Economic Research
WEEKLY ANALYSIS

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A bearish start to the year for the capital markets

A Probable rebound for the long-term rates in 2021. Increase in the relative attractiveness of the U.S. market. Inflationary risks underestimated. Beware of risk premiums and durations.

Key points

- A bearish beginning of the year for the interest rate markets under the influence of the US Treasury
- Unanticipated but probable rebound in long-term rates in 2021
- The rise in long-term rates increases the relative attractiveness of the US bond market
- How far can risk premiums decline in the Eurozone?
- An uncertain situation in the United Kingdom
- Japan's deflationary rates stabilized
- Bond investment policy focused on quality and short maturities

A bearish beginning of the year for the interest rate markets under the influence of the US Treasury

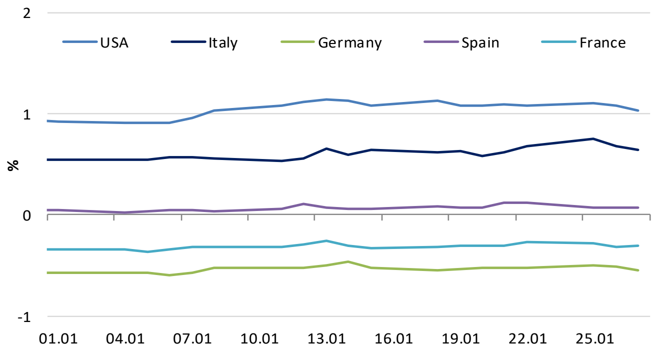
The beginning of 2021 is already clearly marked by new expectations of an economic recovery in the United States, fears of an uncontrolled increase in debt and a resumption of inflation in 2021.

The 10-year US Treasury rates thus initially jumped by nearly 30 basis points, from 0.91% to 1.1855% in the first week. In the euro zone, there was a less noticeable movement, which for the time being is more akin to a stabilization than a clear trend reversal.

In Switzerland, the federal government's rates also underwent a clear adjustment, rising from -0.59% at the January low to -0.41% at the six-month high.

In Japan, the movement remains imperceptible, but yields are once again at the top of the trading range of the last nine months (0.05%). UK rates also rose slightly, but stabilized at 0.3%. Canadian (0.87%) and Australian ten-year government yields (1.15%) are in January at their highest level since April 2020. The first weeks of 2021 are therefore probably already part of a new trend of adjustment of bond yields to the certainly more positive evolution of global economic growth in 2021.

10-year rates – Gvt (January 2021)



Sources: Bloomberg, BearBull

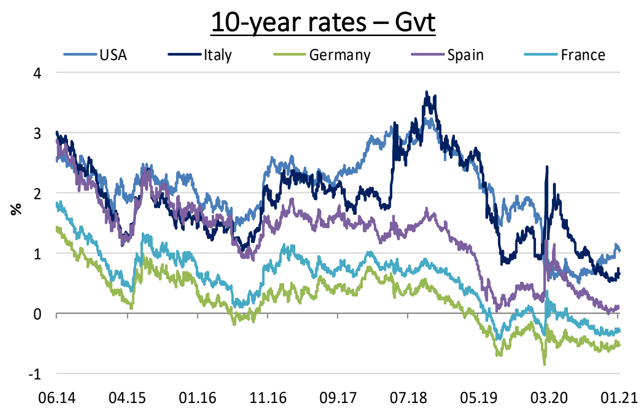
Probable rebound for the long-term rates in 2021

In the bond markets, the risks of an unexpected and uncontrolled rebound in long-term yields seem to us to be increasingly likely. The weakening economic outlook for Q1 is likely to dampen this trend. However, it seems reasonable to us that a normalisation of global growth in the course of the year could lead to a global readjustment of interest rates.

The first country to have already observed such a trend in the US, perhaps because investor confidence in the ability of the US authorities and the Federal Reserve to re-establish conditions conducive to lasting growth is the highest, but also because the incoming Democrats administration will increase the risks of spending and tax increases.

This last point is not the prerogative of the US only, for although it is indeed likely that the Democrats administration, supported by a blue House of Representatives and a blue Senate, will be able to make greater use of debt to finance its stimulus program, in Europe too there will be an increase in government indebtedness for the same reasons.

The additional financing needs resulting from budget deficits globally to meet the direct and indirect costs of managing the Covid-19 crisis will logically have an impact on market interest rate levels. In 2020, investors' perception was that this increase in financing needs would be offset by central bank purchases in a global wave of debt monetisation and that the impact on rates would ultimately be neutral.



Sources: Bloomberg, BearBull

But in 2021, on the contrary, it may well be more difficult than expected for central banks to prevent a certain normalisation of yields demanded by investors given the international competition to attract funds for investment. Long-term rates could therefore well undergo a trend reversal as early as 2021 despite central banks' attempt to control them.

At the beginning of 2021, we will probably also see renewed investor concern regarding a likely rise in inflation. The massive cash injections already made in 2020 and which will continue to be made in various forms in 2021 will be an additional source of uncertainty as global growth picks up speed.

In the US, inflation-linked Treasury bond yields have already reached 2%, their highest level since 2018. The Fed, for its part, may even welcome the fact that inflation is picking up and exceeding its 2% target. This risk still seems to us to be underestimated in financial markets and could therefore have a significant impact in terms of triggering a rise in interest rates in 2021.

The rise in long-term rates increases the relative attractiveness of the US bond market

Over the past six months, US Treasury long-term rates have begun a gradual but significant rise. After reaching a low point of 0.54% in March, ten-year yields almost doubled in one week, rising to 1.1855% before suffering further temporary weakness. It is also important to note that risk premiums have fallen during this period, approaching historic lows and therefore no longer offering sufficient protection in our view.

The yield differential with the 10-year German Bund and Swiss government bond, which had fallen to a low of 100 basis points, is now again above 150 bps. Dollar rates have thus become more attractive to European and Swiss investors, even though yield spreads remain lower than they were at the beginning of the year. This adjustment could strengthen the interest of non-resident and domestic investors. These recent developments show that long-term rates may well tighten, even as the Fed continues its purchases.

Without the Fed's intervention, it is likely that the ten-year Treasury yields would already be close to 2% given the solid economic recovery expected in 2021, unlimited money creation and a possible rise in expected inflation. The CPI index for December jumped to +0.4% for an inflation rate up to +1.4% over a year. The pressure on prices is obviously modest, but expectations rose again in December, from +2.8% to +3% for the next twelve months.

How far can risk premiums decline in the Eurozone?

In Europe, the uncertainty concerning the economic recovery seems to us to be more present, due in particular to the greater risks of lockdown that still weigh on the short-term growth prospects of the countries of the European Union at the beginning of the year.

The risks of a rise in euro interest rates are therefore lower, as investors do not yet seem sufficiently convinced of an acceleration in an economic momentum to start to consider a readjustment of the yields required by the economic situation. The existing correlation between bond markets could logically be temporarily reduced, as long as euro interest rates remain relatively stable despite the likely tensions on the US market.

With regard to the national markets in the euro area, we note that the PEPP has been operating for several months and is effectively driving the evolution of sovereign bond yields in Europe, which have been falling steadily since mid-March and are now sinking deeper and deeper into negative territory.

The yield spreads between European sovereign debtors are thus once again close to those prevailing before the outbreak of the Covid-19 crisis. Risk premiums in euro bond markets have contracted and already reflect to a large extent the new European paradigm resulting from the mutualisation of debts.

The low risk premiums for Italian (1.18%) and Spanish (0.63%) debt now leave little room for further price increases unless a target similar to the current premium in France (0.23%) is considered.

In this environment, European long-term rates have only an extremely limited potential for further declines. The government bond markets in the various national segments thus offer few prospects in terms of yield and capital gains. The stabilisation of yields in Europe could still last for some time before the trend reverses and yields adjust to more positive economic conditions.

Situation still uncertain in the United Kingdom

The expected weakening of an economic momentum in Q4 and early 2021 is unlikely to have an impact on long rates in the Sterling. Ten-year government yields have already approached twice the zero level in March and August in an anticipation of high cyclical risks for the UK economy.

Since then, they have gradually resumed a slightly upward trend. Ten-year yields could thus rise by a further 0.27% to 0.5%, marking in our view the likely short-term inflection point for UK rates.

The final agreement negotiated with the European Union does not rule out the risks of a rise in imported inflation in the United Kingdom in 2021, which is also a negative factor for the Sterling bond market.

At these levels, capital markets still do not seem very attractive to us and the risks of holding Sterling bonds seem sufficient in this context to avoid positioning in this market. Key interest rates were lowered from 0.25% to 0.1% during the health crisis in March and have remained unchanged since then.

Negative rates should be one of the options available, but it seems that the BoE will instead expand its securities repurchase program to act on the entire yield curve. It may now be more difficult for the BoE to effectively control the level of long rates, which could then come under further pressure.

Japan's deflationary rates stabilized

The consumer price index collapsed in December to -1.2%, recording its sharpest decline in nine years, driven by falling energy prices and government offers to lower travel and hotel accommodation costs. Inflation is moving away from the BoJ's target, which says it is not concerned about it in the short term, although it no longer expects a positive recovery before next summer. In this deflationary environment and in the absence of a rapid recovery in economic growth in the first quarter, interest rates may remain stable and close to zero across the entire yield curve.

Against this backdrop, the BoJ will have to maintain its policy of extreme economic stimulus by continuing its share buyback programs. "without limits". It should not, however, push its action to the point of lowering ten-year yields very significantly below zero.

The outlook for the Japanese bond market is therefore unattractive; only a strong yen could bring a positive element to an exposure to Japanese bonds, a possibility that seems to us very unlikely in Japan's current economic situation.

Bond investment policy focused on quality and short maturities

In 2020 central banks came to the rescue of economies and had a very strong and lasting impact on bond markets.

They have been able to effectively control and steer interest rates not only on the short end by lowering their key rates, but they have also allowed long-term rates to fall thanks to their government debt purchase activity in particular.

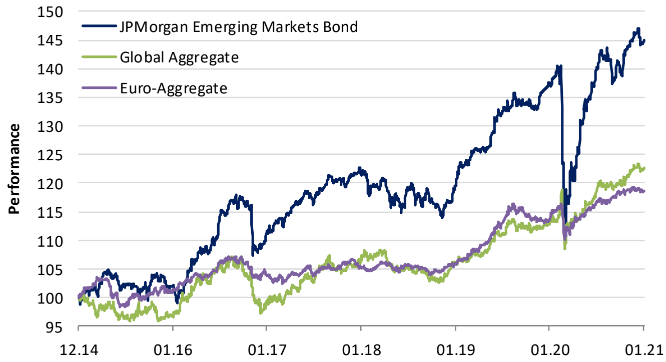
Against the backdrop of a highly anxiety-inducing 2020 very much affected by the risks of a collapse in global economic activity, the actions of central banks were decisive and took place in an environment deemed rather deflationary and marked by the risk of recession. The recovery of most economies in Q3 was not enough to change fundamental risk perceptions in interest rate markets, which were still convinced that interest rates would remain persistently low thanks to central bank actions. Growth estimates for Q4 point to a slowdown, which could continue into the beginning of the year.

Inflationary risks have therefore logically been put on the back burner and have not been taken into account so far in the bond markets. 2021 could, however, prove to be more complex and less easy for central banks to control. With the economic recovery expected this year there will also probably be a general adjustment of interest rate levels that may not be as effectively controllable by central banks.

In China, for example, the government's yuan yields rose from 2.45% at the height of the crisis in April to 3.4% in November, jumping by 100 basis points as GDP growth resumed.

Yuan yields have thus very gradually adjusted to this new reality by returning to levels that prevailed in Q4 of 2019, before the health crisis. In the US, the trend reversal was obviously less spectacular, with Treasury yields beginning their adjustment phase in August, going from 0.5% to 1.18% at the beginning of 2021. This trend is expected to continue in the US and to gradually take hold elsewhere in Europe, in the UK and in other developed countries and emerging markets more generally.

Emerging bond performance (base 100)



Sources: Bloomberg, BearBull

Our bond strategy now focuses primarily on diversification within developed markets in the investment grade segment and in high quality government debt in emerging markets. Short maturities are absolutely essential given the likely upward adjustment of interest rates. Yield pick-up strategies, often favoured by investors seeking positive returns, are now particularly risky as yields enter a period of adjustment. In 2020 risk premiums reached historically low levels and have likely reached their limits in an economic climate that is now less penalised by the health crisis.

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