2020 and likely 2021.**
- **With growth slowing, but still positive for now, we believe that macro downside risks and muted inflation pressures will continue to dominate the Eurozone's outlook in 2020, weighing on rates market sentiment and warranting an ultra-accommodative stance.**
- With the main Refi rate at zero, the ECB restated its (open-ended) asset purchase programme (APP) on November 1 2019, with purchases currently set at EUR20b per month.
- Quantitative easing will also be an anchor on generic yields as we enter 2020, especially in the Eurozone, and in particular Germany, where the consequent depth of demand for government bonds (Bunds) will keep yields in negative territory across the maturity curve and raise the spectre of Europe's own 'Japan-ification' era.
- New ECB president Christine Lagarde now facing the challenge of setting monetary policy to address an uncertain macro environment due to U.S./China trade tensions and the question marks over Brexit.
- In the near-term, Lagarde is unlikely to make any structural policy changes; expect Draghi status quo to be maintained. But will more of what hasn't worked up until now really make a difference?
- Low and negative interest rates are here to stay, but as we enter 2020 their contractionary characteristics may do more harm than good; negative yield curve raises challenges for asset allocation and medium-term economic stability.
- The ECB notes that HICP inflation and measures of underlying inflation remain subdued despite rising wages.
- Moreover, ECB has hinted previously that because inflation has been below target for such a long time, that it may allow it to trade above target for an extended period going forward, in order for it to balance out around the 2% target. We interpret such a line of thinking as a significant dovish shift in the Eurozone rates outlook.
- Focus in 2020 should increasingly be on expansionary fiscal policies to support growth, and the necessary implementation of structural reforms.

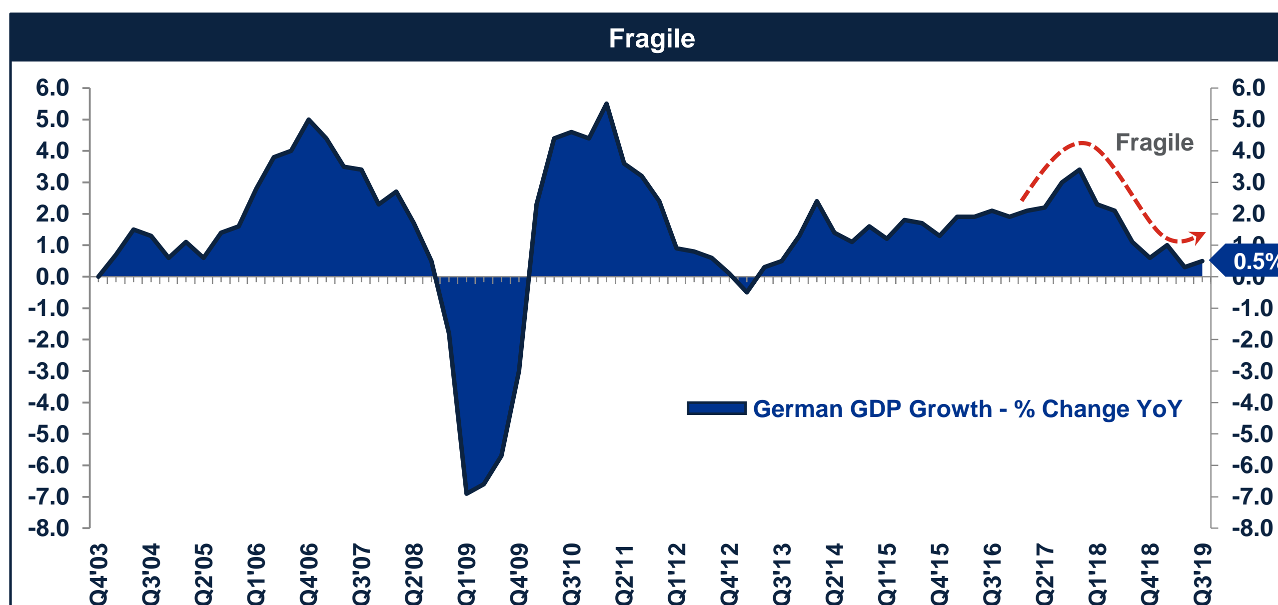


Source: Bloomberg/FAB

FAB
First Abu Dhabi Bank

Eurozone rates analysis

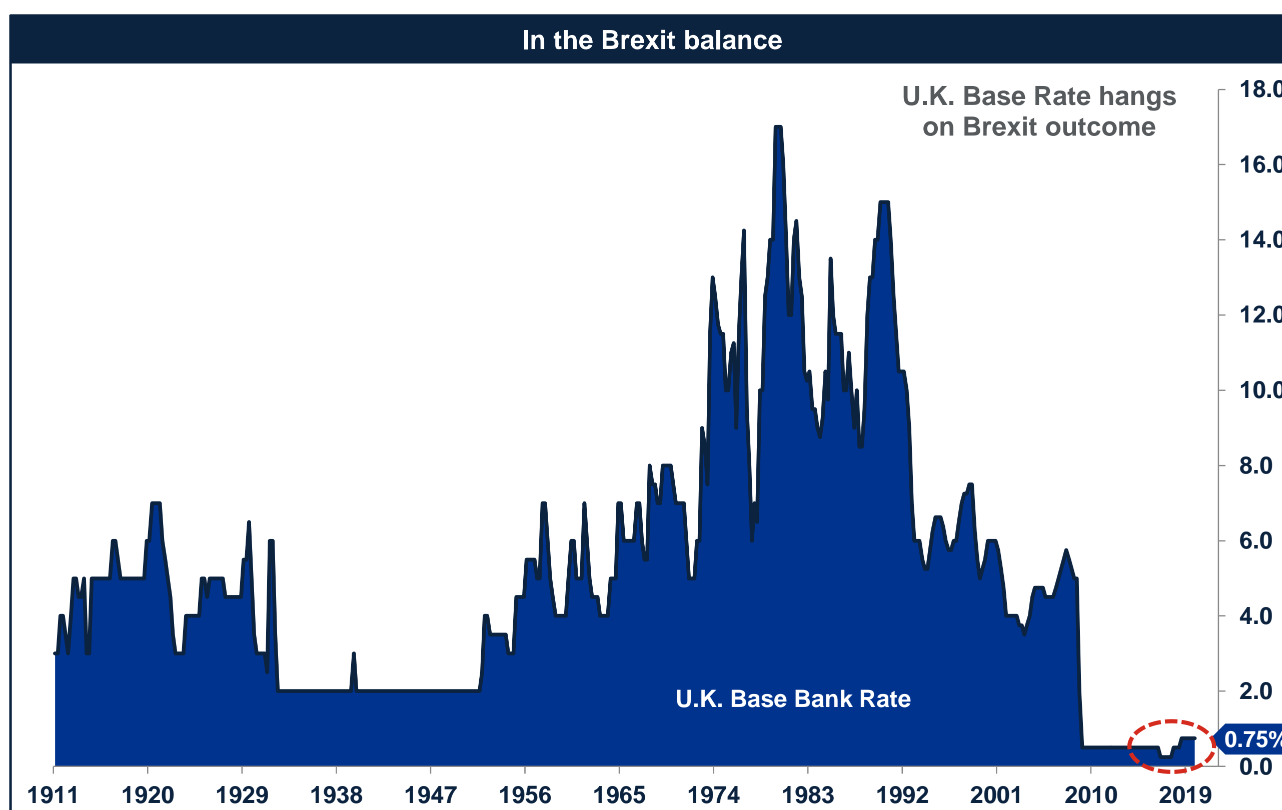
- The fragile nature of the Eurozone economy is now experiencing 'slower growth momentum', with the former engine of growth – Germany – recently flirting with recession.
- Nonetheless, Q3 GDP came in at +0.2% QoQ, unchanged from Q2's expansion; avoiding contraction territory, but one of lowest growth rates in past 6 years.
- The Eurozone's manufacturing sector is in recession overall – with Germany the most affected economy – meaning that private consumption is now the main growth engine for the region.
- Eurozone manufacturing PMI fell to 45.9 in December, from 46.9 in November; 11th consecutive month of contraction.
- German manufacturing PMI fell to 43.4, from 44.1, and well below forecast consensus increase to 44.6
- German GDP growth has seen steady decline over the past 2yrs, touching a low of +0.3% in Q2 2019. With GDP having ticked up to +0.5% in Q3, while growth clearly remains anaemic, the optimists hope that the economy has now seen the 'bottom'.
- Brexit remains a key risk for the Euro area as a weaker GBP/stronger EUR dents export volumes to the U.K.
- So the economic outlook is being supported by household spending which rose 0.5% in Q3, up from +0.2% in Q2, as well as low unemployment rate and stubbornly muted inflationary pressures, all of which helps to cushion the slowdown in the domestic economy.
- But structural weakness highlighted by the sharp decline in fixed investment growth in Q3 to +0.3% from +5.7% in Q2 and also fading in government consumption growth to 0.4% in Q3 from +0.5% in Q2.
- We see mixed signals from the consumer: employment and consumption still growing (at declining pace), but savings rate is rising and consumer confidence and durable goods sales have weakened in past 24 months.
- Mildly expansionary euro area fiscal stance should continue to create support to economic activity, but soft aggregate macro conditions suggest that those economies that still have fiscal capacity should act in an effective and timely manner.
- While there may be signs that the Eurozone economy is now beginning to stabilise and establish a floor for growth from which to exit the cyclical downturn that began in Q1 2018, we see little evidence of a near-term recovery.
- Growth in 2020 is expected to be largely flat on that of 2019, holding around +1.0%, before then perhaps seeing modestly greater growth potential 2021 of around +1.3%/+1.4%.



Source: Bloomberg/FAB

U.K. Rates

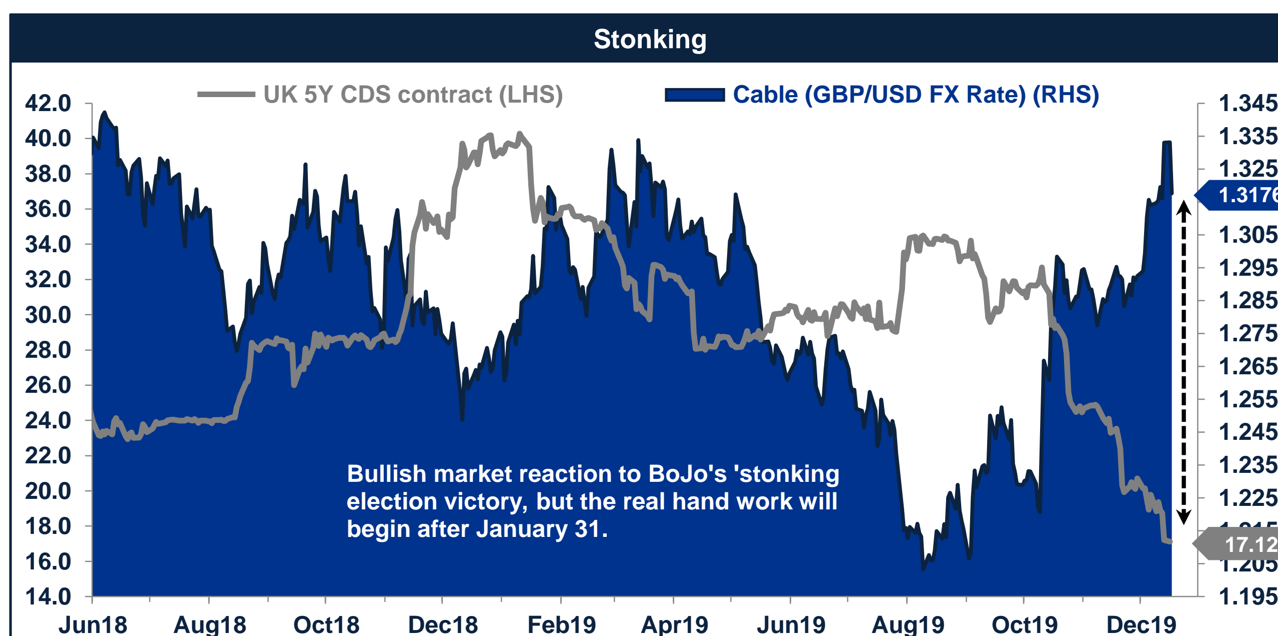
- **We do not anticipate any move in Bank Rate from the Bank of England during 2020.**
- With the December General Election now behind us, and the Conservatives having won a new 'stonking' parliamentary majority, the process of delivering Brexit now begins, for which we now perceive an element of closure. The transition period for the 'divorce' will end in December 2020.
- The size of the Conservatives' majority (80 seats) affords Boris Johnson the strength to push through his withdrawal deal and take the U.K. out of the EU (legally) as planned on January 31 2020.
- But that is when the hard work will really begin. Agreeing a trade deal in 11 months may be a tall order; Canada took 7 years to conclude a trade deal with the EU. The spectre of a hard Brexit could still be the price of failure.
- Nonetheless, easing of the uncertainty surrounding Brexit that has hampered the U.K. economy since 2016 should now help to buoy the macro outlook and underpin a stable U.K. rates outlook.
- The BoE is expected to be on hold throughout 2020; any hawkish bias will also be tempered by the continued uncertainty and execution risk associated with the Brexit process.
- BoE will remain cognisant of global macro weakness; monetary policy will be fine-tuned to support activity, keep inflation close to target and hedge for potential (external) shocks.
- Sentiment in the near-term is being buffeted by political uncertainty post the General Election. Notwithstanding Conservative victory on December 12, a ''smooth' Brexit is not a foregone conclusion by the end of the U.K./EU transition period.
- A 'soft' Brexit should fuel renewed economic expansion and consumer confidence, even if the market doubts this will be enough to support the notion of the Bank of England adopting a tighter monetary policy bias.
- If the U.K. and EU fail to agree a trade deal, the spectre of a 'hard Brexit' could rise again. This would likely result in the BOE cutting rates in an effort to underpin a much weaker macroeconomic outlook over the next couple of years.



Source: Bloomberg/FAB

U.K. rates analysis

- U.K. economy continues to experience subdued momentum, despite robust private consumption, as slow global macro conditions hinder recovery in exports.
- But with the general election result on December 12 and the 80-seat majority now commanded by Boris Johnson's government, which should bring some near-term clarity to the Brexit polemic, we would expect the strains on the U.K. economy to ease.
- But leaving the EU on January 31 will be when the hard work really starts; aiming to agree a trade deal with the EU by December 31 2020. Cost of failure in this respect could still be a 'hard Brexit' scenario, much weaker GBP and the BOE needing emergency rate cuts in an effort to support the economy.
- BOE notes in its latest U.K. Monetary Policy Report (Nov 2019) that 'underlying UK GDP growth slowed materially in 2019 as weaker global growth and Brexit-related uncertainties weighed on spending'.
- The positive effect of inventory building in Q1, ahead of the initial March 31 Brexit deadline, has faded in subsequent months, weighing on economic performance.
- Monetary policy adjustments will also need to take into account recent cooling of the labour market, and the uptick in the unemployment rate, albeit still hovering around its lowest level since mid-1970s.
- Services and Manufacturing PMI indexes paint a soft macro picture; both sub-50 in November.
- With economic growth running below potential, the BoE notes a modest amount of slack in the economy.
- The U.K. RICS Residential Market Survey again depicted a relatively subdued, if not stagnant U.K. housing market in November, both from a buyers' and sellers' perspective as key metrics remained in negative territory. Market conditions were constrained by Brexit and the General Election.
- More positively, near term expectations are for a more stable trend to emerge over the coming quarter. And the twelve-month RICS outlook is also now pointing to a pick-up in both sales and prices on a UK-wide basis. We now await end of year data.
- New buyer enquiries continued to decline for the third consecutive report with a net balance -9% in November. RICS Newly Agreed Sales net balance also saw a modest fall, albeit with the pace of decline slowing – the latest reading was -8% compared to -18% and -27% in the prior 2 months.
- Economic expansion in 2020 likely to be curtailed in part by limited business investment as a result of persistent uncertainty over the future U.K.-EU trading relationship.
- Dovish rates outlook also fuelled by muted inflation expectations, with price pressures anchored by the recent weakness in energy prices and downside in water bills.



Source: Bloomberg/FAB

FAB
First Abu Dhabi Bank

Simon Ballard
Executive Director & Chief Economist
Market Insight & Strategy
FAB Global Markets
Tel: +971-2-6110012
Mobile: +971-50-933-2806
Email: Simon.Ballard@bankfab.com

Please click here to view our recent publications on MENA and Global Markets

Disclaimer: To the fullest extent allowed by applicable laws and regulations, First Abu Dhabi Bank (the “Bank”) and any other affiliate or subsidiary of the Bank, expressly disclaim all warranties and representations in respect of this communication. The content is confidential and is provided for your information purposes only on an “as is” and “as available” basis and no liability is accepted for or representation is made by the Bank in respect of the quality, completeness or accuracy of the information and the Bank has undertaken no independent verification in relation thereto nor is it under any duty to do so whether prepared in part or in full by the Bank or any third party. Furthermore, the Bank shall be under no obligation to provide you with any change or update in relation to said content. It is not intended for distribution to private investors or private clients and is not intended to be relied upon as advice; whether financial, legal, tax or otherwise. To the extent that you deem necessary to obtain such advice, you should consult with your independent advisors. Any content has been prepared by personnel of the Global Markets division at the Bank and does not reflect the views of the Bank as a whole or other personnel of the Bank.

The Bank processes your personal data to provide you with information or promotional and advertising communications on products, services, other events and campaigns. If you wish not to receive email from the Market Insights team at the Bank, please click here to send us your request to unsubscribe, and you shall no longer receive such information.

You are entitled according to the applicable laws to exercise your rights to access, to rectification, to erasure and to portability of your personal data, to restrict the use of and to object to the processing of your personal data. You may exercise your aforesaid rights by sending your request to FAB at the following address: privacy@bankfab.com.