

Rates: New year, new money

Market participants were positioning for higher rates through much of Q4 2017



Bracing for higher market rates

Away from fundamentals, a key theme in the final months of 2017 was a tendency for market participants to position for higher rates. This can be gleaned from flows data which show a broad increase in holdings in less interest sensitive products (short maturities) and a reduction in exposure to longer duration funds. In fact, over the final quarter of 2017 there was a near 4% liquidation in holdings of long-end funds and a near 1.5% increase in holdings of short-end funds—effectively the marketplace had been shortening duration and bracing for higher market rates.

Another notable theme into the end of 2017 was buying of inflation-linked products. In the final quarter, there was a 4% expansion in holdings of European inflation-linked bonds, and US inflation-linked products saw continued good inflows too. This is important as an indicator of resumed market confidence in rising inflation in the months and quarters ahead.

The other theme is one of flows out of high yield and into investment grade corporates (which in fact was a trend seen through most of 2017). There was a mild widening trend into year end, but resumed tightening has been seen since. The launch of new liquid syndicated deals in the next few weeks and through January should sustain a reasonable tone for spreads, at least for now.

Catalysts for change

Beyond that, market participants will be looking for a potential catalyst for change. One such excuse comes from looming Italian elections set for early March and thus to be front and centre through February. Another is ongoing US inflation, which looks more and more likely to move in the direction of upholding the Fed's ambition to deliver on the dots for a second year. This is likely in the market psyche, but not discounted yet.

There has been a clear march higher in yield on the front end of the US curve over the past quarter. Meanwhile, the 10-year yield has spent practically the full quarter north of 2.3%, and is eyeing a break above 2.5%. The same is true for the 10-year German Bund, which is looking comfortable in the 45bp area, though it is now at the top end of its recent trading range.

Bottom line

The path of least resistance is for a nudge higher in rates. But progress higher will be tempered by new money being put to work, which will be supportive for spreads. That said, the dominant theme should still centre on a mild test higher in yields.

This article comes from our Monthly Economic Update. Download the [full report here](#).

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