CORE SOVEREIGN BOND YIELDS - UPDATE

CLOSE TO A PEAK?

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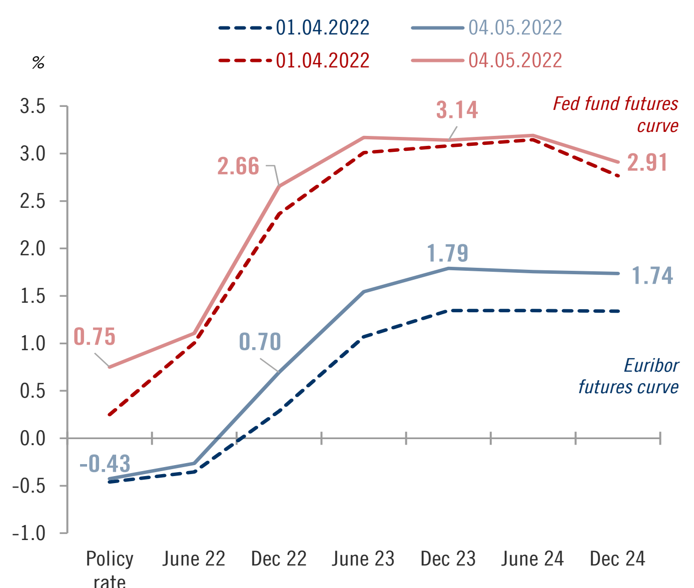
SUMMARY

- Since the beginning of the year, the continued acceleration of inflation has led central banks to sound increasingly hawkish, driving the yield on the 10-year US Treasury up sharply to 2.92% and on its German Bund equivalent to 1.01%. This has triggered one of the worst year-to-date total return performances ever, at -11.3% for the 10-year US Treasury and -11.0% for the Bund on 4 May (in local currency).
- The main driver of the rise in long-dated rates has been the market's repricing of the terminal rate. Looking at futures curves, the market expects the fed fund rate to peak at 3.2% in 2023 and the European Central Bank (ECB)'s deposit rate to peak at 1.8% (on 4 May). Both these figures are above the central banks' own terminal rates estimates and our forecasts.
- After peaking at around 3%, our central scenario (to which we ascribe 55% probability) is for the US 10-year yield to fall toward 2.6% in H2 as slowing inflation leads the US Federal Reserve (Fed) to tone down its hawkish rhetoric, and a slowdown in economic growth triggers a pause in its rate-hiking cycle.
- Although the 10-year German inflation breakeven rate has shot up recently, we expect it to drop again in H2 as inflation falls. Our central scenario is for a 10-year Bund yield of 0.6% at year's end after a short-term peak of around 1%.
- In alternative scenarios, we could see 10-year US and German yields rising to 3.0% and 1.2%, respectively at year's end, if economic growth holds up well, or falling to 2.0% and 0.2%, respectively, should recessionary fears rise.

CHART 1: US AND GERMAN 10-YEAR SOVEREIGN BOND YIELDS

Source: Pictet's wealth management division -AA&MR, Factset, 04.05.2022

CHART 2: US AND EURO POLICY RATE CURVES, FUTURES PRICING



Source: Pictet's wealth management division - AA&MR, Bloomberg Finance LP, 04.05.2022

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A limit to central banks' hawkishness?

Since the beginning of the year, further increases in inflation have led central banks to adopt increasingly hawkish rhetoric. Investors are wondering when will the resultant bloodbath in fixed income end. **Having risen to 2.92% and 1.01%, respectively, 10-year US Treasuries and German Bunds have delivered some of their worst year-to-date total return performances in history** (at -11.3% and -11.0% on 4 May, *see chart 1*).

Markets are currently pricing cumulative rate hikes of 192 bps in the US and 87 bps in the euro area by end-2022 (*see chart 2*). More important are the terminal rates being priced in by market participants, which are driving long-dated rates in particular. Based on futures curves, **the market sees both the Fed fund rates and the ECB's deposit rate peaking in 2023, at 3.2% and 1.8%**, respectively (on 4 May). Although both curves flatten slightly beyond 2023, it is still striking that market participants seem to anticipate terminal rates higher than the Fed's and ECB's official estimates of 2.4% and 1%-1.5%, respectively.

The Fed's 2.4% terminal rate can be derived from the Federal Open Market Committee (FOMC) longer-run projections (as seen in its median dot plot), even though the FOMC expects to hike rates to as high as 2.8% by December 2023 (*see chart 3*). In the past**, the Fed's terminal rate has proved to be a reliable anchor for the 10-year US Treasury yield.** Historically, when bond yields rise rapidly, market participants generally end up aligning their estimate for the terminal rate (using the 5yr/5 yr forward US Treasury as a proxy) with that of the Fed.

This year is proving no different, with market pricing of the terminal rate peaking at 2.99% on 4 May, and the US 10-year yield following closely behind. As such, **the key question now for US Treasury yields is whether the FOMC will revise higher its own projections for the terminal rate** and for the Fed fund in 2023 when it releases new 'dot plot' projections in June. Unless there is a revision higher, we continue to believe that the Fed's current terminal rate should be a reliable anchor for the US 10-year Treasury yield in the medium term.

Propped up by market participants' expectations of aggressive Fed rate hikes, the US 10-year yield could remain around 3% in the short term. However, Fed Chairman Jerome Powell seemed to dampen those expectations on 4 May by stating that the FOMC was not actively considering 75 bp rate hikes. At this stage, our central scenario (to which we assign a 55% probability) is for the 10-year US Treasury yield to fall from around 3% toward 2.6% in H2 as slowing inflation leads the Fed to dial back on hawkish rhetoric. After one further 50 bp hike in June, we expect the Fed to opt for a smaller rate increase in July and then to mark a pause as it assesses the risk of a sharp slowdown in economic growth and a further sell-off in risk assets.

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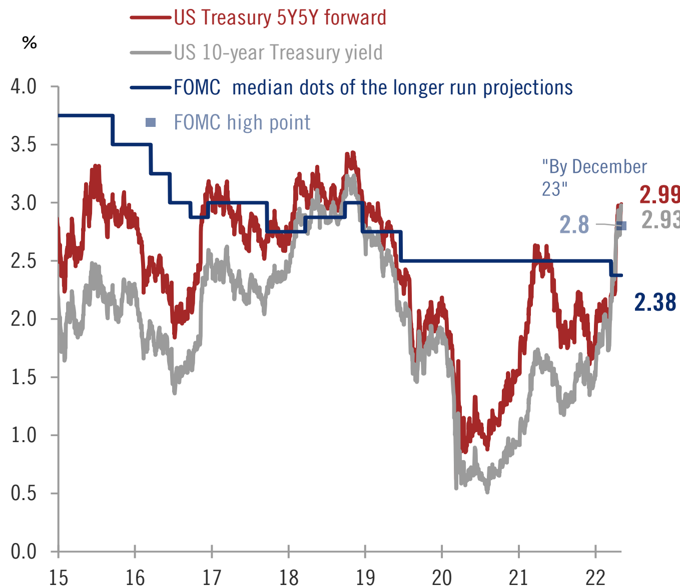
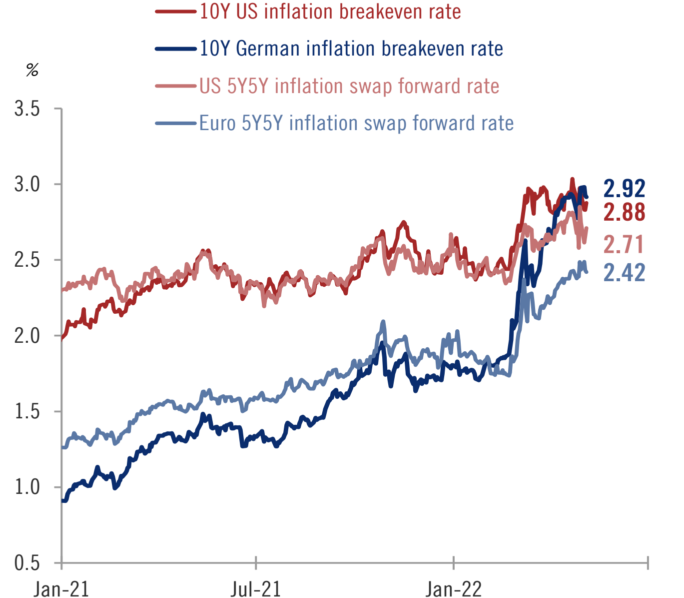
CHART 3 : US TREASURY YIELD AND FED'S TERMINAL RATE



Source: Pictet's wealth management division - AA&MR, Bloomberg Finance LP., 04.05.2022

CHART 4: US AND EURO LONG-TERM INFLATION EXPECTATIONS



Source: Pictet's wealth management division - AA&MR, Bloomberg Finance LP., 04.05.2022

After a step-down to a +25bp hike in July (but with a high risk for +50 bps), our US economist expects a long pause before the Fed potentially resumes hiking in 2023 (see Fed looks vaguely into the future). **This would mean an effective Fed fund rate at 1.63% at the end of this year, or about 100 bp lower than current market pricing (on 4 May). This is key to our expectation for a drop in the 10-year yield in H2.**

Nevertheless, we recognise t**here is a risk that the Fed does not actually pause its rate hikes** if wage growth and inflation remain elevated. Under this alternative scenario (to which we assign a 45% probability) **we could see the 10-year yield move above or below our 2.6% year-end forecast, depending on how the US economy holds up**. The 10-year yield could end the year at 3.0% if recession is avoided and peak closer to 3.5% in the short-term, but fall to 2.0% if aggressive rate hikes trigger fears of a recession in 2023.

Will the peak in inflation equal a peak in rates?

The outlook for Bunds is similar to the one for US Treasuries. As with the Fed, we think ECB rate hikes will come in lower than current market expectations. We see the ECB hiking twice by 25 bp this year, starting in September (although there is a risk of three hikes, starting in July), and bringing the deposit rate back up to 1.0% next year (whereas market participants were pricing in an end-2023 deposit rate of 1.8% on 4 May). **We expect the ECB to hike the deposit rate close to its terminal rate projection of 1%-1.5% over time**. But we see limited risk of the deposit rate overshooting it, as the market currently expects, because the euro area economy is in a very different situation than the US.

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First, the European economy is much more vulnerable to the rise in commodity prices as well as to the risk of an energy shortage and of a sharp slowdown in China. Depending on how the situation evolves, all of these factors could trigger a slowdown in the euro area economy, or even push it into recession. Second, we believe that the recent increase in European inflation is predominantly driven by the surge in commodity prices rather than excess demand whereas the risk of a wage-price spiral is lower than in the US, despite a falling unemployment rate.

The recent sharp rise of the 10-year Bund yield to 1% was mostly linked to a surge in market-based inflation expectations, with the 10-year inflation breakeven rate moving to 2.92% on 4 May, above its US counterpart for the first time since 2009 (*see graph 4*). This means that inflation-linked (IL) bond yields remain deeply negative in Germany, with the 10-year IL at –2.06%, while it has become slightly positive for 10-year Treasury Inflation-Protected Securities (TIPS), at 0.05% (on 4 May).

The divergence between the factors driving the US 10-year Treasury yield higher (a rise in TIPS yields) and its Bund equivalent (a higher inflation breakeven rate) owe much to differences in the macroeconomic backdrop, in our view. Inflationary pressure is likely to remain high in the euro area as long as commodity prices keep rising—something over which the ECB has little influence. In the words of ECB president Christine Lagarde, “if I raise interest rates today, it is not going to bring the price of energy down.”

This means **inflation expectations could stay high in the euro area until alternatives to Russian energy supplies are found or until the economy slows down sharply**. But in our central scenario (to which we ascribe 55% probability), **we still expect the 10-year inflation breakeven to moderate in H2 as inflation falls, justifying our forecast of a 10-year Bund yield of 0.6% by year’s end after a short-term peak of around 1%.** In alternative scenarios, the Bund yield could rise to 1.2% if the euro area economy holds up well or fall to 0.2% if a recession leads the ECB to postpone rate hikes.

As inflationary pressures in the US are in part linked to excess consumer demand and rising housing prices, the Fed is better placed to cool them down through monetary tightening (for example, the 200 bps rise in the 30-year mortgage rate since the beginning of the year is already impacting the demand for home loans). Moreover, US growth seems more resistant to the rise in commodity prices (in part due to the large excess saving accumulated thanks to past fiscal stimulus) and to China’s GDP slowdown. This probably explains why the US 10-year inflation breakeven rate has stabilised at around 3% since mid-March.

The Fed and ECB are still likely to keep large government bond portfolios

The Fed’s resolve to hike swiftly and reduce the size of its balance sheet (through passive quantitative tightening, QT) in a bid to control inflation as well as the continued resilience of the US economy are probably behind the sharp rise into positive territory of the of the 10-year TIPS yield.

Although we believe that the hints of a start to ‘passive’ QT (with a cap on non-reinvestments of maturing US Treasuries and mortgage backed securities (MBS)) **contained in the March FOMC minutes partially explain the sharp increase in TIPS**

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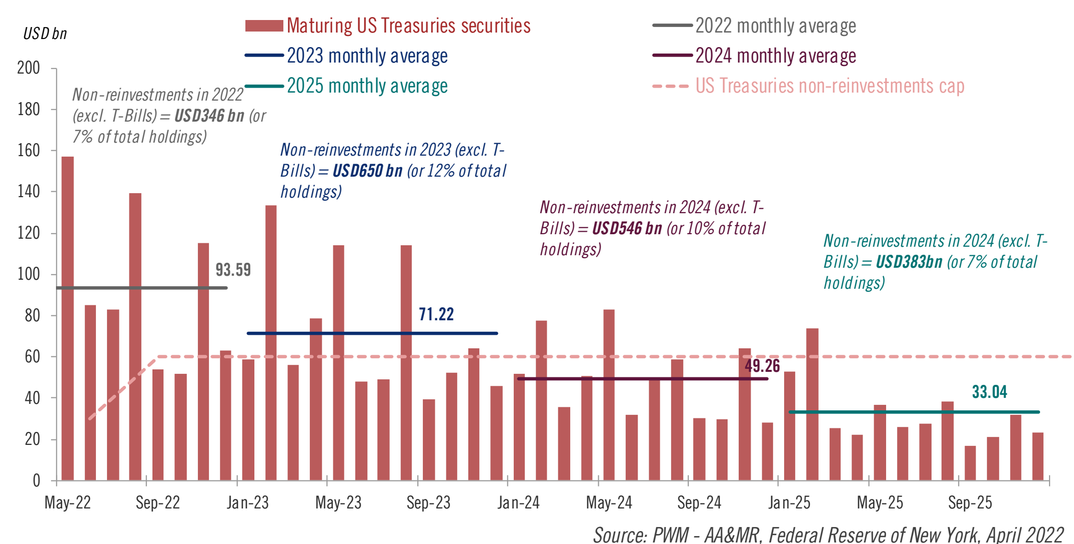
yields, the actual announcement of a start to QT made on 4 May reinforces our belief that **the reduction of the Fed's US Treasuries holdings will be slow**. A cap of USD60 bn per month on QT from end-August onward amounts to a reduction of only 7% of the Fed's Treasury holdings (excluding Treasury bills) in 2022, with the run-off increasing to a maximum of 12% in 2023, according to our estimates (*see chart 5*). Assuming its balance-sheet reduction proceeds smoothly, **the Fed could have a US Treasuries portfolio of about USD3,000 bn at end-2025 compared with USD5,300 bn today**.

CHART 5: MATURING US TREASURIES HELD BY THE FED AND NON-REINVESTMENTS CAPS



Source: PWM - AA&MR, Federal Reserve of New York, April 2022

Coupled with fewer Fed's rate hikes than the market is currently pricing, a slowdown in the US economy in H2 and a core inflation rate that remains above the Fed's 2% average inflation target for some time (feeding retail investors' interest in inflation-hedge instruments), we expect the 10-year TIPS to fall back to -0.3% by year's end.

We see the German 10-year IL yield at -1.8% by year' end, slightly higher than its current level (of -2.06% on 4 May), mostly because we believe the ECB will end its quantitative easing (QE) purchases in June and inflation will slow in H2. **However, we expect the ECB to fully reinvest its maturing bonds. We see the risk of QT as very remote in the euro area given the recent widening in euro periphery sovereign bond spreads over Bunds.** Reinvestment of the ECB's bond holdings could be one way for the ECB to address concerns over fragmentation as a result of this widening. Hence, the ECB is likely to hold onto its EUR3300 bn of euro area government bond holdings for years to come.

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