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MARKET *view*

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The rise in bond yields leads to new opportunities for investors

> *"While sovereign debts could be considered "safe havens" given past central bank support, they currently carry more risk than Credit. This shift in risk perception is reflected in relatively stable credit spreads despite rising rates."*

What caused the increase in yields?

Yields on Treasury bonds have reached a new high in more than a decade. Borrowing costs for U.S. 10-year government bonds have surged from 3.7 percent in mid-July to over 4.8 percent this week. 10-year yields in Germany surged from 2.2 percent to 2.9 percent and in Italy from 4.0 percent to 4.9 percent over the same period. There are several reasons explaining the recent increase in yields: central bank policies, economic growth and strong labor markets, inflation expectations, and term premia.

1. Central bank policies: On September 20, 2023, the Fed did not raise interest rates but made crystal clear that rates will most likely stay higher for longer:"… the most important question at this point is not whether an additional rate increase is needed this year or not, but rather how long we will need to hold rates at a sufficiently restrictive level to achieve our goals …" (Fed Vice Chair for Supervision Michael Barr). Christine Lagarde also argued that interest rates will stay high "as long as necessary" to fight inflation. Market participants are now realizing that interest rates will most likely remain "higher for longer" which drives borrowing costs even higher.

2. Economic growth and strong labor markets: The economic resilience and the persistent strength in the labor market are another reason for the increase in yields.

Nonfarm payrolls in the U.S. increased by 336,000 jobs last month, much stronger than expected. The U.S. economy is too resilient 18 months after the Fed started to increase interest rates. The time-lag between the first interest rate hike and a slow-down in the economy is usually between 12 and 18 months. It seems that the economies both in the U.S. and in Europe adjust this time much slower to rising interest rates which supports the higher for longer narrative. As economic growth is still strong and labor markets tight, central banks have to keep interest rates high to cool down demand for goods and services which will cause inflation to fall.

3. Inflation expectations: Inflation expectations are an important driver for future inflation rates. In a recent study, Albrizio and Bluedorn (2023) argue that inflation in advanced economies surges by 0.8 percentage points for each 1 percentage point increase in near-term expectations.

Forward inflation rates are now higher than average historical inflation expectations both over the near-term and the long-term.

While headline inflation rates are coming down, core inflation – which excludes the more volatile prices on food and energy - is still more than twice as high as the 2% inflation target of the ECB and the Fed. The surge in inflation expectations is one of several factors that bond yields are now at 16-year highs.

4. Term premia: Investors ask for a compensation for bearing the risk that interest rates may change over the life of a bond. This compensation is referred to as "term premium". The term premium for 10-year treasuries has increased not only as investors assume that central banks will keep interest rates higher for longer but also as governments announced that they will issue more debt to finance growing deficits. The dysfunctional debate in the U.S. over congressional spending and a possible default does not increase investor confidence. But the U.S. is not the only sinner. While the debt-to GDP-ratio in Italy already exceeds 140 percent, Giorgia Meloni's government has recently hiked its deficit targets. The increase in deficit targets threatens Italy's credit rating. As the scrutiny of rating agencies increases, the gap between the yields of Italian and German yields widened. If investors fear that countries may default or try to inflate away debt, governments have to pay investors higher yields to attract capital flows to finance the growing debt burden. Investors already started to demand a higher premium for holding longer-term maturity bonds as a compensation for increased risks.

What are the investment implications of the rise in bonds yields?

No Need to Hurry

A smooth landing of the economy is crucial to repositioning towards risky assets. To achieve this, the FED must adopt a more accommodative monetary policy, synonymous with interest rate cuts. However, recent events have reduced the chances of these preventive cuts, which are necessary to avoid a recession. Consequently, we remain convinced of the wisdom of underweighting global stocks compared to government bonds over the next 6 to 12 months. However, choosing the appropriate bonds remains a crucial question.

With a rate of 4.8% on 10-year US Treasury bonds, long-term yields have clearly exceeded reasonable estimates of nominal potential growth. Considering the current prediction of real potential growth in the United States, around 1.8%, and long-term inflation of 2.5%, the nominal yield on bonds should be around 4.3-4.5%. Furthermore, yields on 5-year Treasury bonds in 5 years now exceed the median nominal GDP growth of the last decade.

Positioning in 10-Year US Sovereign Bonds

In this context, we have chosen to increase the duration of our portfolios by investing in 10-year bonds. Although the yield curve is still slightly inverted, it is much less so than it was a few months ago, with the spread between 2-year and 10-year rates now only 30 basis points.

On the other hand, the German bond market is less attractive, with neutral nominal rates around 3.5%, considering potential growth of 1% and inflation of 2.5%. However, the risks of turbulence in European sovereign debts justify the current rates of 2.88% on 10-year German bonds.

Preferring Credit over Sovereign Bonds

This suggestion may seem paradoxical since default rates are expected to increase due to economic slowdown. However, over a one-year horizon, global default rate expectations from Moody's have recently been revised downward, from 4.9% to 4.3%. Moreover, many companies have strong balance sheets and still generate comfortable cash flows.

Make no mistake, small businesses may face difficulties in the coming months due to increased capital costs and the inability to repay state-guaranteed loans. However, the investment universe we consider is not limited to this sector of the economy. Unlike states, companies have not massively increased their debt during the COVID period. They appear to be more robust and better prepared to weather a potential moderate recession.

While sovereign debts could be considered "safe havens" given past central bank support, they currently carry more risk than Credit. This shift in risk perception is reflected in relatively stable credit spreads despite rising rates.

Preference for Short-Term High-Yield Credit

We recommend positioning in short-term high-yield bonds which offer a yield of 5.50% with an estimated lifespan of 1.6 years. Another possible option is to invest in "Investment Grade" bonds, offering both a marginal yield compared to anticipated inflation of 2% and the opportunity to benefit from a capital gain in case of a return to the sovereign rates average of 50 basis points.

When to Reposition in Stocks?

In this perspective, a 5 to 10% decline in stock indices would offer the opportunity to rebalance long-term portfolios, focusing on sectors and companies with attractive forward-looking ratios, such as LVMH at 20 times forward earnings.