IIF Weekly Insight
Steamless rally

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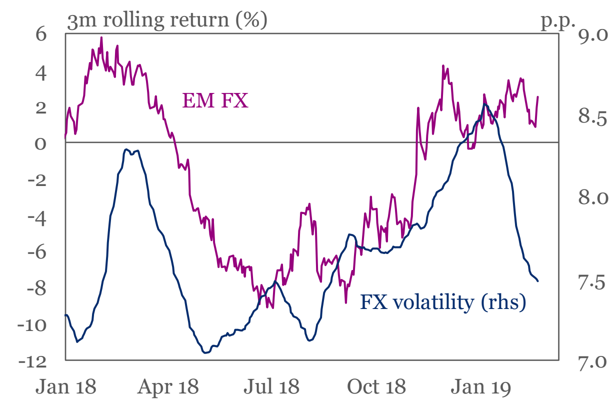
- Return to low volatility has underpinned the risk rally, but a less-dovish Fed could hurt
- Term premium compression again—bond markets to the rescue?
- MiFID II ushers in a decline in turnover, shift towards cheaper ETFs in the EU
- Older Americans shoulder a growing burden of student loan debt

Behind the volatility climb-down: A striking feature of Q1 has been the decline in cross-asset volatility—a good reflection of belief in the Fed's U-turn. As this belief has been a primary driver of recent risk-on sentiment (Chart 1)—along with hopes for a U.S.-China trade deal—this week's more nuanced Fed messaging (still debating tightening this year) could take more steam out of the rally. The steady drumbeat of concerns about the growth outlook also threatens risk appetite (consensus probability of recession for both U.S. and Euro Area over the next year now 25%, up from 15% in December). For EM assets in particular, further gains will require more validation from fundamentals—e.g. an extension of the improvement seen in our latest EM Growth Tracker.

Might bond markets ride to the rescue? Another shift in the landscape in Q4 was the big drop in inflation expectations—5X5yr breakevens down over 40bp for the U.S. to 1.8% (now stabilized near 2%), and a total drop of 30bp since end-Q3 for Germany, to just over 1.3%. Similarly, the U.S. 10yr term premium—which jolted higher after the 2016 presidential election—is back near its lowest levels since mid-2016. Other factors behind the decline in the term premium include near-record low bond market volatility and perhaps a sense of growing insouciance about the U.S. debt trajectory across the political spectrum: former Obama advisors Jason Furman and Larry Summers recently argued that "…policymakers should focus on urgent social problems, not deficits."

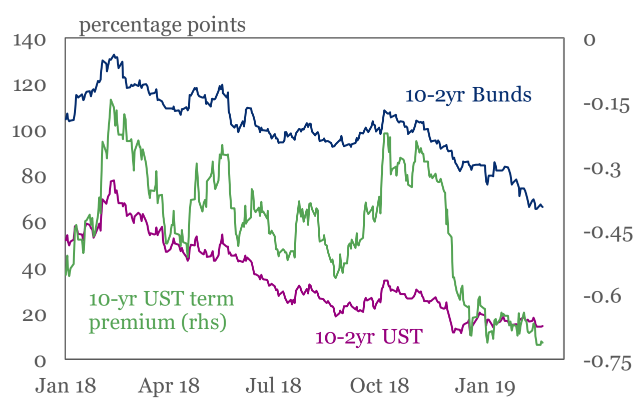
With yields falling again elsewhere, the TINA principle has also been behind the drop in the U.S. term premium. In anticipation of new ECB liquidity operations, and as Brexit and trade war worries (e.g. the potential for higher U.S. tariffs on

Chart 1: Q1 slump in volatility supports EM, risk assets



Source: Bloomberg, IIF

Chart 2: Euro yield curve flattens; UST term premium pushes further into negative territory



Source: Bloomberg, IIF

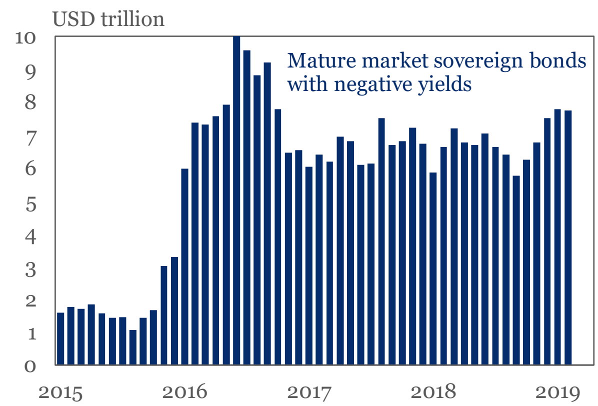
autos) add to broader concerns about European growth, the EUR 10-2yr yield curve has continued to flatten sharply. In contrast, the U.S. yield curve has been broadly stable this year (Chart 2). This downward pressure on European yields (and on JGB yields, now firmly back in negative territory for the first time since late 2016) is reflected in regrowth of the stock of mature market sovereign bonds with negative yields (Chart 3). Given the alternatives, strongly positive U.S. Treasury yields suggest demand is likely to hold up.

While new LTROs or TLTROs could provide short-term relief for European banks, flatter yield curves will weigh on profitability—despite a pickup in bank lending. Other financial institutions in Europe, including insurers and pension funds, will also continue to struggle if negative yields remain entrenched.

Changes afoot under MiFID II: As European financial markets continue to adapt to the changing regulatory environment, the impact of MiFID II (intended to protect investors via more efficient, resilient and transparent markets) is being closely scrutinized. With implications for research, liquidity and trading, implementation of MiFID II over the past year has revealed a range of challenges for the industry. Research unbundling, for example (separate pricing for research and execution), should bring the benefit of more unbiased research. However, a recent CFA survey suggests that less research spending may be resulting in reduced coverage in some sectors. Moreover, ESMA data point to lower transactions volume in H2 2018, as compliance with the new rules increased. Turnover in European equities fell almost 20%, while for bonds and other non-equity securities, the decline in turnover was close to 35%. MiFID II also favors slimmer fund structures with lower fees. Indeed, while Europe-focused ETFs saw modest net outflows last year, more expensive non-ETF funds (mainly mutual funds) saw much more substantial withdrawals of some $120 billion (Chart 4).

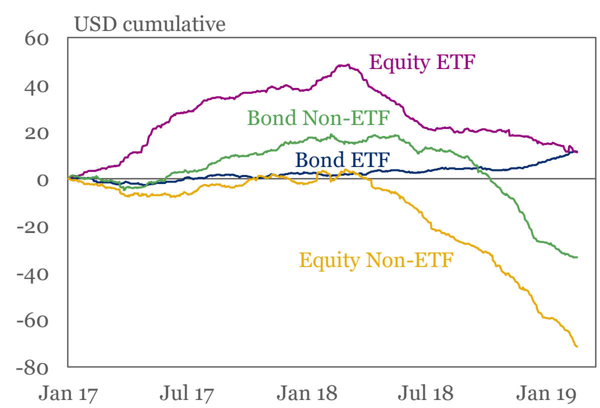
Student loans—a growing burden for the elderly: In 2018, U.S. student loan debt stood near 11% of total household credit or $1.5 trillion (7% of GDP). With a default rate of 11.4%, average debt per student stands at $32k—up over 70% since 2007. Moreover, a breakdown of borrowers by age highlights another worrying trend—older Americans are carrying debt later into life to finance their children and grandchildren's education. Indeed, debt held by the 60+ cohort has more than quadrupled since 2007, to an estimated $98 billion. The number of borrowers in this group more than tripled, from 1.0 to 3.1 million (Chart 5). On average, borrowers over 60 had $28k in student loans in 2018, up almost 95% from 2007. This makes the 60+ segment the fastest growing group of student loan holders, both in numbers and

Chart 3: Chronic pain for the financial sector: stock of bonds with negative yields rose again in Q4



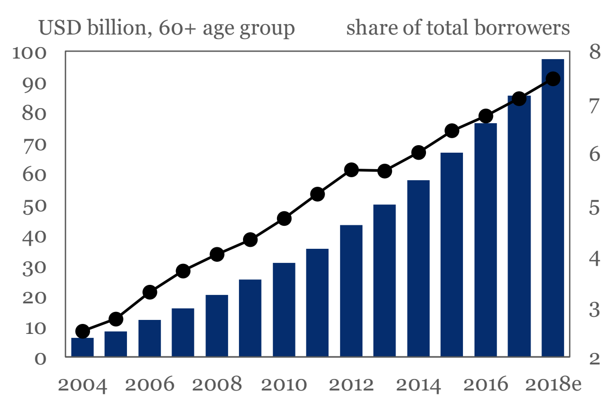
Source: Bloomberg, IIF

Chart 4: Investors in European funds flee pricier options



Source : EPFR, IIF. Non-ETFs are mainly mutual funds.

Chart 5: Older Americans shoulder a growing burden of student loan debt



Source: New York Fed CCP/Equifax, IIF estimates for 2018.

loan size. While still the smallest cohort among all student loans debtors (7%), older Americans are shouldering an increased burden that may become difficult to manage.