PICTET WEALTH MANAGEMENT

Core Sovereign Bonds Outlook 2023

US Treasuries' safe-haven status set for a comeback

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AUTHOR

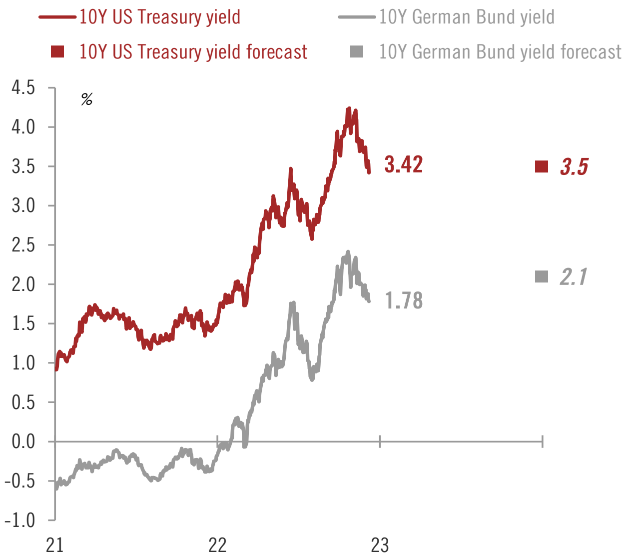
LAURÉLINE RENAUD-CHATELAIN
lchatelain@pictet.com

FLASH NOTE

SUMMARY

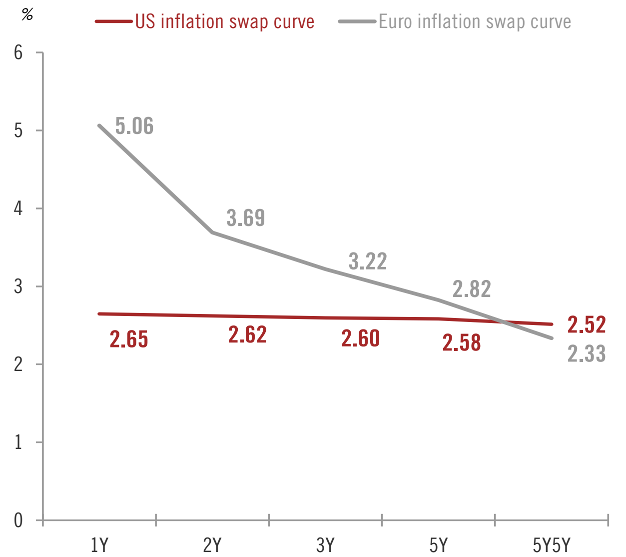
- **After a difficult 2022, we expect bonds to be back in favour in 2023, with long-dated US Treasuries' safe-haven status serving to protect multi-asset portfolios in the event of recession**. The US Federal Reserve's (Fed) continued hawkishness going into next year due to the stickiness of US inflation and the robust employment market is likely to maintain some upward pressure on the 10-year US Treasury yield from current levels (3.42% on 7 December) in the first months of 2023.
- Nevertheless, **both lower US Treasuries Notes and Bonds issuances in 2023 and recession risks lead us to foresee the 10-year US Treasury yield ending 2023 at around 3.5%, with occasional rallies towards 3% during the year**. Due to their safe-haven status, we expect US Treasuries to benefit from any market turmoil or worries around a recession in the US, even if the Fed does not cut its policy rate.
- Although we position tactically on long-dated US Treasuries, **we have decided to move from neutral to overweight on US Treasuries going into next year** in order to benefit from their safe-haven status.
- However, **we remain neutral on core euro government bonds**, as we expect more elevated inflation in Europe and large net issuance by the German government to finance substantial fiscal stimulus, **pushing the 10-year Bund yield from 1.78%** (on 7 December) **towards 2.1% by end-2023.** This means a narrowing of the yield differential with its US counterpart. And although **we consider the Bund's safe-haven status to be questionable in this environment, we foresee a range of between 1.5% and 2.5% next year.**

Chart 1: US and German 10-year government bond yields and end-2023 forecasts



Source: Pictet Wealth Management, FactSet, 07.12.2022

Chart 2 : US and euro inflation swap curves



Source: Pictet Wealth Management, Bloomberg Finance, L.P., 07.12.2022

BONDS ARE BACK

After a difficult 2022, we expect bonds to be back in favour in 2023. **Long-dated US Treasuries' safe-haven status could again come to the fore to provide protection for multi-asset portfolios in the event of recession**. The 10-year yield has risen materially this year to 3.42% (on 7 December), posting one of its worst total return performances in history (-13.7%) along the way. Ten-year and 30-year US Treasury yields have recently fallen below the US federal funds mid-rate (3.88% on 7 December), **but even if long-dated bonds now offer lower yields than cash, if history is any guide, they are likely to perform much better in a recession should their correlation with risky assets become negative again.**

The inversion in the US Treasury yield curve usually signals that market participants are starting to price in the risk of a US recession. The fact that most of the US Treasury yield curve is now inverted, and that the 10-to-two-year slope has reached negative levels not seen since the early 1980s, is clearly a red flag for growth prospects (*see chart* 3). While the long-end part of the US curve is likely being pushed lower by expectations inflation will moderate and the fact that the US Federal Reserve (Fed) may be approaching the end of its hiking cycle due to growing risks of recession, the two-year Treasury yield remains above 4% (4.24% on 7 December) as the Fed is still forecast to hike further at upcoming policy meetings. **We expect the US Treasury yield curve to invert further until the Fed signals a pause in its hiking cycle**, as usually the bulk of the steepening happens when the Fed cuts rates.

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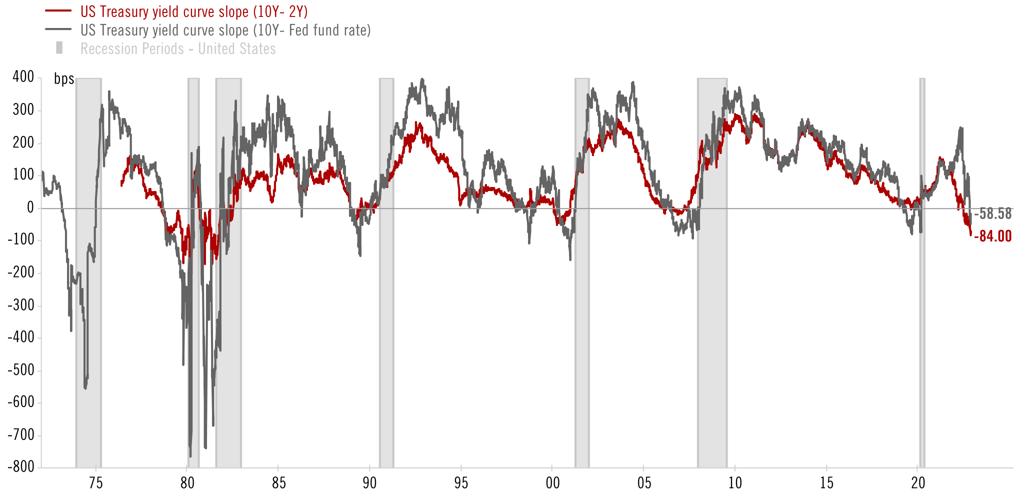
US TREASURIES SAFE-HAVEN STATUS IS SET FOR A COMEBACK

These growing risks of recession (recently accompanied by some softening in US economic data) and some early signs that US inflation has peaked have led market participants to reprice lower the expected terminal rates for both the Fed and the European Central Bank (ECB). We still expect the former to hike several times more to bring the Fed funds rate to a range between 5 and 5.25% in early 2023 (which is higher than current market expectations on 7 December).

Chart 3: Slope of the US Treasury yield curve



Source: Pictet Wealth Management, FactSet, 07.12.2022

The Fed's continued hawkishness going into next year due to the stickiness of US inflation and **the robust employment market is likely to maintain some upward pressure on the 10-year US Treasury yield from current levels** (3.42% on 7 December) **in the months of 2023**. Nevertheless, with lower US Treasuries Notes and Bonds issuances in 2023 (due to a divided Congress and more T-Bills issuances, *see chart 4*) combined with recession risks, **we see the 10-year yield ending 2023 at around 3.5%, with occasional rallies towards 3% during the year** (*see chart 1*). Due to their safe-haven status, we expect US Treasuries to benefit from any market turmoil or worries around a recession, even if the Fed does not cut its policy rate.

Similar to 2022, **2023 is likely to prove a volatile year for fixed income, and we expect the 10-year US Treasury yield to hover between 3% and 4% during the year**, torn between Fed hawkishness and sticky inflation on one side and slowing growth and potential financial market turmoil on the other. Although we position tactically on long-dated US Treasuries, **we have decided to move from neutral to overweight on US Treasuries in order to benefit from their safe-haven status**.

BUND'S SAFE-HAVEN STATUS IS IN QUESTION

The 10-year German Bund historically has also been a safe-haven asset. However, we remain neutral on core euro government bonds, as we expect still elevated inflation in Europe next year (5.3% on average) and substantial net issuance by the German government to finance large-scale fiscal spending to counter the

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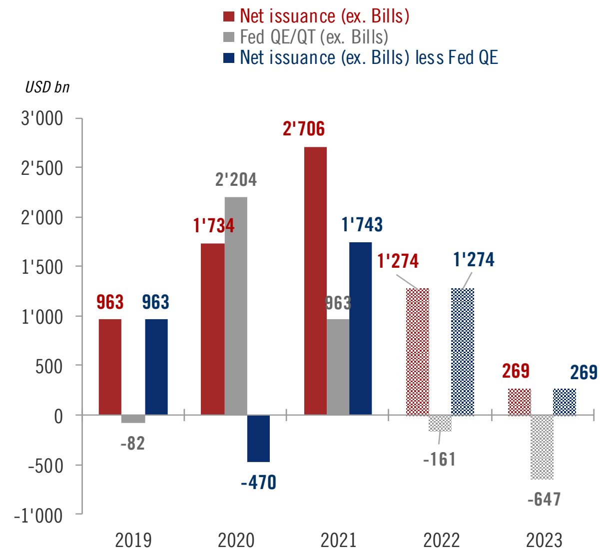
surge in energy cost. **This surge in fiscal spending is likely to coincide with a reduced ECB presence in the euro government bond market**, as we expect the ECB to follow the Fed's footprint in Q2 2023 by announcing the quantitative tightening of its Asset Purchase Programme (APP) by letting a portion of both its corporate and sovereign bonds holdings mature without reinvestments. As such, we forecast net issuance of euro government bonds less ECB's quantitative easing (QE) purchases to reach EUR500 bn – levels not seen in years.

On the inflation front, the peak is likely to be reached in Q4 this year, but the fall in the inflation rate could be slow due to labour and energy cost pressures. This is also what is expected by market participants, as shown by the inverted euro inflation swap curve, whereas in the US the inflation swap curve is mostly flat as they expect US inflation to fall faster in the coming months (*see chart 2*). **This elevated and sticky inflation is likely to force the ECB to keep hiking rates**, probably until the deposit rate reaches 2.5% (slightly below the current market pricing of a terminal rate at 2.8% on 7 December) **and to maintain them there even in the event of a recession in the euro area**.

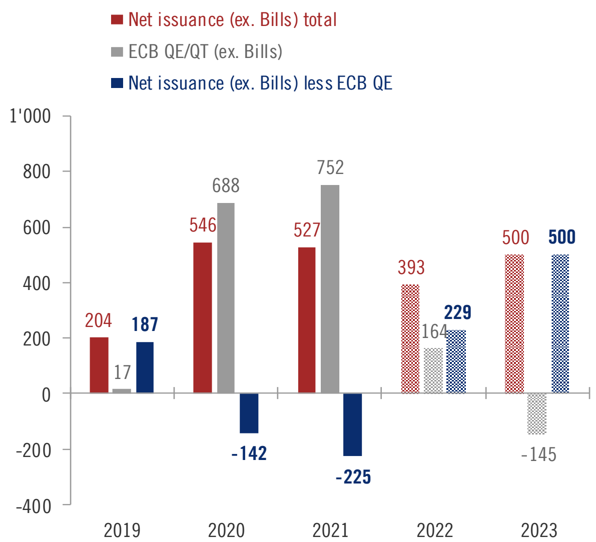
As such, despite our expectations for a recession in the euro area, **we expect the 10-year German Bund yield to rise towards 2.1% by end-2023 on the back of substantial fiscal stimulus and sticky inflation.** These two factors are likely to lead to the build-up of a higher inflation risk premium. This means that we expect the yield differential with the 10-year US Treasury yield to narrow from 164 bps (on 7 December) to 140 bps by the end of next year. And although we consider the Bund's safe-haven status to be questionable in this new environment, we foresee a range between 1.5% and 2.5%, as its yield could still fall shortly on the back of recession fears, only to go up again due to the significant headwinds that are large net issuances and elevated inflation.

Chart 4: Past and forecasted US Treasuries net issuances and Fed's impact



Source: Pictet Wealth Management, Securities Industry and Financial Markets Association (SIFMA), US Federal Reserve of New York, own estimates, 31.10.2022

Chart 5: Past and forecasted euro government bonds yearly net issuances



Source: Pictet Wealth Management, ECB, National Treasuries, own estimates, 31.10.2022

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