PICTET 1805

PICTET WEALTH MANAGEMENT

We are more constructive on European government bonds

Risk asymmetry is skewed towards lower 10-year yields

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FLASH NOTE

SUMMARY

- European and US government bonds had rallied strongly from July until mid-September in anticipation of central banks cutting policy rates at a faster pace in the wake of falling inflation and a softening economic backdrop. As short-dated bond yields dropped more than longer-dated ones, the sovereign yield curves finally disinverted. Lower oil prices between July and early September had also contributed to the global fall in sovereign bond yields through lower inflation expectations, but the recent oil price surge on the back of escalating geopolitical tensions in the Middle East reversed this trend in early October. Moreover, market participants have recently revised higher their expected policy rate paths given the resilience of the US and UK economies and the announced Chinese stimulus, which could favourably impact the lacklustre German economy.
- After the big US Federal Reserve (Fed) rate cut in September and more dovish comments from the likes of the Swiss National Bank (SNB), the European Central Bank (ECB) and the Bank of England (BoE), we believe that the risk asymmetry is skewed towards lower 10-year European sovereign bond yields. But while all short-term rates have room to fall at least as far as central banks' terminal rates, the room for further compression of US long-term sovereign bond yields could be more limited given fiscal and political uncertainties.
- For this reason, we have moved back to neutral on US Treasuries in favour of long-term euro government bonds, where we are now overweight, along with UK gilts. Given the strength of the Swiss franc we now expect the SNB to become stimulative in the coming months, so we have moved from underweight to neutral on Swiss government bonds. We remain overweight government bonds overall, which could continue to play a protective role in portfolios in this disinflationary environment.

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AN OPPORTUNITISTIC REBOUND IN EUROPEAN BOND YIELDS

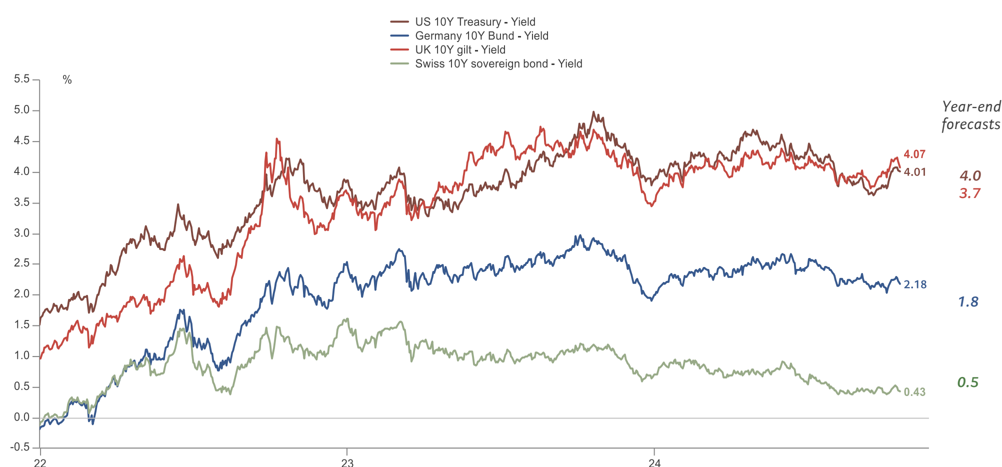
European and US government bonds had rallied strongly from July until mid-September in anticipation of central banks cutting policy rates at a faster pace in the wake of falling inflation and a softening economic backdrop (*see chart 1*). As short-dated bond yields dropped more than longer-dated ones, sovereign yield curves finally disinverted. Lower oil prices between July and early September had also contributed to the global fall in sovereign bond yields through lower inflation expectations, but the recent oil price surge on the back of escalating geopolitical tensions in the Middle East has reversed this trend. Moreover, market participants have revised higher their expected policy rate paths given the resilience of the US and UK economies and the announced Chinese stimulus, which could favourably impact the lacklustre German economy.

Looking beyond the surface of this recent global increase in sovereign bond yields, we see that regional divergences are nevertheless visible. Between 1 and 16 October, 10-year yields have risen by 28 bps in the US, 12 bps in the UK and 15 bps in Germany. As mentioned above, higher oil prices have pushed up inflation breakeven rates (i.e. markets' long-term inflation expectations) by around 10 bps.

However, the increase in inflation-linked sovereign bond yields (i.e. real yields) has been more significant in countries where economic growth is perceived as the strongest (*see chart 4*). During this period, the 10-year real yield rose by 20 bps in the US, 7 bps in the UK, and only 5 bps in Germany. This is explained by the fact that inflation-linked sovereign bond yields are primarily influenced by market participants' expectations for economic growth and policy rates.

The robustness of the US economy along with the Fed's credibility with regards to its inflation target of 2% also explain why real yields are much higher there (10-year real yield at 1.74% on 16 October) than in the UK or Germany (*see chart 4*). In the UK, the BoE's lack of credibility on inflation is what primarily accounts for low real yields (0.57% on the 10-year), while in Germany its tepid economic growth recovery since the Covid-19 outbreak justifies the very low, and recently falling, 10-year real yield (0.28% on 16 October, *see chart 4*).

Chart 1: 10-year sovereign bond yields have rebounded since mid-September



Source: Pictet Wealth Management, FactSet, 16.10.2024

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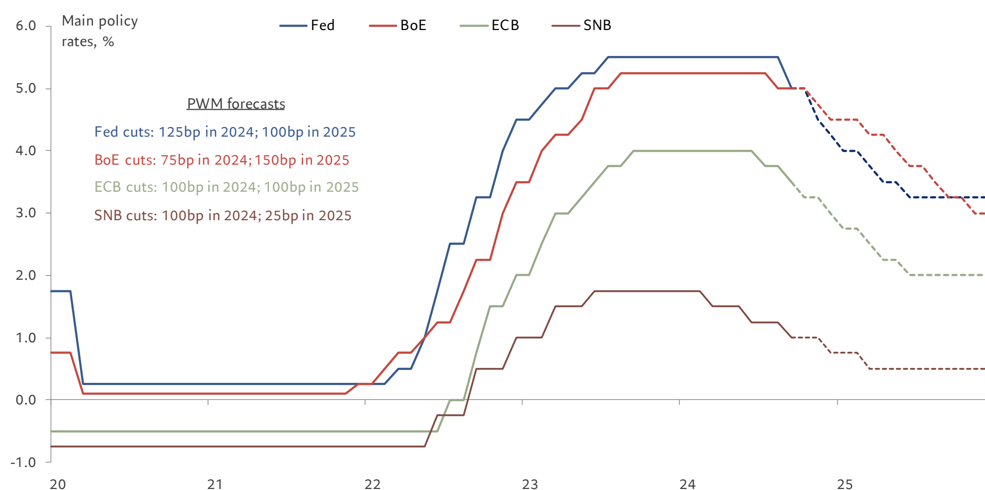
RISKS OF FASTER AND MORE AGRESSIVE MONETARY POLICY EASING

With September data pointing to weaker growth and inflation dynamics than the ECB staff projections, the Governing Council (GC) cut its key interest rates by 25 basis points on 17 October, as we expected, bringing the deposit facility rate (DFR) down to 3.25%. The October rate cut is thus the first back-to-back cut (the ECB also cut rates in September) and is likely to signal a pivot to a faster rate cut cycle, although ECB President Christine Lagarde has insisted that the bank will stick to a "meeting by meeting" and "data-dependent" approach.

Looking ahead, we expect the ECB to accelerate the easing of financing conditions and bring forward convergence to neutral (which we think is around 2%), with 25bp cuts at each GC meeting from now until June 2025. This implies another 25bp cut in December and a total of 100bp cuts in H1 2025 (*see chart 2*). We also see a risk that the ECB will have to cut rates even faster than we now forecast and possibly bring the DFR below its neutral level. The probability of the staff's inflation projections falling below target over the medium term has increased significantly, and the dynamics of growth, the labour market and inflation expectations will need to be monitored closely in this regard.

Chart 2: We expect policy rate cuts to continue into 2025



Source: Pictet Wealth Management, central banks, 11.10.2024

In Switzerland, the SNB cut its policy rate by 25bp to 1.0% in September. The SNB sounded increasingly concerned about the "significant" decline in inflationary pressures due to the appreciation of the Swiss franc opening the door for more rate cuts. While the strength of the Swiss franc was useful during the post-Covid inflation surge, it has now become a deflationary force that is difficult for the SNB to control. We now see at least two more 25bp rate cuts, one in December and one in March, bringing the policy rate to 0.5%. This would take the policy rate below neutral. Risks are tilted towards more easing in the event of further downside surprise to inflation or strength of the Swiss franc.

Inflationary pressures have been stickier in the UK, with core CPI standing at 3.2% year-over-year in September, compared to only 2.8% for the euro area, in part because UK services inflation remains elevated at 4.9% (versus 4.0% in the euro area).

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This has been fuelled by elevated wage growth (around 5% year-over-year), as both the labour market and economic growth in the UK are resilient. Despite lesser credibility from the BoE regarding price stability, we are confident that UK core inflation will continue to moderate. A key driver should be wage pressures continuing to soften. This could open the door to a more aggressive rate-cutting cycle for the BoE, up to 3% at the end of 2025, which is our estimated neutral rate for the UK.

WE ARE NOW OVERWEIGHT EURO GOVERNMENT BONDS

As mentioned above, the recent rebound in UK and euro 10-year sovereign bond yields was driven by a mix of market participants revising upward their central banks' terminal rate expectations, as well as their growth and inflation outlook. We see this rebound in yields as a good opportunity, because we expect them to fall in the coming months.

In the UK, market participants' expectations for a terminal rate of 3.5% is much higher than our forecast of 3.0% (*see chart 3*). Moreover, because of sticky core inflation and higher oil prices recently, the 10-year inflation breakeven rate remains well above its long-term median of 3.0% (3.5% on 16 October). Lower inflation expectations and a more aggressive BoE rate-cutting cycle than currently priced in should pave the way for lower gilt yields, which we think will fall to 3.7% by year-end on the 10-year, well below the 4.1% where it currently trades (on 16 October *see chart 1*).

The downside risks to the German economy and euro area inflation lead us to expect market participants to price in a stimulative monetary policy from the ECB, which would mean that the terminal rate pricing could fall well below 2% (the estimated neutral rate). Because market participants' terminal rate expectations currently stand close to 2% (1.9% on 16 October, *see chart 3*) and because inflation expectations could fall along with actual inflation, we have adjusted downward our 10-year German Bund yield year-end forecast from 2.0% to 1.8%, which is also well below its current level of 2.2% (on 16 October, *see chart 1*).

In Switzerland, market participants are already anticipating a stimulative monetary policy from the SNB, with terminal rate expectations at 0.25%, which is close to the zero lower bound (ZLB, on 16 October *see chart 3)*. Baring a flight-to-safety from market participants that would put strong pressure on the Swiss franc to appreciate, we think it is unlikely that the SNB will signal a willingness to go back to the ZLB. We therefore forecast the Swiss 10-year sovereign bond yield to end the year at 0.5%. This is close to its current level of 0.43% (on 16 October, *see chart 1*), but we do not rule out the possibility that it reaches 0%, should market participants expect the SNB policy rate to fall to the ZLB or beyond.

While we believe there is scope for the rally in global short-term bonds to go further before central banks reach their terminal rates, longer-term US Treasuries may have less mileage if the US economy does achieve a 'soft landing'. The forthcoming elections are another reason to turn more tactically neutral on US Treasuries. Not wishing to go beyond maturities of five years, we have therefore moved from a tactical overweight to a neutral stance on US government bonds.

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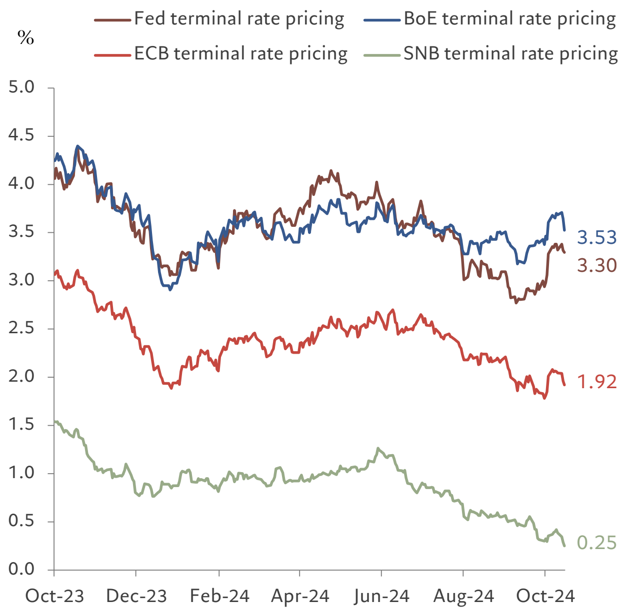
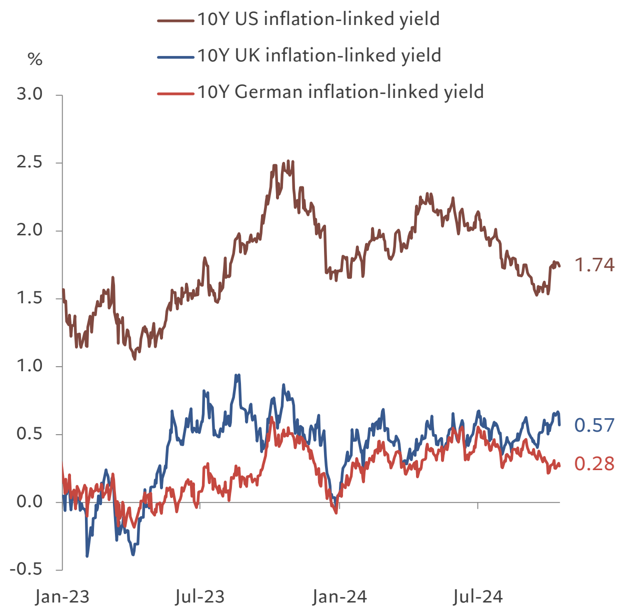
Chart 3: Terminal rate pricing has risen again



Source: Pictet Wealth Management, Bloomberg Finance, L.P., 16.10.2024

Chart 4: Inflation-linked yields show divergences



Source: Pictet Wealth Management, Bloomberg Finance, L.P., 16.10.2024

Our belief that both the BoE and the ECB will step up their rate-cutting campaign given fading inflation and economic sluggishness leads us to raise our position on core and periphery euro area bonds to overweight from neutral while reiterating our overweight on gilts. Moreover, the signalling of a stimulative monetary policy by the SNB has persuaded us to move from underweight to neutral on Swiss government bonds.

We remain overweight government bonds overall, which could continue to play a protective role in portfolios in this disinflationary environment.

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