

2017 Slide Pack on the Outlook for Bond Yields

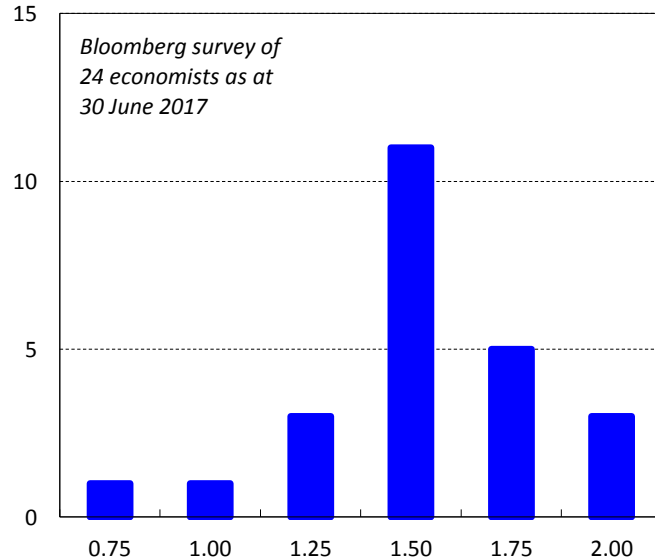


Besa Deda
Chief Economist, Bank of Melbourne, 14 July 2017



Australian Cash Rate

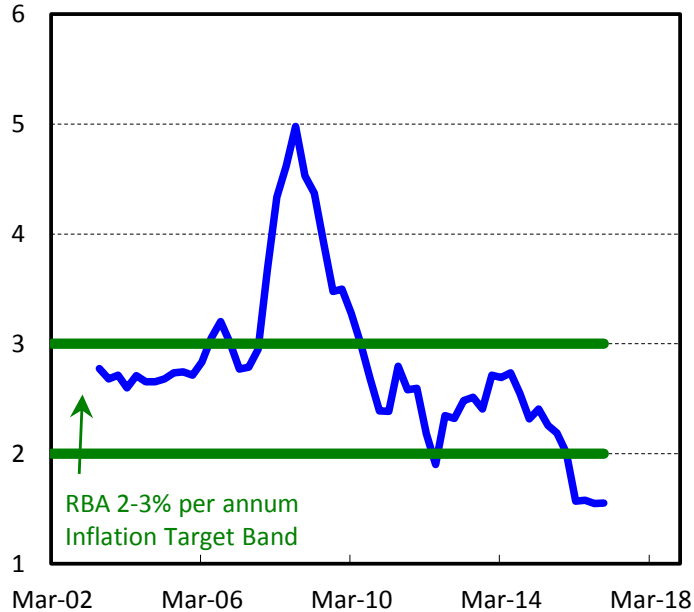
Where Will the Cash Rate Be at the End of Q2, 2018?



- The cash rate is at a record low of 1.50%.
- Reserve Bank faces a juggling act.
- In recent months, more economists have moved away from calling more rate cuts.

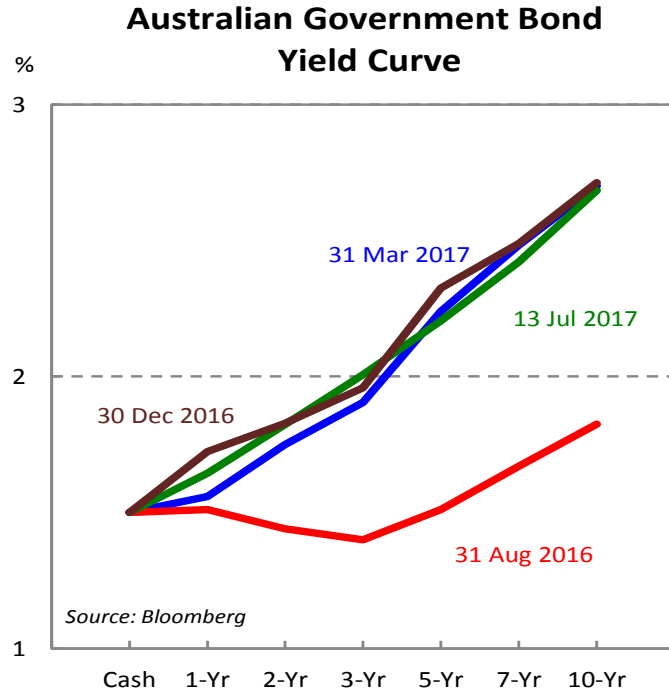
Inflation Outlook in Australia

Underlying Consumer Prices
(annual % change)



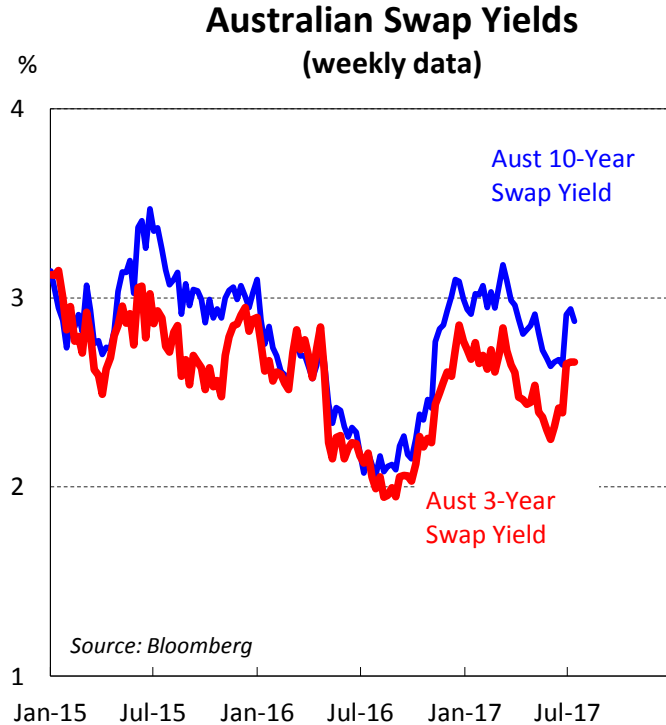
- We expect the RBA to leave the cash rate steady this year and next year.
- Household indebtedness and soft inflation supports our view.

Australian Bond Yield Curve



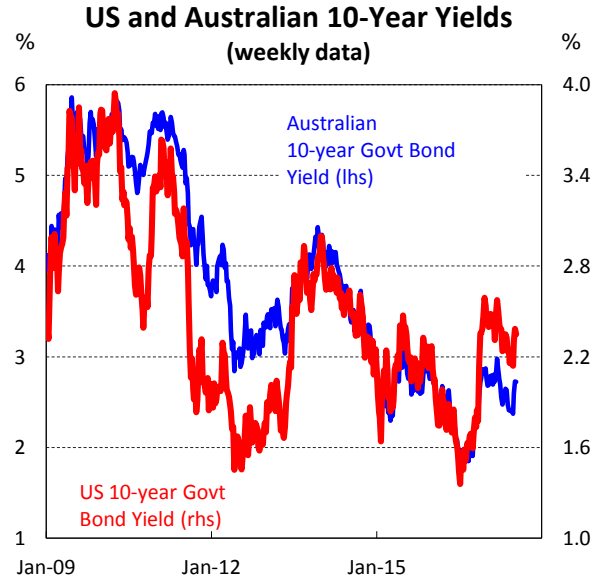
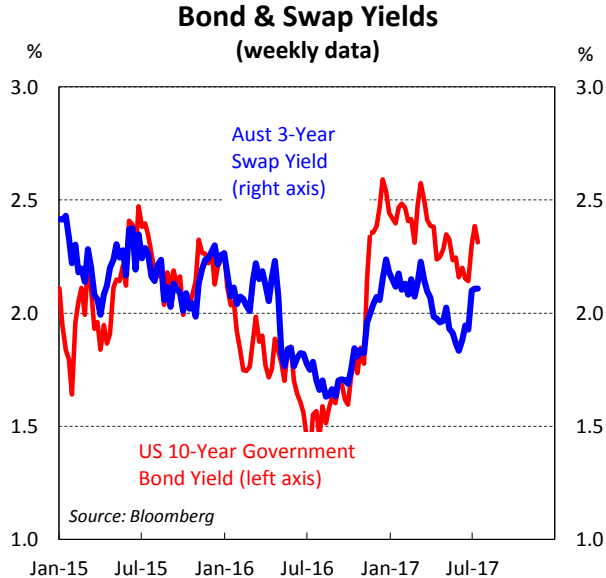
- We expect further modest steepening by end of 2018.
- Consensus is expecting more substantial steepening than our forecasts. Consensus expects the 10-year bond yield will rise more sharply next year (from 2.88% expected at end of 2017 to 3.50% at end of 2018).

Australian Swap Rates Outlook



- Australian swap rates bottomed in August 2016.
- Australian 3-year swap yields are up 49 basis points and Australian 10-year swap yields are up 84 basis points from their lows.

Australian Swap Rates Outlook

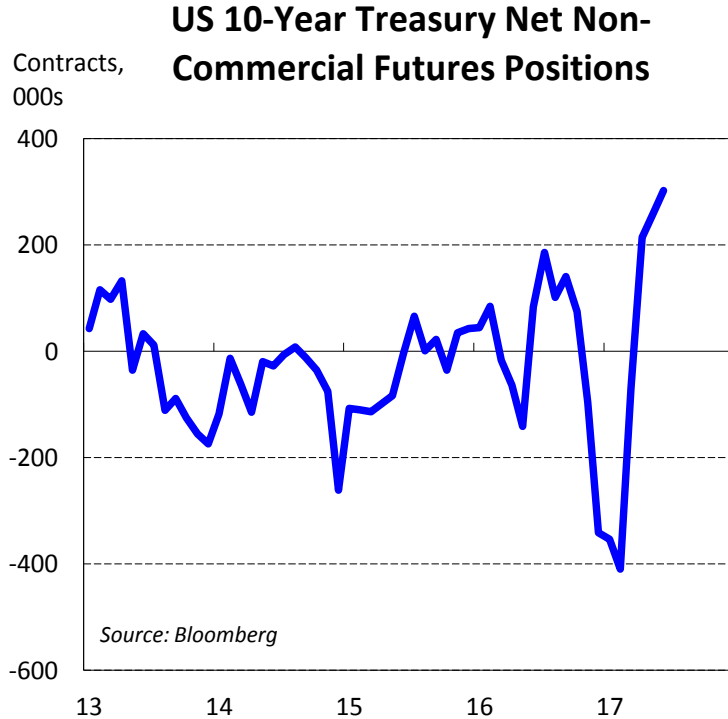


- Australian yields are being heavily influenced by US yields, more so since mid 2015.
- This correlation should continue over the year ahead.

US 10-Year Bond Yields Outlook

- A synchronised global economic recovery is in play. Economic data is improving in key advanced economies, including Europe and Japan.
- The recent gyrations in US Treasuries is in part a function of what the market expects US President Trump will do with fiscal policy (and how successful he will be). US economic data has not substantially altered in recent months.
- The US Federal Reserve has assured the market that the impending balance sheet shrinkage will be gradual, minimising the risks of another tantrum.
- The Fed intends to increase the balance sheet run off cap every three months until a fully phased-in level is hit.

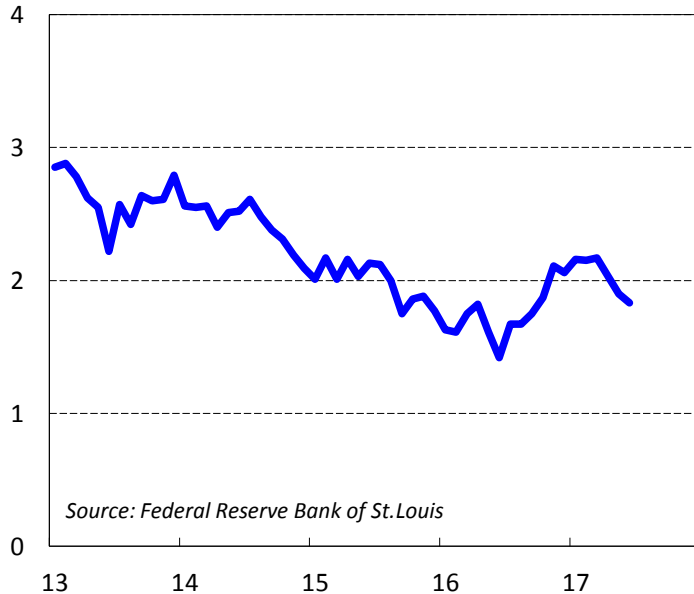
Risk of Sharp Sell off in US Treasuries



- Net long positions in 10-year US Treasuries have built up.
- The market is now net long 302,000 in 10-year US Treasury futures contracts; these are levels last witnessed in late 2007.
- It leaves US 10-year bond yields vulnerable to a sharp spike if inflation and/or economic growth surprises to the high side.

US Inflation Expectations

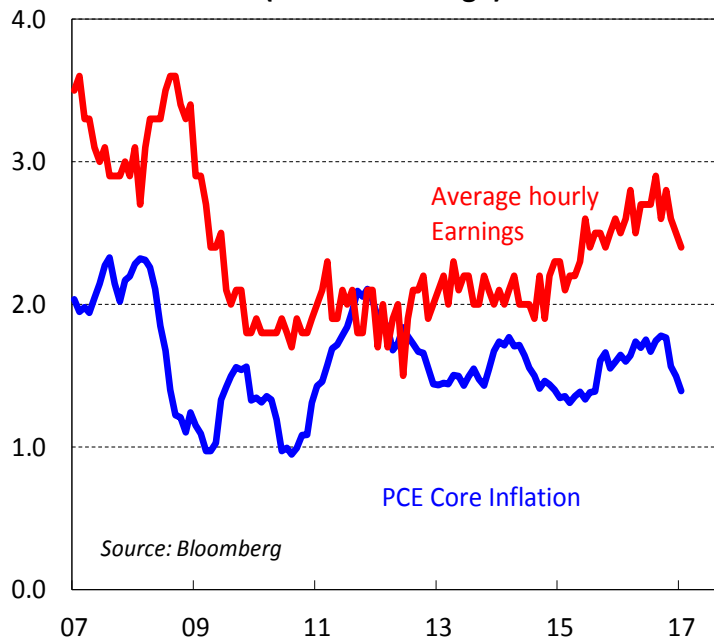
US 5-Year, 5-Year Forward Inflation
Expectation Rate, %



- Markets are not convinced that US inflation will push sharply higher over the next few quarters.
- It is reflected in the 5-year, 5-year forward inflation expectation rate, which is a measure of expected inflation (on average) over the next five years.

Fed Looking Through Soft Inflation

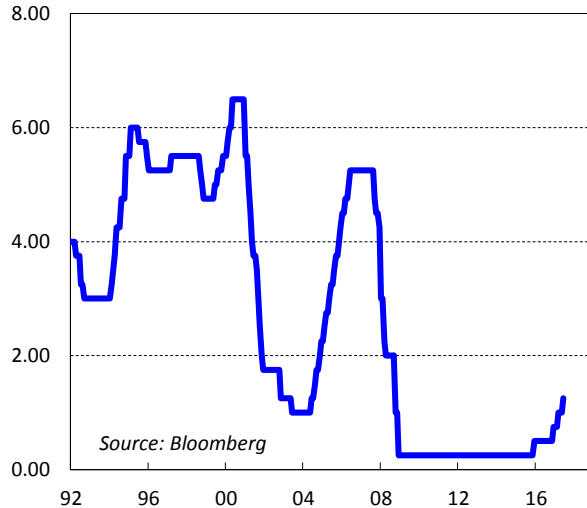
US Inflation & Wages Growth
(% annual change)



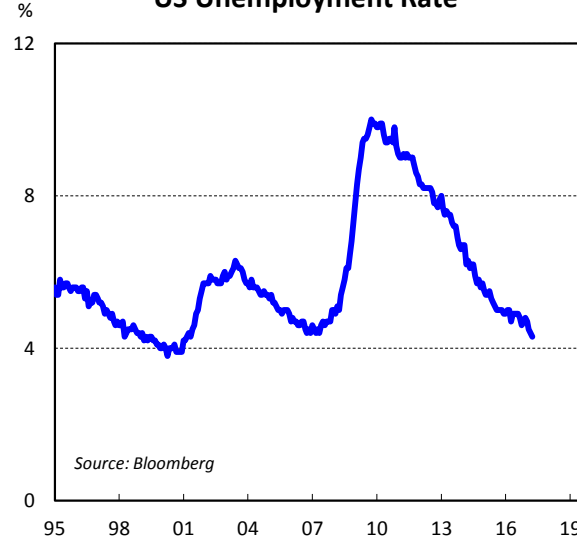
- Fed appears willing to look through weaker inflation outcomes, for now.
- US Federal Reserve Chair still believes in the Phillips Curve – the notion that lower unemployment will generate stronger wages growth in time.

More Rate Hikes to Come in the US

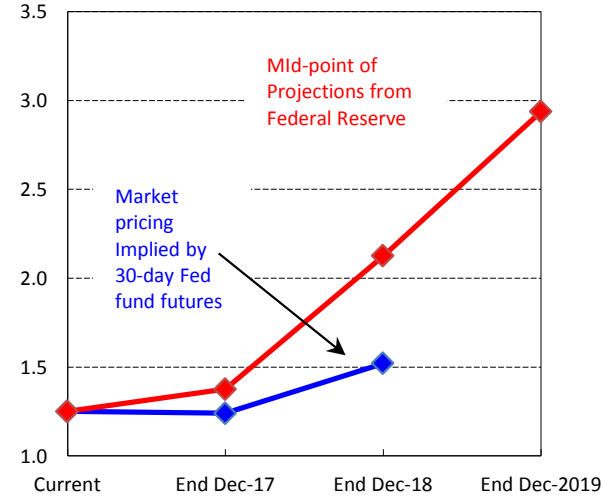
US Fed Funds Rate
(percent)



US Unemployment Rate

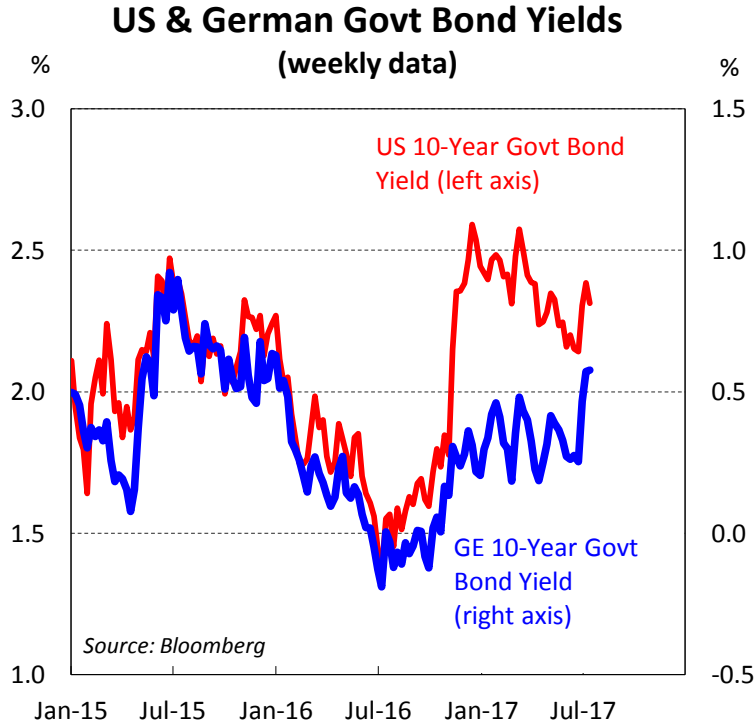


Expectations for the Fed Funds Rate
(Effective rate, %)



- Financial markets expect one more rate hike this year and one more next year. We think markets are not pricing in enough tightening.

Europe



- Europe is at a turning point with European Central Bank (ECB) President Draghi recently stating that the “threat of deflation is gone and reflationary forces are at play”. German long-end yields are, therefore, likely to nudge higher over the coming year.
- With higher inflation expectations lacking domestically, data and event developments in Europe and Japan will be important.

More on Europe

- The European Central Bank's (ECB) asset purchase program runs out by the end of the year. Financial markets are speculating that the ECB may taper the current program for 2018.
- The market is likely to look for greater clarity in the next few ECB policy meetings.
- Any change in outlook or hint of a reduction in asset purchases would likely push German 10-year yields higher and thereby produce US 10-year bond yields higher.
- In other developments, Bank of Canada recently raised their benchmark rate, making it the first major central bank to follow in the footsteps of the US Federal Reserve.

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