PICTET WEALTH MANAGEMENT

Core sovereign bonds - update

Bonds' rollercoaster ride may not be over yet

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SUMMARY

- Bond market volatility returned with a bang in March. Market participants repriced forecasts for the path of central banks' policy rates sharply lower as failures among US regional banks brought home the fragilities caused by the rapid increase in rates over the past year. The two-year US Treasury yield fell from a peak of 5.06% on 8 March to a low of 3.76% on 5 April.
- These sharp whipsaws in yields are signs of market uneasiness about the state of the US economy. Although US households have been holding up so far, specific sectors like real estate (as well as regional banks) face real challenges. Even if US Treasury and other core sovereign bond yields (they remain tightly correlated) could rebound in the coming weeks due to stabilisation in the banking sector, our year-end forecast of 3.5% for the US 10-year US Treasury yield and 2.5% for its German counterpart still faces downside risk.
- In view of the US's uncertain economic prospects, we have been extending duration to maturities in the 7-10 year range within our overweighting of US Treasuries in general. However, stickier core inflation in the euro area means we remain neutral on core euro sovereign bonds. Nevertheless, we would expect core long-dated yields to fall in the event of a more severe-than-expected US recession that hurts risk sentiment.

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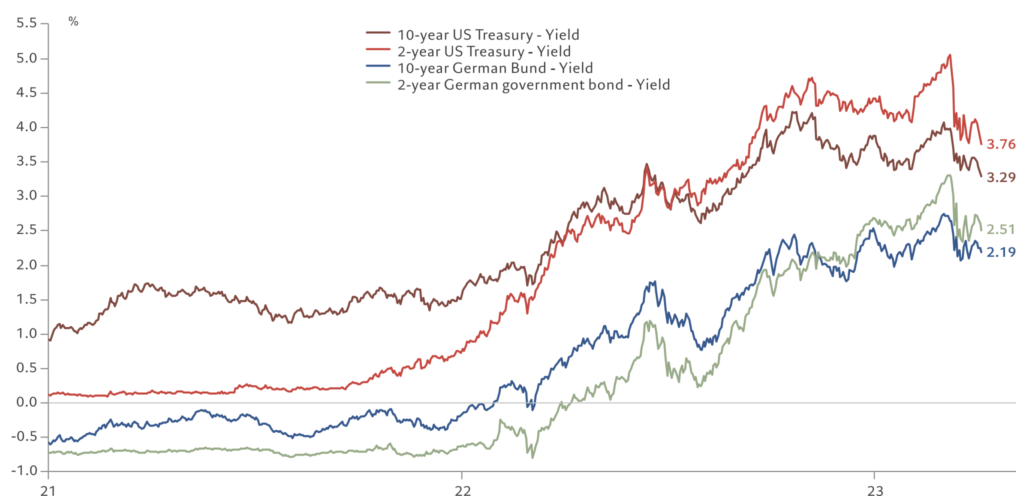
Chart 1: US and German 10- and two-year sovereign bond yields



Source: Pictet Wealth Management, FactSet, as of 05.04.2023

A CREDIT SQUEEZE COULD MAKE CENTRAL BANKS' JOB IN THEIR PLACE

Bond market volatility was back with a bang in March, with the ICE Bank of America (BofA) MOVE index (which tracks US Treasuries' implied volatility) surging to highs not seen since March 2020. **The rally was more pronounced on short-term rates as market participants repriced forecasts for the path of central banks' policy rates sharply lower**. The failures among US regional banks last month exposed the fragilities caused by the rapid increase in rates over the past year and raised the likelihood that US banks would continue to tighten their lending conditions. **Together with the US Federal Reserve (Fed)'s rate hikes, tighter lending conditions are likely to cool down the US economy as well as inflation.**

Hence, the two-year US Treasury yield fell from a peak of 5.06% on 8 March to a low of 3.76% (on 5 April). Futures markets see a 50-50 possibility of an additional 25 bp Fed rate hike in May but are pricing more than three 25 bps rate cuts by the end of this year. For our part, **our central scenario is that the Fed will not raise rates in May but that it will not cut rates this year either**. This is mostly because we see core Personal Consumption Expenditures (PCE) inflation in the US remaining well above the Fed's 2% target throughout this year (see our note here). If our central scenario plays out (we assign a 55% probability to it), then market anticipations for rate cuts this year are premature, opening up the possibility for the two-year US Treasury yield to rebound to slightly above 4% by year's end. **But we believe the 10-year yield could remain within its recent 3-4% range. We are therefore sticking with our year-end forecast of 3.5% for the 10-year US Treasury** yield (*see chart 1*).

Market forecasts for the European Central Bank (ECB) are more aligned with our central scenario of two additional rate hikes of 25 bps by end-June. These would bring the deposit rate to 3.5% where we project it to stay for the rest of 2023 (although on 5 April market pricing was suggesting a slight risk of rate cuts by year-end).

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BALANCE SHEET EXPANSION AS CENTRAL BANKS' FIRST FIRE EXTINGUISHER

In the wake of the failures of three US regional banks in March, the creation of the Fed's Bank Term Funding Program (BTFP) to provide loans of up to one year to US banks in exchange for eligible collaterals[1] valued at par epitomise the approach that central banks are taking to tackle fragilities in the banking system. In short, **both the Fed and the ECB are ready to provide liquidity to banks and address financial stability risks by expanding their balance sheets**. But at the same time, **they have been signalling that they intend to keep monetary policy tight** (through elevated policy rates and quantitative tightening (QT, i.e. passively reducing their securities holdings)), as long as inflation shows no signs of returning to their 2% target over the medium term.

Sure enough, t**he Fed's balance sheet increased again by USD364 bn between 10 and 31 March, basically erasing more than half of the decline since QT was launched in May 2022** (*see chart 2*). Banks using the BTFP accounted for USD64 bn of this increase, while banks' usage of the Fed's discount window (where much broader collateral is accepted, but at market value) accounted for another USD88 bn.

The ECB's balance sheet has declined by over EUR1,000 bn since November 2022. Initially, this was due to the reimbursement of past targeted longer-term refinancing operations (TLTROs, with one more tranche of EUR478 bn due to be reimbursed by June) and more lately because of the launch of QT. But in a move that would be similar to the Fed's, **the ECB could launch new TLTROs to address banks' liquidity needs or it could purchase sovereign bonds again through its Transmission Protection Instrument (TPI) if monetary transmission were strongly impaired.**

Banks are often large holders of domestic sovereign bonds (US banks owned USD1,389 bn of US Treasuries in Q4 2022, 6% of the total outstanding, and Italian banks EUR411 bn of Italian sovereign bonds, 15% of the total outstanding), as these require them to hold less capital than riskier securities. Hence, by inviting US banks to park their US Treasuries at par at the Fed in exchange for cash, **the Fed is probably not only reducing the risk of fire-sales on US Treasuries but could actually encourage US banks to buy more.**

As such, even if there are no signs (yet) that either the Fed or the ECB is considering halting their QT programmes, **signals of their readiness to expand their balance sheets if needed could limit the risk of a repeat of the sharp 2022 sell-off of bonds.** Moreover, while core inflation is still too elevated and sticky for central banks' comfort, **the well-known lagged effect of rate hikes makes us confident that core price increases will slow sufficiently in the coming months on both sides of the Atlantic to provoke a pause** in what has been an unprecedently rapid rate-hiking cycle.

[1] Eligible collaterals comprise mostly of US Treasuries, agency Mortgage-Backed Securities (MBS) or Federal Agency debt.

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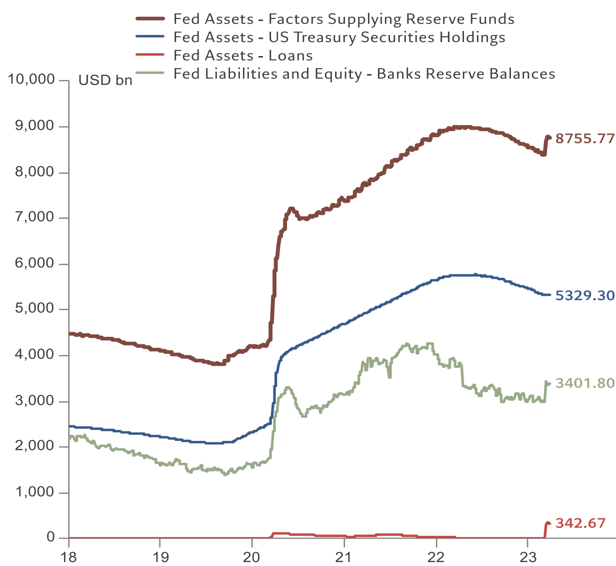
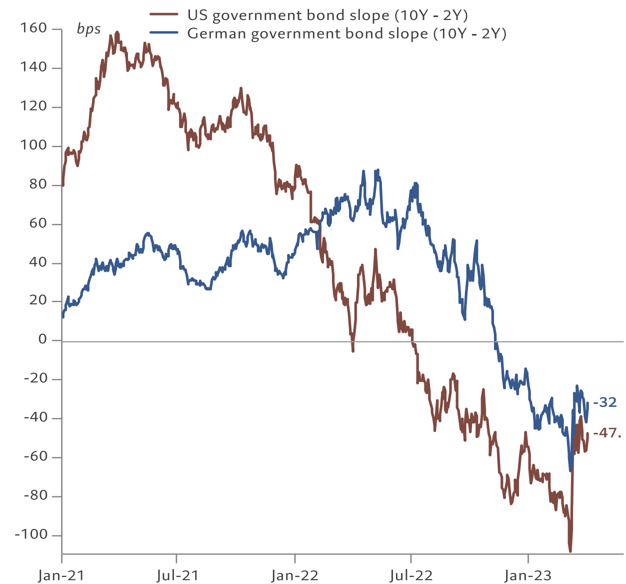
Chart 2: Fed's balance sheet



Source: Pictet Wealth Management, FactSet, as of 05.04.2023

Chart 3: US and German sovereign yield curve slope



Source: Pictet Wealth Management, FactSet, as of 05.04.2023

RATE CUTS AS A LAST RESORT

Although we believe that the Fed's recent liquidity accommodation and its full guarantee of the three failed banks' deposits may lower the likelihood of a full-blown credit crunch (a complete halt of banks' and capital markets' lending to the real economy), **we still foresee a credit squeeze** (a slowdown in lending). Nevertheless, in the event of a credit crunch and/or a more severe-than-expected US recession (a negative scenario to which we assign a 40% probability)**, the Fed is very likely to go for rate cuts and probably for more than what was being priced in** by market participants on 5 April. That **could trigger a further rally in US Treasury yields and a further steepening of the slope of the yield curve** (*see chart 3*).

In our negative scenario we foresee the US Treasury yield curve ending the year flat, with both the two- and 10-year yields at 3.0%. However, due to the safe-haven status of the 10-year bond, we could well see its yield dipping below 3% if markets participants rush for safe assets due to market turmoil, only rebounding towards 3% if, as we suspect, a recession is not enough to bring US core inflation back to 2%. In view of the **US's uncertain economic prospects, we have been extending duration to maturities in the 7-10 year range within our overweighting of US Treasuries** in general. Both the safe-haven status and higher interest rate sensitivity of long-dated US Treasuries could help them protect portfolios in the event of a credit crunch.

However, **stickier core inflation in the euro area means we are maintaining our neutral stance on core euro area government bonds**. Although market turmoil is usually global, **we see less likelihood for ECB rate cuts**. This could limit the downside for the 10-year German Bund yield (probably to slightly below 2% from 2.2% on 5 April) and as such the potential protection provided by long-dated core euro sovereign bonds.

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