PICTET 1805

PICTET WEALTH MANAGEMENT

# Core sovereign bonds - Update

## Upcoming rate cuts should boost bonds' appeal

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FLASH NOTE

### SUMMARY

- Ten-year core sovereign bond yields have fallen steeply this summer on the back of continued disinflation, an unwinding of carry trades and downside surprises in the US labour market. This has sharpened markets' focus on central banks' plans for monetary easing, particularly the pace of cuts and the terminal rate.
- The equity sell-off in early August showed that in a disinflationary environment core sovereign bonds have reassumed their protective role in portfolios. We also believe US Treasuries could act as a hedge against an unforeseen US recession or in case of financial market turmoil.
- The balance of risks has shifted from inflationary pressures to the slowdown in manufacturing and the labour market. This means that central banks could deliver more aggressive rate cuts than in our central scenario. For this reason, we have revised lower all our year-end forecasts for 10-year core government bond yields (except for bonds in Japan, where we expect more rate hikes).
- Given the risk asymmetry that we see in central bank policy, we have moved from neutral to overweight in fixed income in general, including an overweight in sovereign bonds, in particular in the US and UK.

### A DISINFLATONARY NEW WORLD

The inflation scares of 2021 and 2022 have made market participants cautious about recent disinflation, with some questioning the feasibility and appropriateness of the major central banks' 2% inflation target. The sharp fall in inflation in H2 2023, along with recession fears, contributed to the fall in the 10-year US Treasury yield towards 3.8% at the end of last year (*see chart 1*). Then, upside inflation surprises during the first months of 2024 meant this trend went into reverse and the 10-year yield climbed again, towards 4.7% in April.

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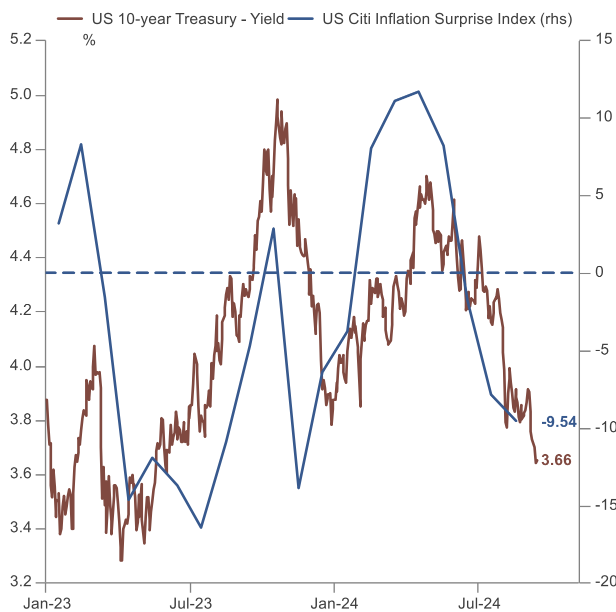
Illustrating how sensitive Treasury yields have been to inflation upsets, it was the lower-than-expected figure for June consumer inflation that triggered the summer rally in US Treasuries, with other core sovereign bonds following suit.

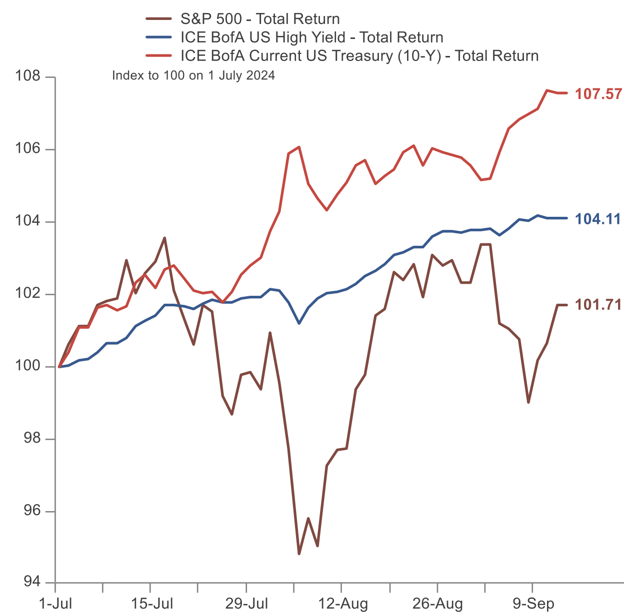
This new disinflationary world has brought about two major paradigm changes in our view. First, with disinflation, long-term core sovereign bonds, and in particular US Treasuries, have regained their protective role in portfolios. During both US equity sell-offs this summer, 10-year US Treasuries rallied (*see chart 2*). Second, the drop in inflation has led the US Federal Reserve (Fed) and market participants to shift their attention to the state of the US labour market.

**Chart 1: US 10-year Treasury yield and Citi inflation surprise index**




Source: Pictet Wealth Management, FactSet, as of 11.09.2024

**Chart 2: Total returns for US equity and bond indices since 1 July**




Source: Pictet Wealth Management, FactSet, as of 11.09.2024

## THE BALANCE OF RISKS HAS SHIFTED TOWARDS MORE AGGRESSIVE RATE CUTS

In this new disinflationary world, the balance of risks has shifted towards more aggressive rate cuts from central banks in our view—risks that have been well priced in by market participants, because terminal rate expectations have fallen steeply (*see chart 3*).

Both the Bank of England and the European Central Bank have already started their rate-cutting cycle (in June and August, respectively). At time of writing, market participants were expecting them each to cut rates by a further 180 bps to reach a terminal rate of 3.2% and 1.9%, respectively (on 11 September). These terminal rate pricing are slightly higher than our own terminal rate estimates in the UK (3%), but slightly lower in the euro area (2%). Rate cut expectations have increased recently, despite tight labour markets and elevated services inflation. Nevertheless, the economic

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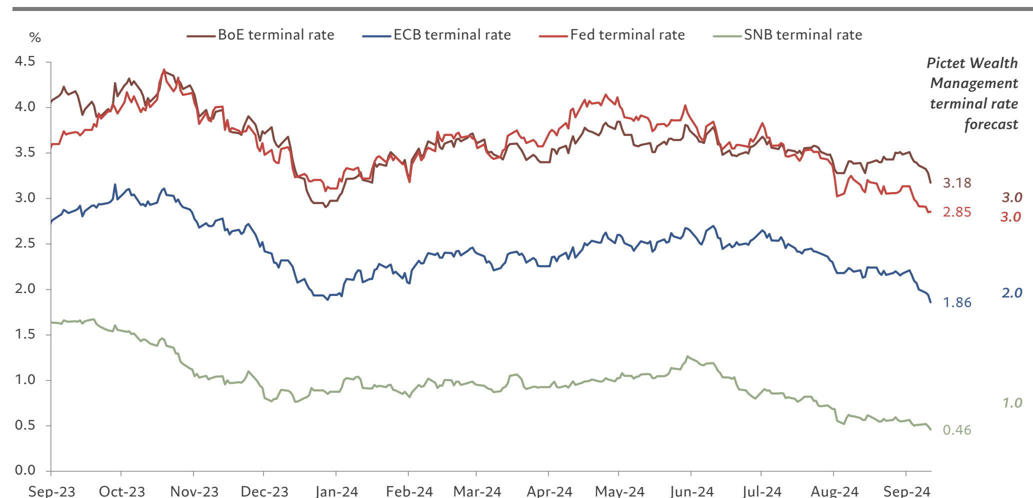
growth outlook has deteriorated, both because of the ongoing global recession in manufacturing and lacklustre productivity.

The Swiss National Bank was the first of the major central banks to cut rates in March. Given the greater-than-expected decline in Swiss inflation and the strength of the Swiss franc since June (thus reducing import prices), market participants had lowered their Swiss terminal rate expectations to 0.5% by the time of writing.

Turning to the US, market participants presently see the Fed cutting the Fed funds rate all the way to 2.85%, which is below our 3% estimate of the neutral rate (see Policy normalization or labour market rescue?). This means that market participants see the need for the Fed to stimulate the economy since the neutral rate is the rate at which monetary policy is neither accommodative nor restrictive. In the same vein, the option market on the Secured Overnight Financing Rate (which is closely linked to the Fed funds rate) suggests there is a 50% probability the Fed's main policy rate falls below 3% by December 2025. This scenario would be consistent with the belief that the Fed will have to reverse its restrictive policy rapidly to deal with a marked slowdown in the labour market.

**Chart 3: Central bank terminal rates priced in by market participants (at 11 September)**




Source: Pictet Wealth Management, Bloomberg Finance, L.P., as of 11.09.2024

## US ELECTIONS IMPACT ON THE FED'S TERMINAL RATE

The outcome of the November elections in the US could impact the Fed's terminal rate because of the possible implications for government spending and inflation.

We would expect the federal fiscal deficit to increase under all election scenarios. But a Republican 'clean sweep' of the presidential and congressional elections would likely lead to the sharpest increase in the deficit because Donald Trump wants to cut corporate taxes and prolong income tax cuts, which are unlikely to be covered meaningfully by increased import duties (*see table below*). For her part, Kamala Harris wants to hike corporate taxes and extend income tax cuts only to the lower- and middle-income households, but she is unlikely to achieve this should the Republicans control one of the houses of Congress.

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While deficit spending might stimulate economic growth, we believe that the most important issue for the Fed, should Donald Trump be elected, will be tariffs and their impact on inflation. For this reason, we expect the Fed's terminal rate would be higher than if Kamala Harris wins. The terminal rate could be close to 4% if Donald Trump is elected in November and if he implements tariffs of the magnitude he has mentioned (60% on Chinese imports, 10% on imports from elsewhere). We believe the mere threat of such tariffs could lead market participants to revise higher their terminal rate expectations and push the US 10-year yield above 4% again in the course of 2025 (baring a recession).

In the case of a win by Harris, we would expect the Fed to cut its policy rate to neutral (i.e. 3%), but a mild recession could push the Fed to cut it further (to around 2%). Either way, we estimate the 10-year yield would likely remain below 4%—at around 3.8% -at end 2025 in a non-recessionary scenario and around 3% in a recessionary scenario (to which we assign a 30% probability). For now, we see slightly shorter odds of a Harris victory in November, but the race remains tight. Hence, we have lowered only slightly our 10-year US Treasury yield forecast for end-2024, from 4.3% to 4.0%. This forecast is liable to be revised again, depending on economic developments and clarity on the electoral race.

The table below shows how we expect the two-year US Treasury yield to move in different US election scenarios. In all cases, we would expect the US yield curve to steepen and the slope between 10- and two-year yields to move well into positive territory again.

### US election scenario and their economic and market impact

| | Most likely to less likely (but it is a close race) → | | | | |
|---|---|---|---|---|---|
| *Potential impact on:* | Democrat w/ divided Congress | Republican sweep | Republican w/ divided Congress | Democratic sweep | US recession |
| **Inflation** | = | ↑↑ | ↑↑ | ↑ | ↓ |
| **Deficit* in % of GDP** | ↑↑ | ↑↑↑ | ↑↑ | ↑ | ↑ |
| **Term premium in %** | 0.80 | 0.90 | 0.80 | 0.70 | 1.00 |
| **Long-term policy rate in %** *(end-2026)* | 3.00 | 4.00 | 3.75 | 3.00 | 2.00 |
| **10-year US Treasury yield in %** *(end-2025)* | **3.80** | **4.90** | **4.60** | **3.70** | **3.00** |
| **2-year US Treasury yield in %** *(end-2025)* | 3.20 | 4.20 | 3.90 | 3.20 | 2.20 |
| **US Treasury slope (10Y-to-2Y) in %** | +0.60 | +0.70 | +0.70 | +0.50 | +0.80 |

Source: Pictet Wealth Management, 10.09.2024

## WE ARE OVERWEIGHT SOVEREIGN BONDS

The balance of risks has shifted from inflationary to economic pressures against the backdrop of a slowdown in manufacturing and the labour market. This means that central banks could deliver more aggressive rate cuts than in our central scenario. For this reason, we have revised lower all our year-end forecasts for 10-year core

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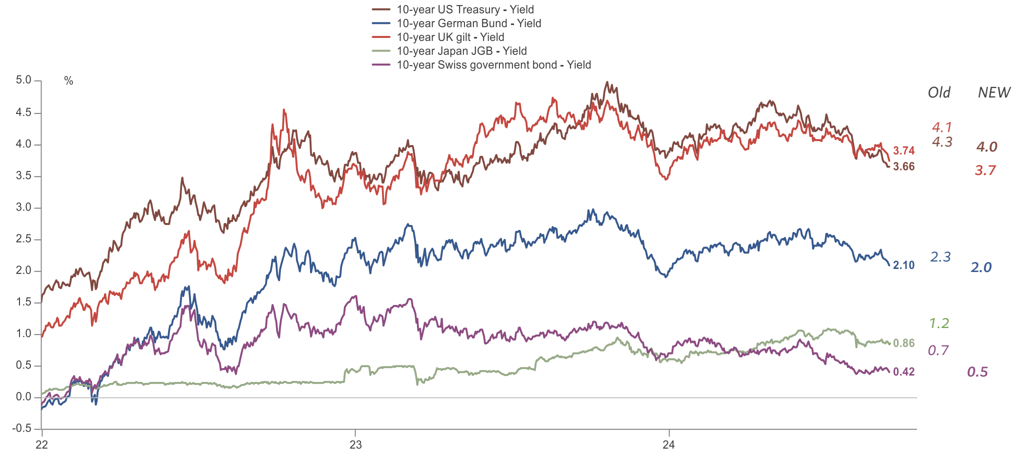
government bond yields (except for bonds in Japan, where we expect more rate hikes) (*see chart 4*).

Given the risk asymmetry that we see in central bank policy, we have moved from neutral to overweight in fixed income in general. This includes overweight positions in sovereign bonds, in particular in the US and UK.

**Chart 4: US, German, UK, Japanese and Swiss 10-year government bond yields**




Source: Pictet Wealth Management, FactSet, as of 11.09.2024

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