Focus

3 december 2018

"Rekindled inflation heralds the start of a bear market for bonds"

> *"The global economy will continue to grow strongly in 2019, prompting further interest rate normalization. Bad news for bond holders and a clear sign to continue investing"*

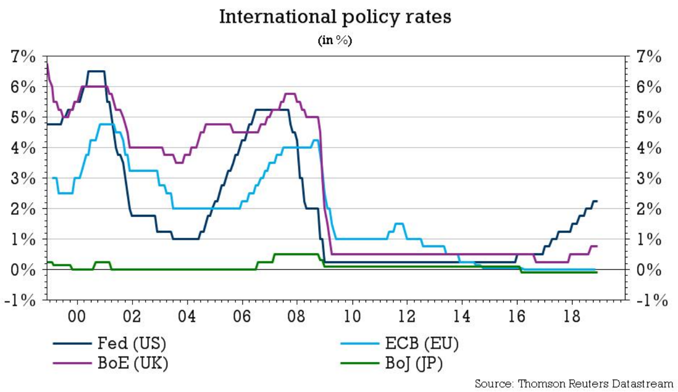
Investing is crucial to safeguard purchasing power

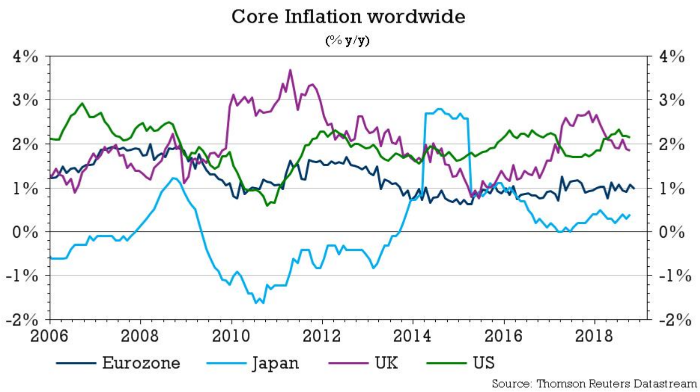
2019 continues to pose a challenge for investors, and for bond investors in particular. KBC still expects interest rates to rise ('normalise') across the board in both the United States and Europe, which obviously creates a difficult environment for bond investors. Higher interest rates reduce the value of bonds, while inflation affects purchasing power. We expect the higher inflation figure of 2018 to continue next year. More than ever, protection against loss of purchasing power remains necessary.

Inflation

In addition to total inflation, underlying core inflation is also rising to above the Federal Reserve's inflation target, under pressure from a tighter labour market/higher wages. That will remain the same in 2019. KBC forecasts US inflation of 2.6% in 2019.

The Eurozone follows at a distance. Headline inflation has temporarily increased in recent months as oil prices recovered but core inflation remained relatively stable. Due to a surplus of capacity in the economy, unemployment remaining relatively high, we expect equal inflation rates in 2019. KBC expects inflation of 1.7%, which means that the ECB's inflation target will not be achieved.





Central bank policy and interest rate forecasts

These forecasts translate into an adapted monetary policy. KBC anticipates a further gradual normalisation of interest-rate policy, but at different speeds: the US will take the lead, while the key rate in the euro area will not start to move until the end of 2019.

The Fed will lift its key rate four more times by the end of 2019, which means it could peak at 3.375%. In the meantime, the Fed's balance sheet will contract, while the strong US economy and accelerating inflation will push ten-year rates towards 3.5% by the end of 2019.

The ECB is expected to complete its quantitative purchase programme by the end of 2018, with a first key-rate hike after the summer of 2019. German bond rates will slowly rise to 1.25% in the wake of US rates.

It's still worth investing!

But looking on in resignation isn't an option as far as KBC is concerned. The bonds asset class has been given a lower than average weighting in the portfolios to make way for bonds with (very) short maturities. This is intended to sharply limit the duration of the portfolios.

The return of inflation immediately explains, however, why it is important to keep investing. Due to the low inflation of recent years, many investors have lost sight of this! Some investments were made because the savings book no longer yields anything but the real reason to invest was/is/remains to preserve or build up purchasing power.

With inflation running around 2% a year (the ECB target), you'll need about 126 euros in 2030 to buy the same amount of goods that cost you 100 euros today. Meanwhile, a savings account on which the interest rate ought to be in the region of 1.5% over the same period will only grow that same 100 euros to 115 euros. The lost purchasing power is clear.

With a growth rate of 3.6%, the global economy will continue to hold up next year. Although profit margins are under some pressure, they remain at good levels and we expect stock markets that can return to the positive trend. Together with some interest rate normalisation, this ensures that the outlook for mixed funds is below historical averages but better than the savings account and above all .... continues to protect purchasing power, especially in the longer term. Adjusted for expected inflation, by 2030 your purchasing power will still increase by about 20% for a defensive investor and even 40% for the dynamic investor. More than ever, investing is the new way to save.

Outlook KBC
Inflation (%, annualised)

	2017	2018	2019
US	**2.1**	**2.5**	**2.6**
Euro zone	**1.5**	**1.8**	**1.7**
Belgium	**2.2**	**2**	**1.8**

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Outlook KBC
key rate (in %)

	Current	+3m	+6m	+12m
US – Fed	**2.25**	**2.50**	**2.75**	**3.25**
EMU - ECB	**-0.40**	**-0.40**	**-0.40**	**-0.20**
UK – BoE	**0.75**	**0.75**	**0.75**	**0.75**
Japan	**-0.10**	**-0.10**	**-0.10**	**-0.10**

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Outlook KBC
10-year interest rates (in %)

	Current	+3m	+6m	+12m
US	**3.19**	**3.30**	**3.30**	**3.40**
Germany	**0.38**	**0.60**	**0.90**	**1.15**
UK	**1.44**	**1.90**	**2.00**	**2.20**
Belgium	**0.82**	**1.00**	**1.35**	**1.70**

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