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Economics

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"Trumponomics" & the outlook for US bond yields

Peter Eadon-Clarke

Head of Global Economics

Macquarie Capital Securities (Japan) Limited
20F The New Otani Garden Court, 4-1 Kioi-cho
Chiyoda-ku, Tokyo 102-0094

Peter.Eadon-Clarke@macquarie.com

+81 3 3512 7850

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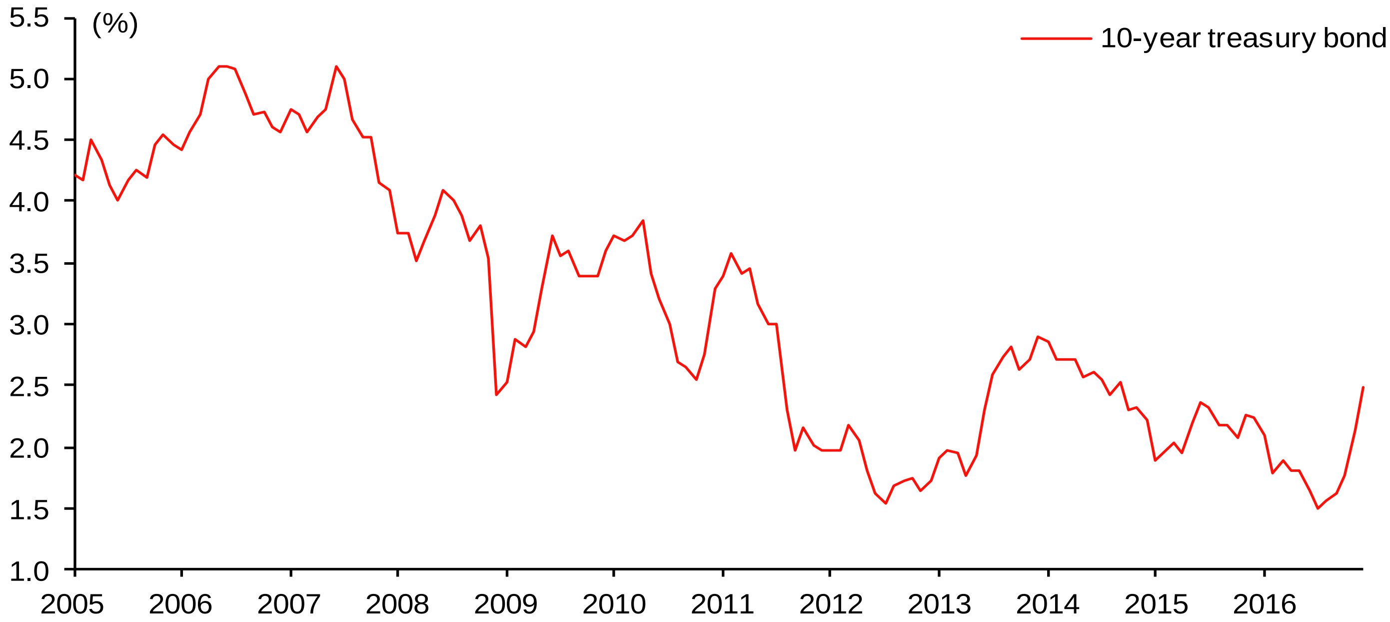
The US 10-year bond yield, three key questions to answer

1) Why have yields trended down over the last decade?

2) What is the outlook for yields over the next few years?

3) Why have yields jumped in the last three months?

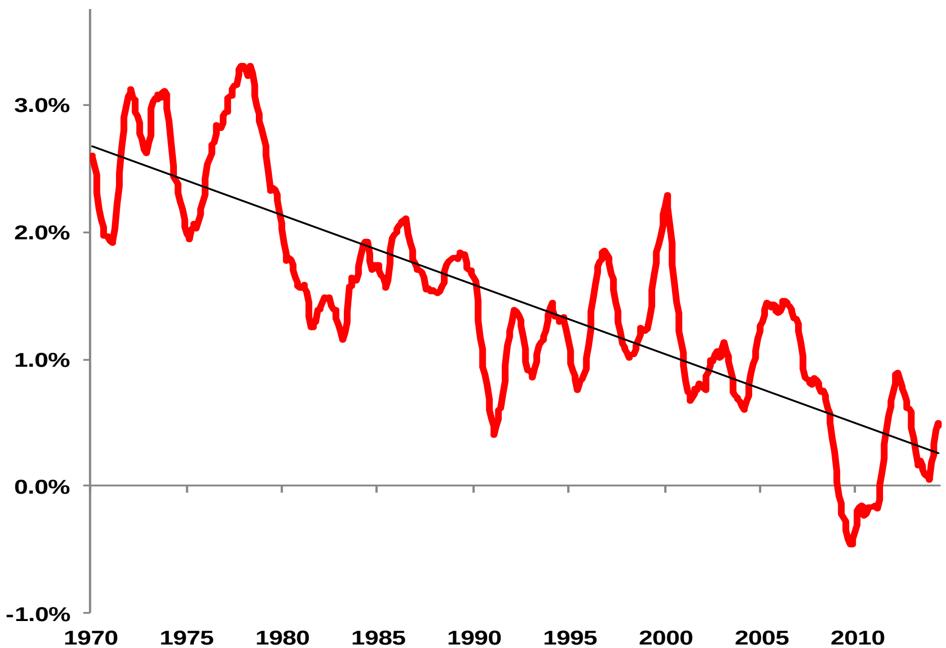


Source: Bloomberg, Macquarie research, January 2017

US bond yields have trended lower with lower trend US real GDP growth

Driven by aging demographics, the growth in the US labour force has been in a multi-decade decline

Labour force growth YoY change in twelve month moving average



This leads to lower trend US real GDP growth

So why does the US Fed want to increase its policy rate?

For 2011-16, the average pace of real GDP growth was a little over 2%, yet the unemployment rate has declined by six percentage points

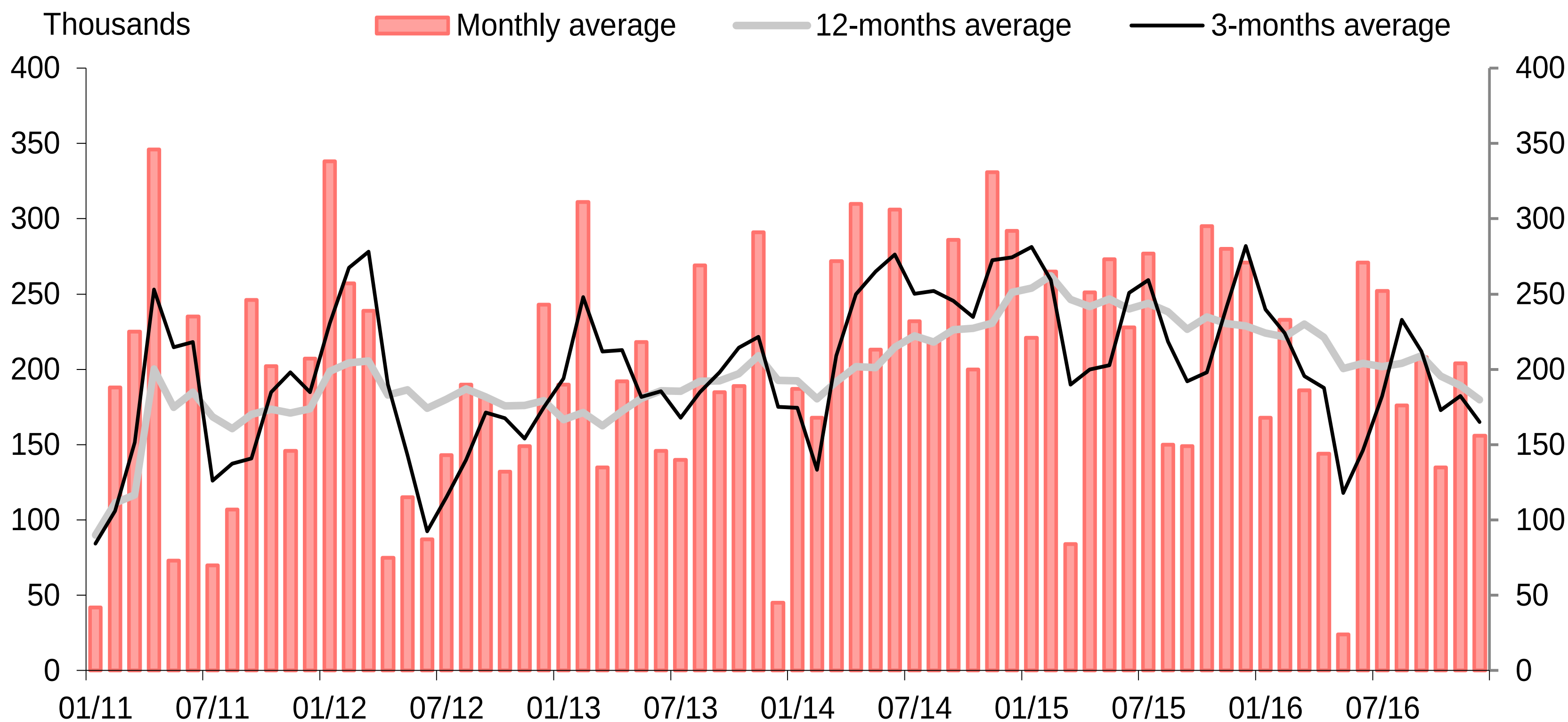
This means that even real GDP growth a little over 2% is too fast on a sustained basis. The US is running out of unemployed workers

We believe the US Fed knows this, and wants to "soft-land" real GDP growth to an average real GDP growth rate around 1.75%

Source: Bureau of Labour Statistics, Macquarie Research, January 2017

US payrolls growth needs to slow to around 100,000 per month within the next 18 months

US non-farm payrolls, monthly data since the beginning of 2011



On a 3mma and 12mma basis monthly payrolls growth is above 150,000

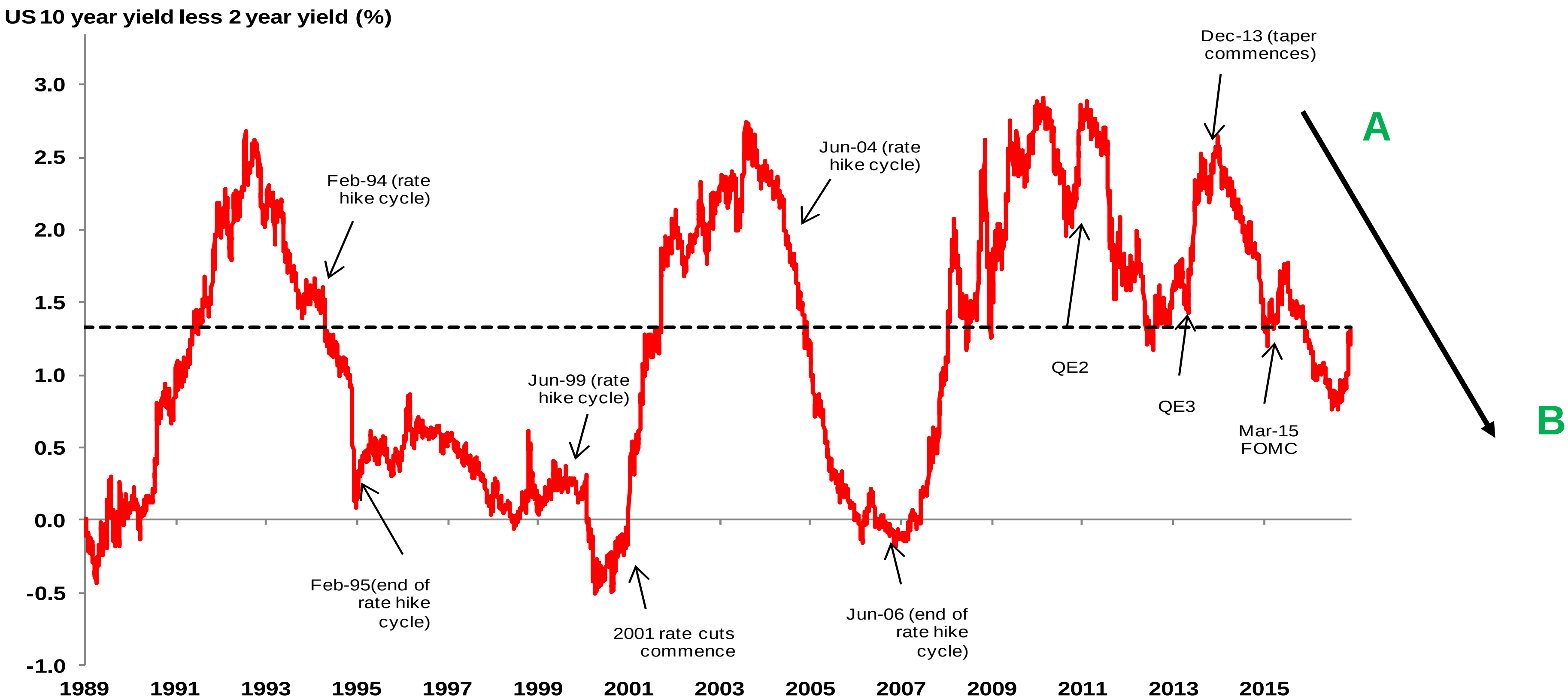
Source: Datastream, Macquarie Research, January 2017

A gradual trajectory of Fed Funds rate increases

- ➔ We estimate the potential real GDP growth rate for the US economy is around 1.75%
- ➔ In terms of monthly employment growth terms, we need the 150-200,000 monthly average to decelerate to somewhere around 100,000
- ➔ We are forecasting a 25bp increase in Fed Funds every six months until it reaches 2% in mid 2019
- ➔ Our forecast for the cyclical fair-value high in 10-year government bond yields is just 2.7%
- ➔ **Global trend growth rates:** It is not just the USA. We believe the pace of the current expansion should continue to prove to be structurally lower than in previous cycles as high leverage levels, demographic factors, low productivity growth and sub-optimal global policy making are likely to remain as headwinds in the years ahead

A cycle-high fair-vale US 10-year bond yield of 2.7%

The yield curve flattens during Fed rate hike cycles. We believe the Fed is halfway through a tightening cycle, from A to B below, that began in December 2013, and which will end in 2019 with 2% Fed funds and 2.7% 10-year bond yields, end-cycle, for around a 70bp yield spread



Source: Bloomberg, Macquarie Research, January 2017

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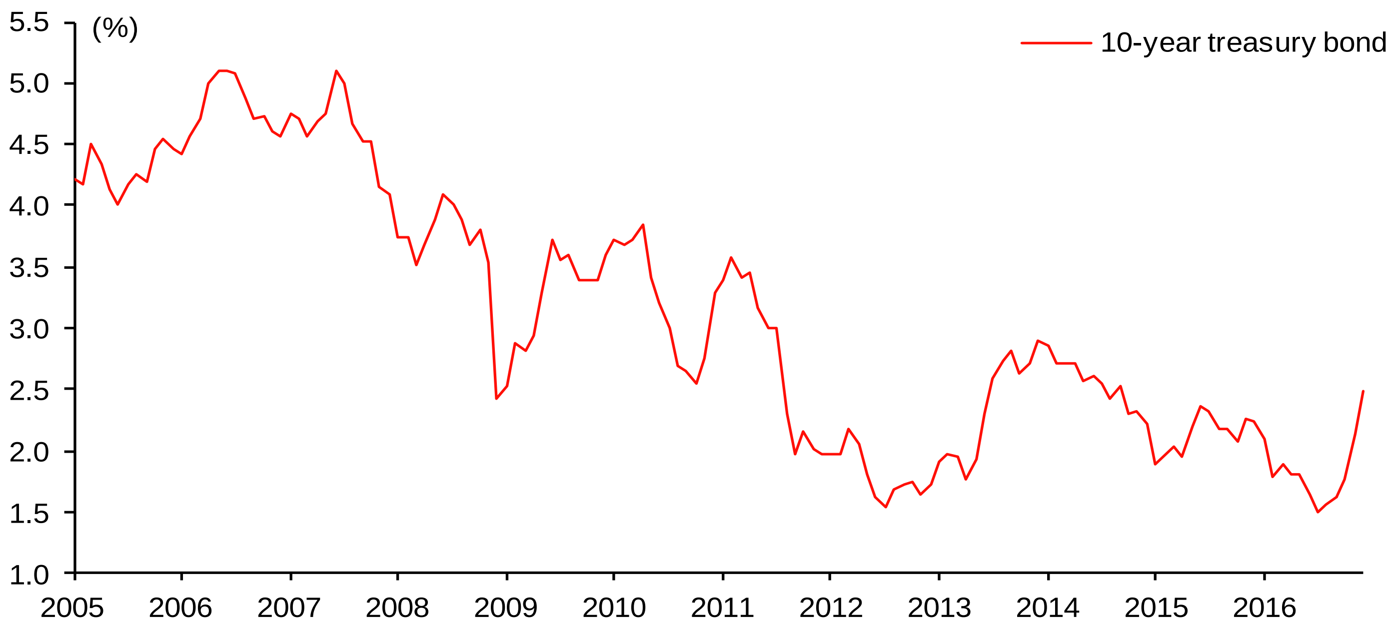
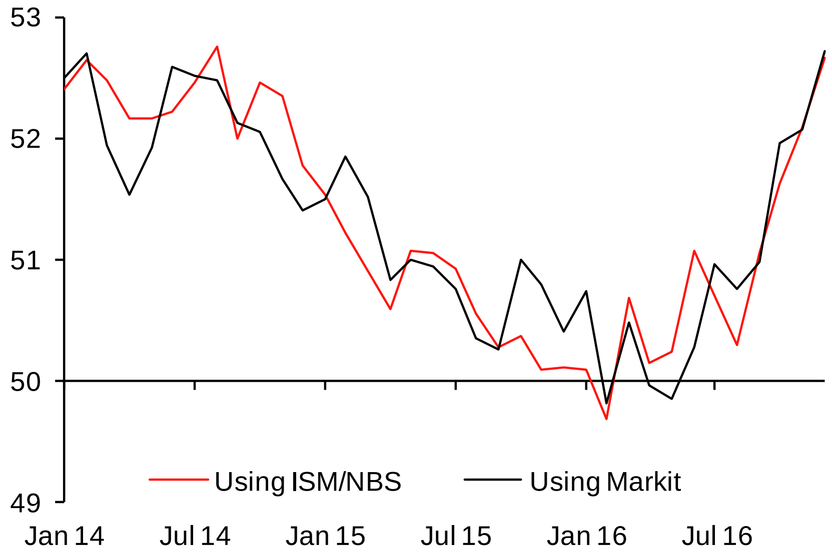


Source: Bloomberg, Macquarie research, January 2017

The trend and the cycle: The global cyclical recovery

Global PMI comparison, January 2014 to December 2016



Source: Markit, ISM, NBS, Macquarie Research, January 2017

OECD Leading Indicators, YoY

	OECD total	US	Germany	OECD Europe	Japan
Jan-16	-0.71	-1.52	-0.20	-0.17	-0.38
Feb-16	-0.74	-1.49	-0.31	-0.24	-0.49
Mar-16	-0.74	-1.43	-0.40	-0.31	-0.59
Apr-16	-0.71	-1.35	-0.44	-0.35	-0.69
May-16	-0.66	-1.26	-0.43	-0.36	-0.76
Jun-16	-0.58	-1.15	-0.36	-0.35	-0.79
Jul-16	-0.49	-1.01	-0.24	-0.32	-0.76
Aug-16	-0.38	-0.81	-0.06	-0.27	-0.66
Sep-16	-0.25	-0.57	0.17	-0.20	-0.51
Oct-16	-0.13	-0.32	0.42	-0.12	-0.32
Nov-16	0.01	-0.06	0.64	-0.02	-0.10

Note: Pale-red shading – up MoM (improving), grey shading – down MoM (falling). The data is usually revised by a few basis points.

Source: OECD, Macquarie Research, January 2017

The OECD LI has improved for eight months in a row since its February trough

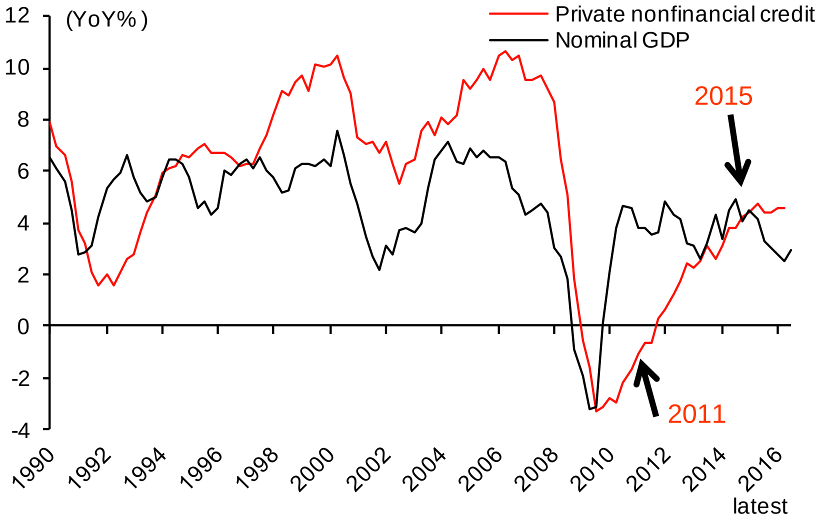
From a nadir of 0.4% YoY in December 2015, global IP was +1.8% YoY in October. The Macquarie 2017 forecast is +2.5% YoY

With the global industrial production growth trough now 12 months ago (December 2015) and the OECD LI trough already 9 months ago (March 2016), the question has become the durability of the up-cycle. A recovery lasting through 2017 implies we are about half way, the cycle is maturing.

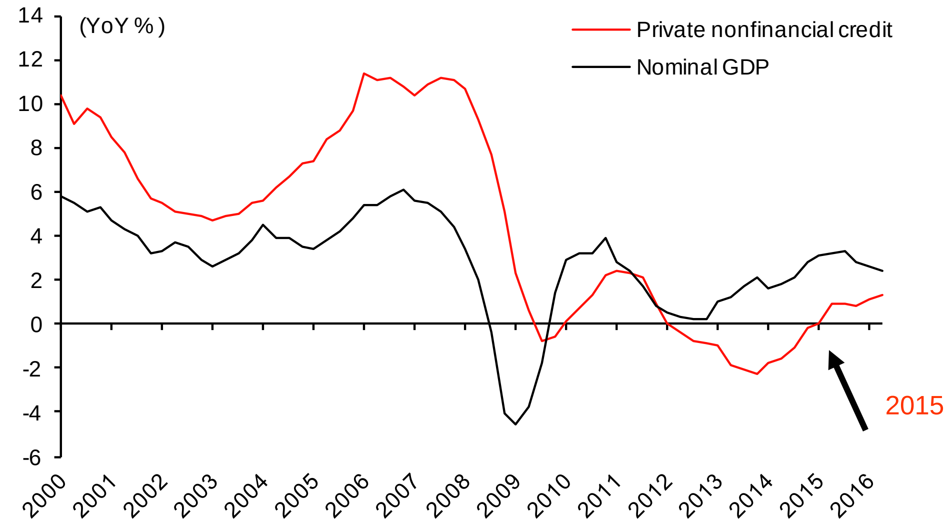
Underpinning our confidence in the global upswing is the return to health by the private sectors of the advanced economies

It took the US six years from the GFC to complete its private sector balance sheet adjustment, with private sector non-financial credit growth in line with nominal GDP growth (2015). Please note that the eurozone is four years behind the US in the return to positive private sector non-financial credit growth, (2015 versus 2011)

US private sector nonfinancial credit is growing faster than GDP for the first time since 2008



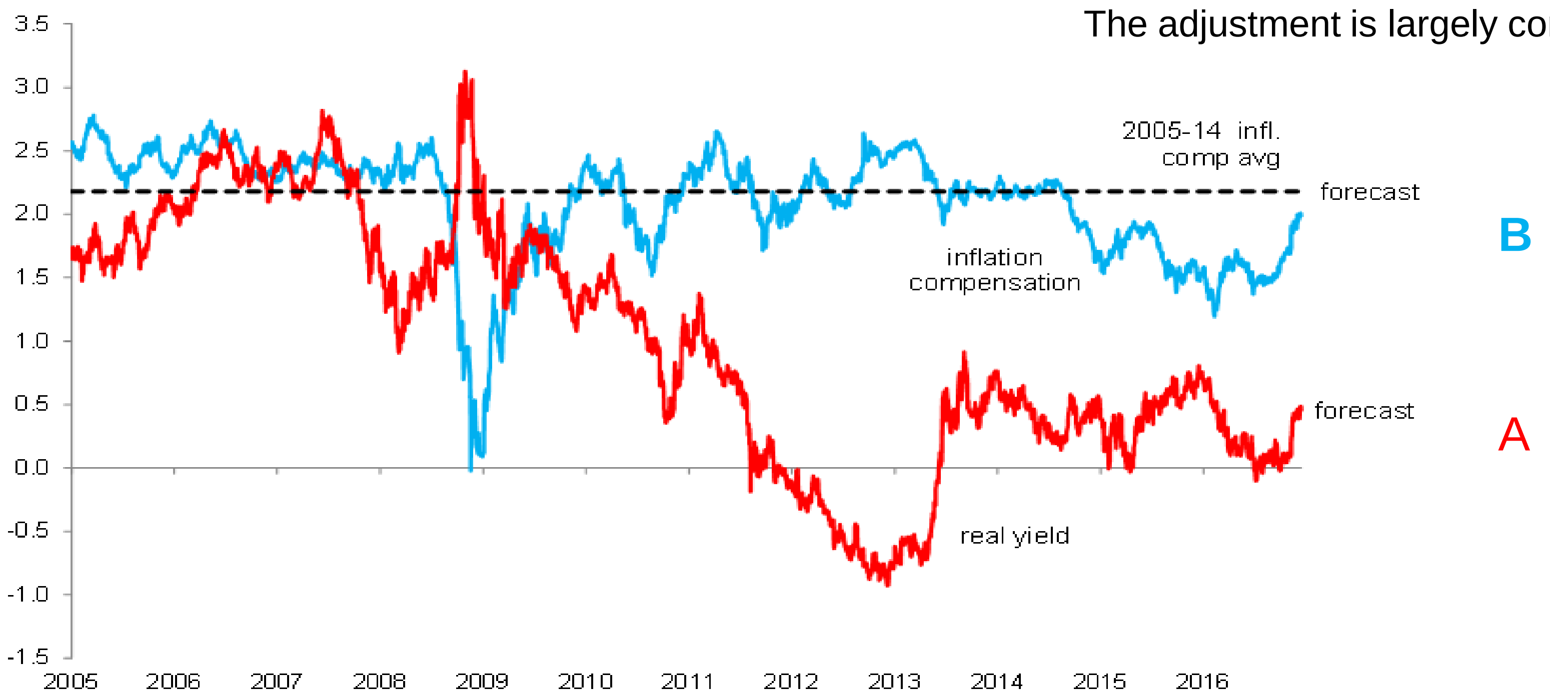
Euro area: private sector nonfinancial credit growth vs. Nominal GDP growth



Source: FRB of St. Louis, Macquarie Securities, January 2017

Decomposing the US Treasury 10-year bond yield

The recent back-up in yields reflected both the global cyclical recovery (via real interest rates, in red, A below), and a return to a more normal local inflation compensation element (in blue, B below).



Note: Over time US 10-year bond yields are expected to have a global real interest rate component of around 0.5%, and an inflation compensation component of around 2%.

Source: Bloomberg, Macquarie Research, January 2017

"Trumponomics" and the drivers of US bond yields

There are a variety of combinations

Driver of US bond yields

	Growth expectations	Inflation expectations
Fiscal policy	Supply-side tax reform ↑ for good reasons	Infrastructure surge ↑ for bad reasons
Trade policy	Protectionism hits growth ↓ for bad reasons	Protectionism increases import prices ↑ for bad reasons

These are, in our opinion, the two most likely

Conclusion: US 10-year bond yields remain low with a cycle-high fair-value of just 2.7%

Important disclosures:

Recommendation definitions

Macquarie - Australia/New Zealand

Outperform – return > 3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return > 3% below benchmark return

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield.

Macquarie – Asia/Europe

Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected <-10%

Macquarie - South Africa

Outperform – return > 10% in excess of benchmark return
Neutral – return within 10% of benchmark return
Underperform – return > 10% below benchmark return

Macquarie - Canada

Outperform – return > 5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return > 5% below benchmark return

Macquarie - USA

Outperform – return > 5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return > 5% below benchmark return

Volatility index definition*

This is calculated from the volatility of historic price movements.

Very high–highest risk – Stock should be expected to move up or down 60-100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40-60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30-40% in a year.

Low–medium – stock should be expected to move up or down at least 25-30% in a year.

Low – stock should be expected to move up or down at least 15-25% in a year.

* Applicable to Australian/NZ stocks only

Recommendation – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Financial definitions

All "Adjusted" data items have had the following adjustments made:

Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit /efpowa*
ROA = adjusted ebit / average total assets
ROA Banks/Insurance = adjusted net profit /average total assets
ROE = adjusted net profit / average shareholders funds
Gross cashflow = adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

Recommendation proportions – For quarter ending 30 September 2016

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	47.26%	55.50%	38.46%	45.47%	59.09%	48.21%	(for global coverage by Macquarie, 8.20% of stocks followed are investment banking clients)
Neutral	38.01%	29.31%	42.86%	48.77%	37.88%	36.79%	(for global coverage by Macquarie, 8.25% of stocks followed are investment banking clients)
Underperform	14.73%	15.19%	18.68%	5.76%	3.03%	15.00%	(for global coverage by Macquarie, 8.00% of stocks followed are investment banking clients)

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