

# Reflating without popping

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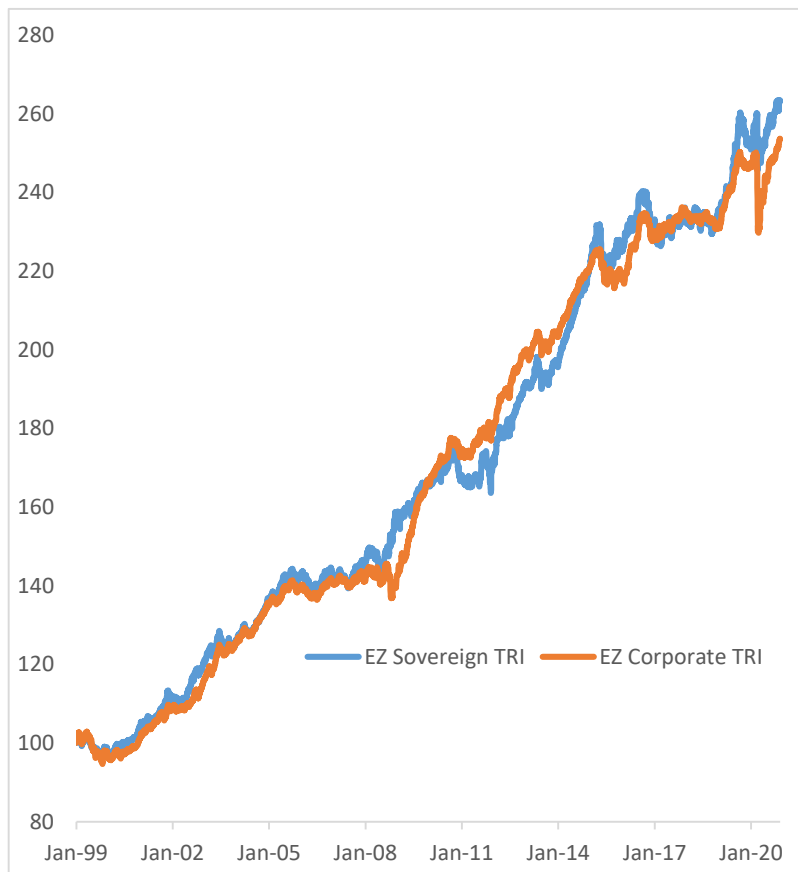
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# Impact of reflation trade – tough times for \*fixed\* income

Over the past 12 years EZ sovereigns have returned 4.7% annual average return. Corporates 4.5%. These are stunning returns but would be unsustainable in the face of an end to disinflation. Bond-like instruments in equity land would also struggle.

iBoxx Sovereign and Corporate total return indices



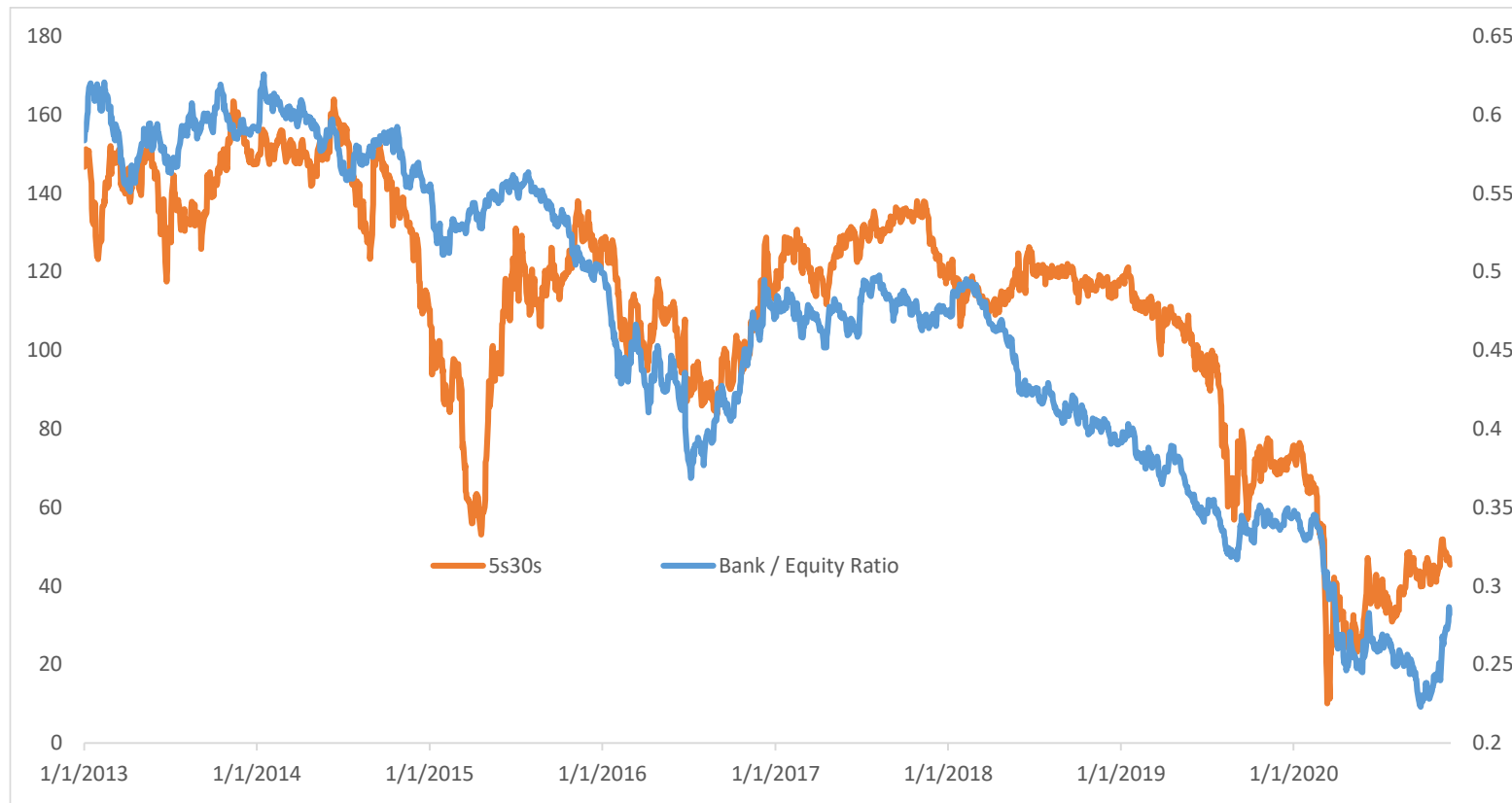
Value-to-growth ratio



# Banks vs. the curve

Banks are staging their best bounce for years. That is likely, in part, thanks to a steeper yield curve. There is a circularity – a steeper yields curve can lead to better profitability for banks which in turn can lead to a steeper yield curve. So reflation should help stymie the multi-year underperformance from banks.

*Relative bank performance against curve performance*



## Thoughts on reflation

- Will likely show itself first as a change in the 'fan chart' of future expectations. Some of the lower bands removed, while some higher ones are added.
- The key beneficiaries of the 'disinflation' age – fixed (and quasi-fixed) income will likely be the key underperformers in a reflationary environment.
- The ECB will face a huge question as to what to do in a reflationary environment. Not a binary question but a scale – *to what extent to fight back against market moves driven by reflation?*
- Remember bonds are both a commodity with fixed supply and demand and a set of forward 3m rates representing a breakeven of future short rates.
- In reflation the latter will be bearish, so the question for the ECB is how much to oppose this with the former.
- A clear implication is that there will be no more 'pushing on a string'. Sensitivity to ECB actions will be much higher because of the friction described above.
- Moves on entering a reflation regime could be extreme. It is an unexpected development for the market. Indeed a significant portion of the market would only have ever worked in a disinflationary environment. We would likely see a sustained period of high volatility within bond markets.

## Appendix A-1

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