

# Bond Bites

UBS Asset Management | **Fixed Income views**  
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## Shifting Sands

Stand atop Cardada Cimetta and enjoy a panorama of Switzerland's two extremes; from the lowest one, Lake Maggiore to the highest, the Dufour peak. It is enduring, beautiful – and deceptive. If only we could watch the time-lapse movie filmed over millennia; colliding tectonic plates, waxing and waning of ice ages and the ebb and flow of tremendous glaciers. Then we would have a better feel for the true nature of reality. The seemingly fixed and enduring are suddenly revealed as fluid and protean. It is just a question of timescale.

And this is true of our social constructs as much as the physical world. Take the role of central banks in many countries, where they have become the dominant actors in financial markets. Through inflation targeting mandates and policy frameworks that feel as permanent as the Monte Rosa massif they are the bedrock for investors' asset allocation decisions. The deployment of 'unconventional' policies in pursuit of these mandates is now the terra firma of financial markets.

### **Current monetary policy not to last forever**

But in making investment decisions about the future investors must accept these things are not fixed or immutable and plan and take action accordingly. Just like the physical landscape, monetary policy objectives and frameworks have varied enormously over time, and for many reasons; changing intellectual fashions, new academic descriptions of how an economy 'works' and, most profoundly for today, when the objectives sought by policy makers were not met, or undesirable side-effects triggered a reassessment of the benefits. And just like changes in the natural landscape this process is ongoing.

Play the time-lapse movie of Western monetary regimes of the last 100+ years and how would it look? Well we would start with a gold standard or the fixed rate currency regimes that embraced the desirability of free international capital movement. Then flow out of the ruins of World War 2 into the Bretton Woods System to foster international trade and preclude competitive devaluations. But erosion and collapse follow. We transition to the monetary targeting in the 1970's and 80's when rates were decided by implications for money supply growth. But this too breaks down as the link between money supply, growth and inflation proves very unstable.

Thus we arrive at today's panorama of inflation targeting deployed via a tool kit expanded to include asset purchases (known as QE) and, in some cases, negative rates. But given the very patchy results for inflation, painful side-effects and the lack of impact in the real economy it is likely central banks and their governments will be forced into a major rethink. Indeed both the ECB and the Federal Reserve will complete reviews of their approach to monetary policy in 2020. In the ECB's case this will be the first review since 2003.

### **The new decade: probably more challenging for bond investors**

These reviews are unlikely to result in a dramatic change in the policy approach, at least in the short term, but investors should pay careful attention nonetheless; they represent the first tremors of a reworking of the investment landscape to come. Concurrently, many governments are seriously considering, or have committed to, more aggressive fiscal policy action to address a range of pressing social and structural challenges not addressed by monetary authorities. Some proposals would fundamentally change the macroeconomic outlook in countries concerned, were they to be implemented. At the very least upside risks to inflation would increase sharply.

The metamorphosis of monetary and fiscal policy globally will be the driving force shaping the investment landscape in the months and years ahead. Over the last 10 years the dominance of monetary policy deployed via very low policy rates and QE has been a smooth ride for bond investors. The journey for the next 10 years could be over rather more bumpy terrain.

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