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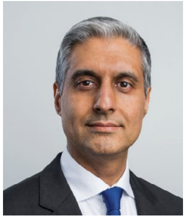
Volatility in sovereign bonds: what comes next?

A combination of softer-than-expected US data and an unprecedented fiscal package in Germany have flipped around growth expectations for the US and Europe. Where are the potential opportunities in this environment?

It has been a volatile start to 2025 for sovereign fixed income markets. After an initial bout of optimism on the US economic outlook, recent softer-than-expected US activity data and uncertainty around US economic policy – mainly on trade and fiscal policy – has resulted in a reappraisal of some of the more bullish investor sentiment priced into US asset markets.



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Key takeaways

- While 10-year US Treasury yields have fallen since the start of the year, in early March 10-year Bund yields saw their largest one day jump since German reunification.
- The spread between 10-year Treasuries and Bunds fell to its the lowest level since mid-2023, while euro investment grade credit and European equities outperformed their US counterparts year-to-date.
- We think this environment favours yield curve steepening trades in both the US and Germany, a yield curve flattening trade in Japan, and long interest rate positions in markets such as the UK, Australia and Norway.

Although the US Federal Reserve has signalled a more cautious approach towards additional policy easing, given the uncertainties on the economic and government policy outlook, short-term interest rate markets are now pricing nearly three Fed rate cuts in 2025, versus barely one priced at the start of the year. Having hit 4.80% in January, 10-year US Treasury yields are back at 4.30%.

It has been a different story in Europe. At the start of this year, the market consensus was for another anemic year for the euro area economy, with economic growth expected to be only fractionally higher than the 0.7% sub-trend growth achieved in 2024. However, the recent escalation of tensions between the US and Europe on security and trade policy have upended expectations about the future path of European fiscal policy. In fact, following the outcome of the German election, the likely CDU/CSU-SPD coalition announced an agreement to pass an unprecedented fiscal package that includes higher public spending on defence and infrastructure. As a consequence, market sentiment has materially shifted on future European economic growth prospects. At the start of this month, 10-year German Bund yields saw their largest one day jump since German reunification, rising to 2.85%. The fiscal news also reduced the pressure on the European Central Bank to cut rates below a perceived 2% neutral rate in this cycle.

The recalibration in future economic growth and policy expectations between the US and Europe can be seen in the spread between 10-year US Treasuries and Bunds. This has dramatically narrowed from close to 230 basis points at the end of 2024 to just 145 today – the lowest level since mid-2023. Meanwhile, euro investment grade credit and European equities have outperformed their US counterparts year-to-date.

It is not just Europe that is recalibrating economic policy. China is also shifting its economic focus from investment-led to consumption-led growth. We think these global shifts in monetary and fiscal policy expectations could be the start of a more structural medium-term trend for financial markets, involving a long overdue rebalancing of global trade imbalances. That could result in the US no longer being the consumer of last resort – and the US dollar's reserve currency status increasingly being questioned.

How do we navigate these cyclical and structural trends?

From a portfolio strategy perspective, there is scope for divergence in global bond markets, increasing the potential for relative value opportunities.

- **Confidence in steepening trade** – We think this environment favours yield curve steepeners in both the US and Germany. We increased our US yield curve steepening positioning in February, adding a five-year versus 30-year steepener in addition to an existing seven-year versus 30-year position. We also added back a German five-year versus 30-year steepener given the prospect of increased fiscal spending in Europe. To balance the steepening expression, we favour a Japanese seven-year versus 30-year flattener as we believe the Bank of Japan is on a path towards monetary policy normalisation as inflation pressures build in the economy.

- **Tactical approach to duration** – Bond market volatility may well remain elevated through 2025, so we think it's also a good idea to tactically trade duration. We continue to maintain a long interest rate duration stance in markets such as the UK, Australia and Norway. In the UK, we think the macroeconomic outlook, Bank of England policy pricing and Gilt valuations present an attractive outlook for Gilts, both on an outright basis, and cross market versus Bunds and Canadian rates – markets in which a lot of rate cuts are already in the price. We hold a tactical short US duration position, but with a bias to exit this position if we see growing evidence of a weakening US economic outlook. In the short term, we opted to take profit on our 10-year US Treasury Inflation-Protected Securities (TIPS) exposure in February, as the 10-year US break-even inflation rate hit our target level of 250 basis points.

- **Yen and Australian dollar in favour** – In currency markets, we have implemented two new strategies to reflect the policy shifts in both Japan and the US – a long Japanese yen position (currently versus the Thai baht) and a long Australian dollar position (versus the US dollar). Ongoing pressure on the Bank of Japan to normalise monetary policy, stable front-end US rates and attractive yen valuations favour a long yen expression. The long Australian dollar versus US dollar position represents a first step into our more thematic view of waning support for the US dollar ahead.

- **Selective approach in credit and EM debt** – In spread product, investment grade credit is pricing fair to rich, but we retain a modest overweight in global investment grade corporates, as well as euro sovereign spreads (via 30-year Spanish bonds). In emerging markets (EM), many economies are showing resilience in the face of the market volatility. We think valuations in EM are attractive following some recent spread widening versus US investment grade credit. In addition, EM local rates and foreign currency markets have been well bid given the diminishing US growth outperformance versus the rest of the world, and consequent US dollar underperformance. We continue to favour a selective approach to EM risk in portfolios.

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