Economic Research

WEEKLY ANALYSIS

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PROSPECTS AND STRATEGIES
INTERNATIONAL BONDS

Long-term interest rates will gradually rise across the board. Renewed attractiveness of dollar bonds. Investment strategy focused on USD, CAD, and AUD markets

Key points

- **Long-term interest rates will gradually rise across the board**
- **Renewed attractiveness of dollar bonds**
- **New upward trend in interest rates temporarily curbed by ECB action**
- **Trend reversal in interest rate markets**
- **Japanese long-term rates are following the general trend without conviction**
- **Chinese bonds still attractive**

Long-term interest rates will gradually rise across the board

At the beginning of the year, we noted that the risks of an unexpected and uncontrolled rise in long-term yields seemed growing and increasingly likely. Q1 fully confirmed our predictions with the rise in long-term dollar yields leading this new trend. Even the downward adjustment of the economic outlook for Q1 in the euro zone countries due to further lockdowns did not prevent European bond markets from participating in the shift in investor expectations. The correlation among bond markets thus proved once again to be high, with practically all markets experiencing the same trend, albeit with varying degrees of amplitude.

The prospect of a strong global economic recovery in 2021 has thus been the main factor influencing bond markets in recent months and will certainly remain one of the determining factors going forward. The competition among governments to attract the capital needed to finance their growing budget deficits will require adjustments and the reconstitution of risk premia that disappeared during the down cycle. It was already clear in March 2020 that the additional financing needs resulting from global budget deficits incurred to meet the direct and indirect costs of managing the Covid-19 crisis should logically have an impact on market interest rates. However, in 2020, central bank interventions had made it possible to postpone this impact. However, with the economic recovery expected in the coming quarters, central banks will no longer face the same problem. It was indeed easier for them to keep long-term rates low through their various asset purchase programmes in a context of recession or health crisis than in a phase of general economic recovery. They will therefore probably no longer be able to contain the new yield requirements of investors, who may also be increasingly worried about rising inflation affecting the real returns on their bonds. This factor will certainly be one of the key elements in the changing outlook for bond markets in H2. While inflation remains below central bank targets everywhere, expected inflation is already above 3% for the year, especially in the US. We had already mentioned these likely developments for 2021 a few months ago, stressing that these risks seemed to us to be largely underestimated. We mentioned the fact that these elements would undoubtedly trigger an upward trend in rates in 2021. Today we reiterate our negative outlook for the bond markets.

Renewed attractiveness of dollar bonds

As we have been saying for several months, we felt that a rise in long-term rates in 2021 was inevitable in the context of a very clear improvement in the US economic outlook. The 50-basis-point rise in 10-year Treasury rates in H2 2020 merely heralded a trend reversal that was expected to strengthen and become more pronounced in 2021. Indeed, Q4 saw long-term rates rise a little further and approach the 2% threshold. The rise in Treasury yields from 0.9% on 31 December 2020 to almost 1.75% is significant and constitutes an important changing outlook factor in terms of financial risk assessment. It is also important to note that this adjustment in long-term yields on US government debt has not yet significantly affected risk premiums on non-government bonds, which remain historically low. Within the dollar bond market, the current 10-year Treasury yield may already be providing an incentive for some investors to reallocate positions, as they decide to reduce their exposure to risky yield pick-up strategies. Internationally, US bonds now also offer a safe haven with the prospect of an attractive yield spread. European, Japanese and Swiss investors may now be more interested in dollar-denominated fixed income investments, as the yield spread has narrowed considerably. As we approach the 2% threshold, we believe that this yield differential is likely to stabilise under the influence of new inflows of funds. The dollar is expected to benefit further from this factor.

New upward trend in interest rates temporarily curbed by ECB action

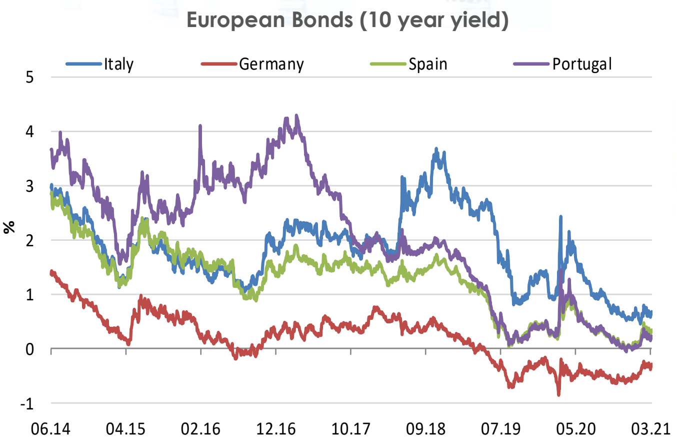
Euro area inflation rose slightly in February to +0.9% year-on-year, its highest level in a year. Inflation excluding food and energy rose even more sharply by +1.1% during the same period. Price indices are expected to rise faster in the coming months, driven by energy prices. Inflation could thus exceed the ECB's forecast at the end of the year, especially if the economic recovery in the second half of the year ultimately proves to be stronger.

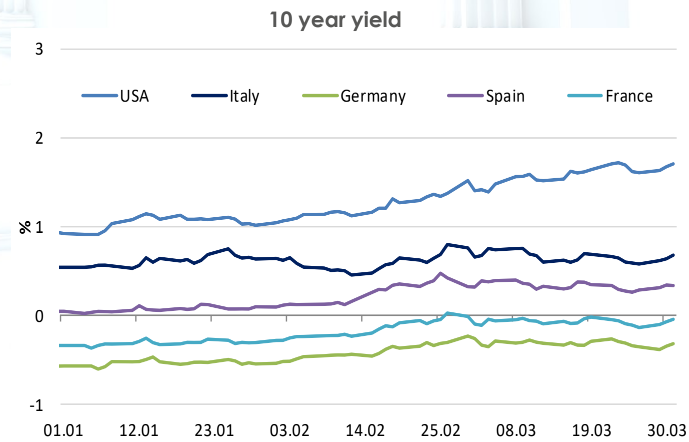
In the current international context, which is more favourable to an overall acceleration of economic momentum, the ongoing adjustment of interest rates not driven by central banks will continue and will also affect euro rates. This investment climate favouring a gradual rise in long-term rates cannot be stopped by the ECB, despite its readiness to intervene.

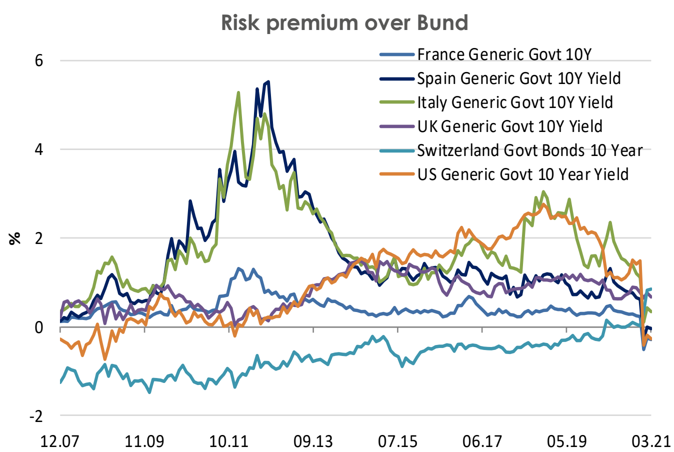
It is clear that the ECB will not be able to do more than slow down the rise in long-term rates that finally materialised in 2021. For a while, the PEPP may give the ECB more leverage to influence the trend, but the low point of the cycle has likely already been reached.

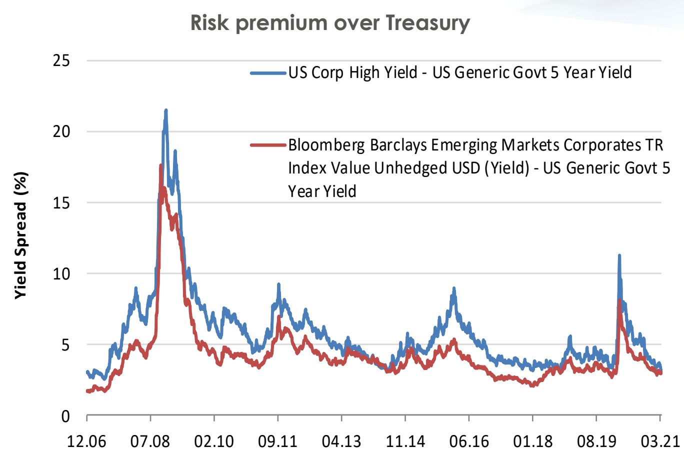
With regard to risk premiums between governments, we believe that current yield spreads leave no room for any further relative price increases for Italian and Spanish debt in particular.

Euro bond markets may still benefit from a short period of respite offered by the ECB's reinforced action. But beyond a few months, the improved economic outlook is expected to finally reignite the upward trend and allow yields to adjust logically to the new macroeconomic situation. German yields could well be above zero again before the end of the year.









Trend reversal in interest rate markets

Long-term sterling rates have also risen in recent months in a general trend that has affected most international bond markets. In the UK, hopes of an imminent economic recovery also supported a very significant adjustment in bond yields. Indeed, they adjusted very quickly back to the level they were at before the health crisis broke out. Ten-year UK government yields jumped from 0.2% to 0.8%, while inflation was negative in January (-0.2%) and remained under 1% yoy at the beginning of the year. Despite the likely weakness in Q1 GDP, expectations are now focusing on the year as a whole, while the favourable economic outlook also supports revised inflation expectations.

The rise in ten-year UK government yields, which we had estimated as likely in Q1 2021 in our previous analyses, essentially manifested itself at the beginning of the year with an increase from 0.2% on 31 December 2020 to 0.8% in mid-March. This rise in 10-year sterling yields has caused spreads over European yields to widen sharply due to the more modest rise of around 0.2% in German Bund yields in euros. The increase in the risk premium from +0.4% to +1.2% was therefore logically a factor supporting investor interest in pound investments offering such a positive yield differential. On the other hand, the likelihood of an end to the lockdown may also push back the threat of a decision by the BOE to adopt negative policy rates.

We had expected a reversal in the early months of the year that would mark the likely turning point for UK rates, and the recent shift confirms this. The increase in positive sterling bond yields places the UK bond market among those offering attractive relative returns compared to the European, Japanese and Swiss markets. The reconstitution of the risk premium is a favourable factor, but the attractiveness of holding sterling bonds still seems insufficient to us.

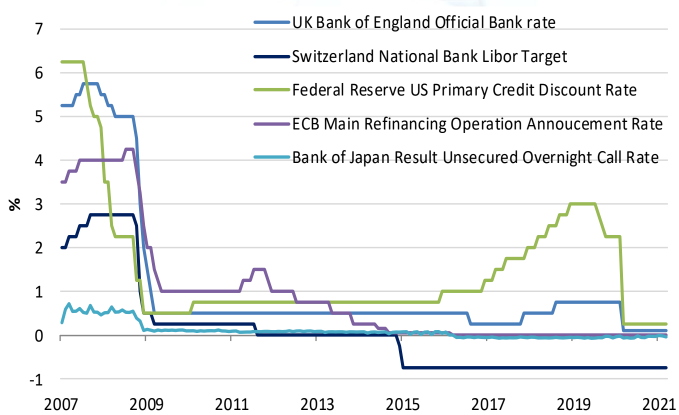
Japanese long-term rates are following the general trend without conviction

Meanwhile, Japanese 10-year long-term rates have also been affected by the upward trend in US Treasury rates and the overall adjustment observed in most bond markets. Even though the inflationary outlook is radically different in the US and Japan, Japanese 10-year government bond yields "tightened" in the first two months of the year.

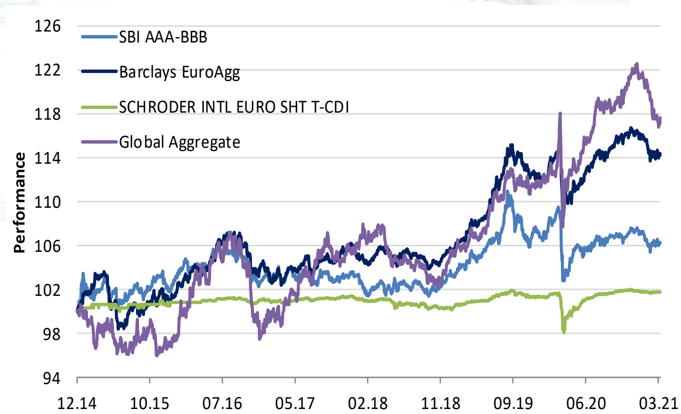
While the trend in long-term rates was similar, the amplitude of change was logically much more modest. Indeed, long-term rates only increased by 15 basis points, a small but sufficient movement to reach a new high point for the last four years.

Ten-year bond yields thus temporarily hit 0.18% at the end of February and are currently stabilising at around 0.15%.

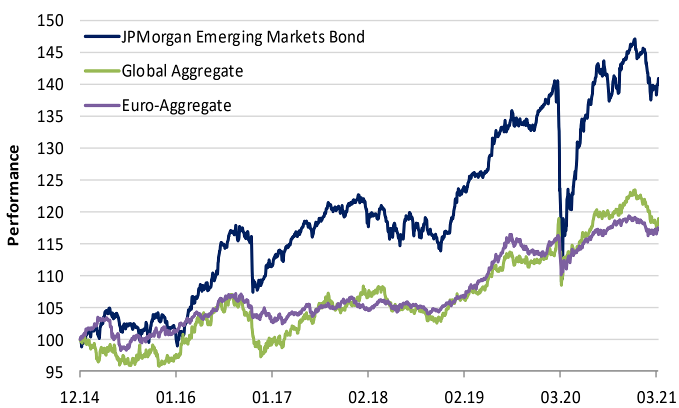
Central Bank rates (EUR, CHF, GBP, USD, JPY)



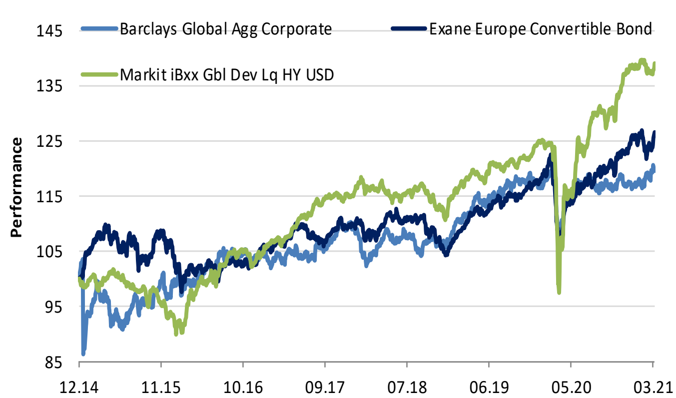
YTD Performance of Bond Indices 1- 5 years (Normalized at 100)



Emerging Bonds - Performance (Normalized at 100)



Eastern Europe Bonds - Performance (Normalized at 100)



Chinese bonds still attractive

The Chinese bond market has become the world's second largest bond market and is gradually gaining recognition among international investors. Particularly sought after during the pandemic because of its high yield by international comparison and the attractiveness of the yuan, it could however temporarily lose some of its competitive advantages. Indeed, the rise in dollar rates reduced the yield differential from 2.5% to only 1.6% in four months, and the likelihood of a weakening of the yuan over the next few months reduces its expected net yield. The 3.25% yield on government bonds remains attractive and the lack of correlation between this market and other developed bond markets is still an interesting feature. In this environment we maintain our interest and recommendation to diversify into Chinese yuan bonds.

Investment policy focused on USD, CAD, and AUD markets

The recent rise in bond yields has significantly altered the risk parameters and opportunities across bond markets. 2020 was largely characterised by historically low and near-zero rates in most developed economies. This environment left little leeway for bond investment strategies. Yield pick-up strategies became the only alternative to achieve positive returns. They helped push risk premia to historically low and often insane levels. The recent shift in the economic outlook and its consequences on bond markets have changed the situation by offering new opportunities. Several bond markets are now once again offering investment opportunities at yields close to and above 2% over ten years. Long-term yields in US, Australian and Canadian dollars are becoming more attractive again. This is also the case for Chinese bonds, which are already yielding above 3.2%. In emerging markets, too, rising yields are creating new opportunities.

Our bond strategy today focuses on diversification in the investment grade segment in developed markets and in high-quality government debt in emerging markets. Slightly shorter maturities can be considered again after this first phase of rising interest rates. Floating rate notes (FRNs) and inflation-linked securities (ILSs) are also particularly suitable in this phase of rising inflation and yields. Yield pick-up strategies, often favoured by investors in search of positive returns, are now particularly risky as yield levels are adjusting. In 2020, risk premiums reached historically low levels and likely reached their limits in an economic climate that is now less affected by the health crisis.

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