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Bond markets in line with fundamentals

Key takeaways

- Recently strong U.S. data caused market pricing to push rate cut expectations into the future. The ECB is expected to cut its key rates in June.
- Government bond yields have risen to levels broadly in line with fundamental economic data.
- Data dependent central bank decision making argues for a broad sideways pattern of bond yields. Investors are likely to continue to focus on carry.

Introduction

Recent U.S. economic data were somewhat mixed. Non-farm payroll data were lower than expected, retail sales data, however, continued to point to robust underlying consumption. The March inflation reading came in strong as well, which caused a significant change in market pricing for the Federal Funds rate path, moving away from the exuberance of close to 8 cuts by March 2025 in mid-January to around 2.5 cuts currently priced. The terminal rate expectation has also increased from close to 2.75% to around 4%, pushing the yield curve upwards. These developments, such as the shorter cutting cycle, have been a key focus for the markets, helping push 10Y yields towards 4.5%, despite the downward pressure amid geopolitical tensions in the Middle East.

In many aspects an unusual interest rate cycle

The various monetary and fiscal policy market interventions in response to the various crisis events in recent history (Great Financial Crisis (GFC), Euro Crisis, Covid-19) have contributed to unusual characteristics in this interest cycle, which we intend to discuss in more detail in the following sections.

Economic environment with extremely low interest rates: As interest rates approached zero in the aftermath of the GFC, the major central banks used various new monetary-policy instruments where they had little experience until then. E.g. they introduced purchase programs for government bonds and a bit later other securities like corporate bonds (see chart 2). These programs were meant to keep interest rates low and support economic activity via the monetary transmission mechanism.

Special regional situations (for example, the so-called Eurozone debt crisis) required additional purchasing programs. The European Central Bank and the Bank of Japan even used the strategy of negative policy rates (see chart 1). This long period of very loose monetary policies provided the real economy with comparatively large amounts of liquidity.

Global external shock caused by the COVID-19 pandemic: In a textbook economic cycle, economic dynamics are increasing after monetary easing. Economic growth is gaining momentum as demand for consumption and investment increases, and a self-sustaining recovery emerges. The strong dynamism of economic demand leads to an overheating of the economy with rising inflation and central banks are taking a more restrictive stance.

In the current cycle, however, an external shock occurred in the form of the COVID-19 pandemic in the midst of a not particularly dynamic recovery phase. In order to reduce viral diseases, contact restrictions were introduced which led to significant burdens on services and manufacturing. The global spread of the pandemic caused significant disruption in supply chains and had severely affected the production of goods.

In order to avoid a sharp economic slowdown and an increase in unemployment, the governments of industrialized countries implemented public spending programs in order to support economic demand. However, the comparatively robust demand encountered a supply of goods and services which was significantly reduced due to production restrictions and supply chain disruptions. The situation resulted in excess demand, allowing companies to raise prices quickly and sharply. Initially the inflation increase was seen as transitional, but the rapid and sharp rise in inflation rates required strong responses from central banks, which had to raise policy rates significantly within a comparatively short period of time (see chart 1). In February 2022, the inflation shock got an additional boost, as the Russian invasion into Ukraine pushed energy and commodity prices higher.

Fast and strong yield increases: High inflation rates and strong central bank key rate hikes triggered sharp price reactions in international bond markets, leading to equity-like bond price losses. For example, the yield increases of 10-year government bonds between December 27, 2021 and October 23, 2023 (see charts 3 and 4), caused price losses of more than 20% in the US, the UK, and the eurozone. The sudden and strong movements put financial market stability under some stress (e.g. some smaller regional U.S. banks) as bond positions of were exposed to possible losses. Some short-term uncertainties could be calmed, however, problems might continue to linger below the surface.

Only when central banks hinted at a possible end of the rate hikes and a turning point in the interest rate cycle seemed possible, did returns stabilize near the levels then reached. While market participants turned expectations very quickly toward interest-rate cuts in 2023, central banks remained cautious not to encourage a resurgence of rising inflation trends via premature interest rate cuts. Until recently, June rate cuts were expected for both the Fed and the ECB. Robust economic data and increasing inflation risk from higher energy prices, however, caused Fed members to hint that they might postpone rate cuts to a later date. Thus, the ECB might start to cut rates earlier than the Fed. In the Eurozone, declining inflation rates and weaker economic growth dynamics - above all in the manufacturing sectors - provide solid arguments for a rate cut.

Bond holding reductions of central banks: In response to the crisis described above, central banks in the US and Europe had purchased large bond positions to support the economy through additional liquidity (so-called quantitative easing (QE)). The purchase of the securities enlarged central bank balance sheets (see chart 2). As the macroeconomic environment now has normalized, central banks want to reduce the liquidity created during the crisis episodes. Due to the high volumes of purchased paper, however, the reduction in central bank balance sheets will take some time. So far, from March 2022 to March 2024, caps on reinvestments and scheduled maturities of bonds have reduced the Fed's and the ECB's balance sheets by about a combined $3.5 trillion. Due to the differences of the instruments used, the transmission and impact of tightening measures could differ across countries. For example, the Fed made direct bond purchases, while the ECB – in addition to direct purchases – had launched targeted long-term refinancing operations (TLTROs), owing to the greater importance of bank loans in the Eurozone. However, although the transmission of liquidity reduction measures is carried out through different channels, these tightening measures have one thing in common: a dampening effect on real economies.

Government bond yields in line with fundamental economic data

Government bond yields tend to be close to nominal GDP growth over time. Not least because of quantitative easing, the yields on 10-year government bonds in recent years have been well below nominal growth. The pandemic-induced sharp drop in growth in 2020 and the subsequent sharp rise in inflation rates led to strong divergences of bond yields and nominal GDP growth, which are now gradually declining (see charts 5 and 6). The gap in the Eurozone appears still to be wider than in the U.S., but with moderate expected GDP growth and slightly declining inflation rates, the gap should continue to converge in the Eurozone. Yields well above nominal growth are only expected when QT measures are more advanced and liquidity has been reduced towards more normal levels. Investors expect longer-term bond yields to compensate for the expected loss of purchasing power via inflation. Thus, 10-year government bond yields tend to be higher than inflation. But central banks' quantitative easing measures have pushed yields down. Thus, government bond yields stayed below inflation rates for extended periods in recent years, and in some cases were well below the respective inflation rates (see charts 7 and 8). The gap had increased significantly after the sharp rise in inflation in 2021-2022. This gap has since been narrowed both by rising yields and declining inflation rates. Yields are now back to levels that seem to be broadly consistent with inflation rates.

Yields in both the U.S. and the Eurozone are now close to levels as indicated by fundamental economic data. The changes in returns are therefore being driven by changes of incoming economic data, as well as expectations for central bank monetary policy changes, which are likely to be made according to the results of these data. In this environment we expect a steepening of the yield curves and slightly higher yields on 10-year eurozone government bonds and slightly lower yields on 10-year U.S. Treasury bonds.

As longer-term government bonds may experience greater price fluctuations through data-dependent central bank decisions, risk-averse investors might prefer to invest in short- and medium-term government bonds, especially as yields in these areas are somewhat higher and return potential can be realized due to our expectations for a steepening of the yield curves (see charts 9 and 10). Given the recent rises of 10Y government bond yields, the question now is if at these levels serious thought should be given to taking on duration risk or if a further increase in yield can provide a better entry point. It can be pointed out that terminal rate pricing is now almost at par with the pricing during the peak in rates sell-off in October last year. Nevertheless, 10Y yields remain 30 bps off the cycle-high level during that period. While technical analysis suggests that retracing that amount is possible, the underlying fundamental driver is different this time. During last year's episode the market was more focused on the long-term developments, this time the focus has been on the near term – made clear by the breakdown in co-movement of 10 year forward swap rates with the market pricing of rate cuts.

While these long-term forwards have been stable since the end of January, rate cut expectations have changed considerably. We have long held that inflation will remain sticky and the Fed will tread cautiously when it comes to rate cuts especially in an election year. We do recognise that progress will continue to be made against inflation, allowing the Fed to cut rates this year, limiting further potential for an increase in yields from near-term yield drivers. Of course, this does not consider the worst-case geopolitical scenarios which could significantly erode the progress made so far in the fight against inflation. Also, a reemergence of U.S. fiscal sustainability concerns could trigger a higher term premium – as it did last year – but we do not face similar uncertainty surrounding Treasury supply increases. Assuming that last year's peak term premia were adequate compensation for debt sustainability risks, a reversion to those 10Y yield levels can not be excluded. Overall, current yield levels seem feasible enough to gradually take on some duration exposure.

EUR Credit: Room for some spread tightening

Just like its USD counterpart, EUR credit markets have started with a robust performance into 2024 even outperforming their peers from across the Atlantic in terms of spread compression. Spreads on EUR IG versus respective government bond yields have declined by an impressive 23 bps so far this year to a current level of 112 bps (ICE BofA Euro Corporate Index), a far cry from the 196 bps of around a year ago on the back of the Swiss banking crisis. By comparison, the spreads on USD IG (Bloomberg U.S. Corporate Bond Index) have declined by 12 bps. Spreads on the HY segment declined another 44 bps this year with the spread standing currently at 351 bps (ICE BofA Euro High Yield Index).

Easing financial conditions over the past few months along with yields, which on average are around 50 bps lower in the IG market than the highs in October, have prompted issuers to take advantage. Around EUR220bn was issued (gross) in Q1 2024 making it the strongest first quarter since 2010.

Spreads tightened despite the strong surge in supply, which can be seen as testament to the strong underlying demand in the EUR credit market. The new issue premium has declined significantly from the inflated levels of the last two years. Barring a small period between September and November of last year, cumulative inflows have continually increased since the beginning of last year reaching close to 8% (measured as a percentage of AUM at the beginning of 2023).

In our view, demand is likely to remain elevated as money that had flown from the credit market into illiquid alternative investments during the era of ultra-low yields is returning steadily. We therefore expect solid demand to continue. We like IG for its carry potential at the current yield to maturity of 3.96%, despite the decline over the last two quarters, and expect the large institutional investors to find this prospect appealing.

We still see potential for further spread declines of around 10-15 bps over the next 12 months. A spread compression of this range would potentially add around 50bps on top of our expected returns from changes in benchmark Bund yields. This should supplement the current IG market weighted coupon of 2.33% for potential one-year excess returns over Bunds of as much as 1.5-2%.

Additionally, around 40% of the EUR IG market is attributed to financials where we expect banks to see some near-term upside. Financials spreads (current levels: 125bps) continue to lag the non-financials by almost 18 bps. We expect this differential to narrow further. Banks relied upon the forward curves at the end of last year for their management guidance for the current year. However, Euribor forward yields have increased this year while the increase in deposit betas has slowed, making the case for revisions to net interest income higher. The M&A market is inflecting, so strong bond underwriting business will help boost investment banking fees.

Contrary to the other credit classes, EUR HY market has seen benign issuance this year with close to EUR22bn in gross supply. However, thanks to ratings migrations, net supply has been negative. This, along with decent inflows and generally a strong sentiment for risk assets, has resulted in a strong decline in HY spreads. Nevertheless, recent negative newsflow regarding lower-rated issuers has dented optimism. While we do not think that HY is in danger of an imminent fall from grace, we do see spreads retracing to higher levels from the current figure due to idiosyncratic risks. The ratings migrations trend is expected to turn from a tailwind to a headwind, pushing net supply higher in the future. Therefore, despite an enticing yield of around 6.8%, the risk/reward does not look that attractive.

USD credit: compressed

The USD credit market has gone from strength to strength this year. The spreads on IG (investment grade) bonds continued to narrow to a current level of around 89 bps (Bloomberg U.S. Investment Grade Index). The same trend was seen in the HY sector (high yield) where the index followed the tightening path to a current spread level of 324 bps.

Even more impressive is the fact that this spread compression has happened against the backdrop of solid supply, underscoring the strength of the asset class this year. The gross IG primary market issuance in the first quarter was close to USD540bn, around 30% higher YoY for the same period. HY issuance in Q1 totalled around USD89bn, more than double what it was last year. As data over the last 7 years shows, Q1 tends to be the quarter with the highest IG supply followed by a decline in primary issuance in Q2 that averages around USD50bn QoQ.

Demand on the other hand has been strong for the IG market with funds seeing inflows for 20 consecutive weeks. YTD inflows into the IG focused funds have totalled more than USD52bn. The flows were also helped by the quarter-end rebalancing which would have probably triggered outflows from equities following an outstanding first quarter with some of it being redirected into bond funds. Given the strength of demand, the spread compression mentioned above would have been even stronger had it not been for the bumper supply.

We continue to see elevated demand in credit markets. We expect pension funds to increase their purchases of USD IG bonds after the uninspiring buying activity in 2023. The start of the decline in bond yields in 1981 led to the decline in the share of corporate bonds as a percentage of financial assets of pension funds from a high of 10% to a low of below 4% during the GFC. Although it has risen since then, it has only managed to climb to a little over 5%. Given the rise in yields over recent years, pension funds' allocation into corporate bonds is likely to continue climbing. And they seem to have dry powder as well. According to the Milliman 100 Pension Funding Index, the funding ratio for the 100 largest U.S. corporate pension plans stood at 1,049 at the end of February. The overfunded pension funds are likely to sell riskier assets and move their money into bonds to lock in higher and more certain returns from longer-duration IG corporate bonds at current yield levels.

Another support for demand may come from rising coupons. With many of the portfolios and funds following the accumulative approach rather than distributing coupons, a material chunk of the coupons is likely to be reinvested into corporate bonds. U.S. corporate bonds are estimated to generate an aggregated amount of around USD460bn this year, around USD40bn more than last year. Similarly, foreign investors – especially those from Asia – are likely to remain net buyers of USD corporate bonds.

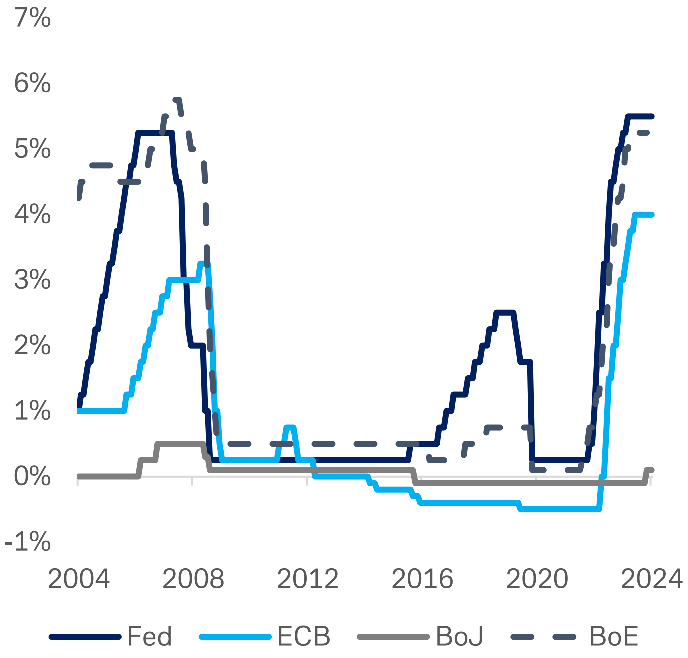
Admittedly, given the strong decline in spreads over the past two quarters, the bulk of the tightening has already been priced in. However, the demand outlook remains favourable while the U.S. economy remains defiant. Coupled with insurance cuts by the Fed, the spreads could see some further mild compression in the IG segment. However, we continue to see the carry as central to our positive view on USD IG credit. On the other hand, the HY sector seems to have overpriced the optimism. Despite strong yield levels, we continue to see elevated risks for lower-rated issuers who continue to struggle in the expected high for longer rates environment.

Additionally, the profitability of lower rated firms remains under pressure with YoY EBITDA growth for the median HY firm negative in three out of the four quarters last year. In the same period the median IG firm remained in positive territory and has been on a rebound since the second half of last year. We therefore expect HY spreads to unwind higher, reducing the attraction of strong yields provided by this segment.

Conclusion

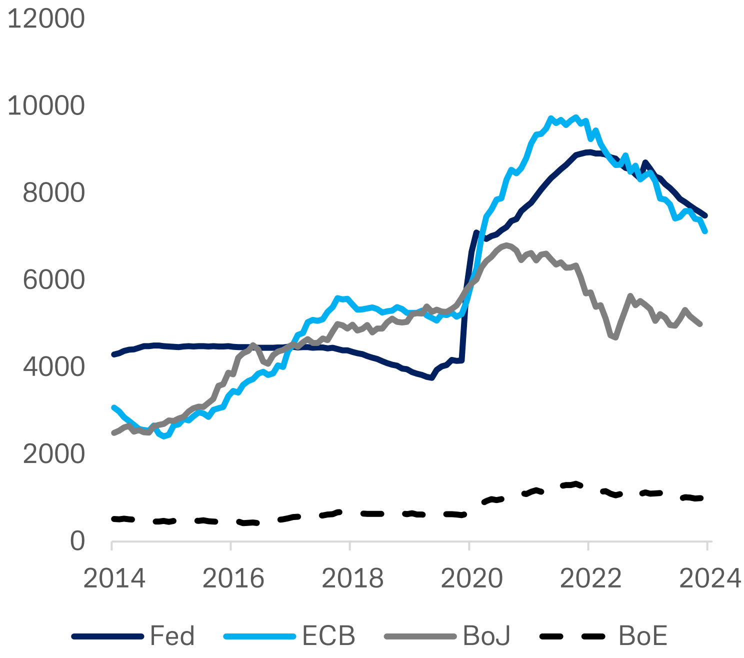
The interest rate cycle is advanced and market participants are closely following central bank comments about any view changes on monetary policy. As expectations for first rate cuts have sequentially been pushed back to Q2 and potentially later, government bond yields have continued to rise since the start of the year. Although a further moderate rise cannot be excluded, we think that the surge in 10Y government bond yields is advanced enough to start to gradually add some duration exposure. We would expect bond markets to stay in a broad sideways trading range in the short term. Bond investors therefore are likely to concentrate on carry with a focus on corporate bond positions.

Chart 1: Central bank key rates (in %)



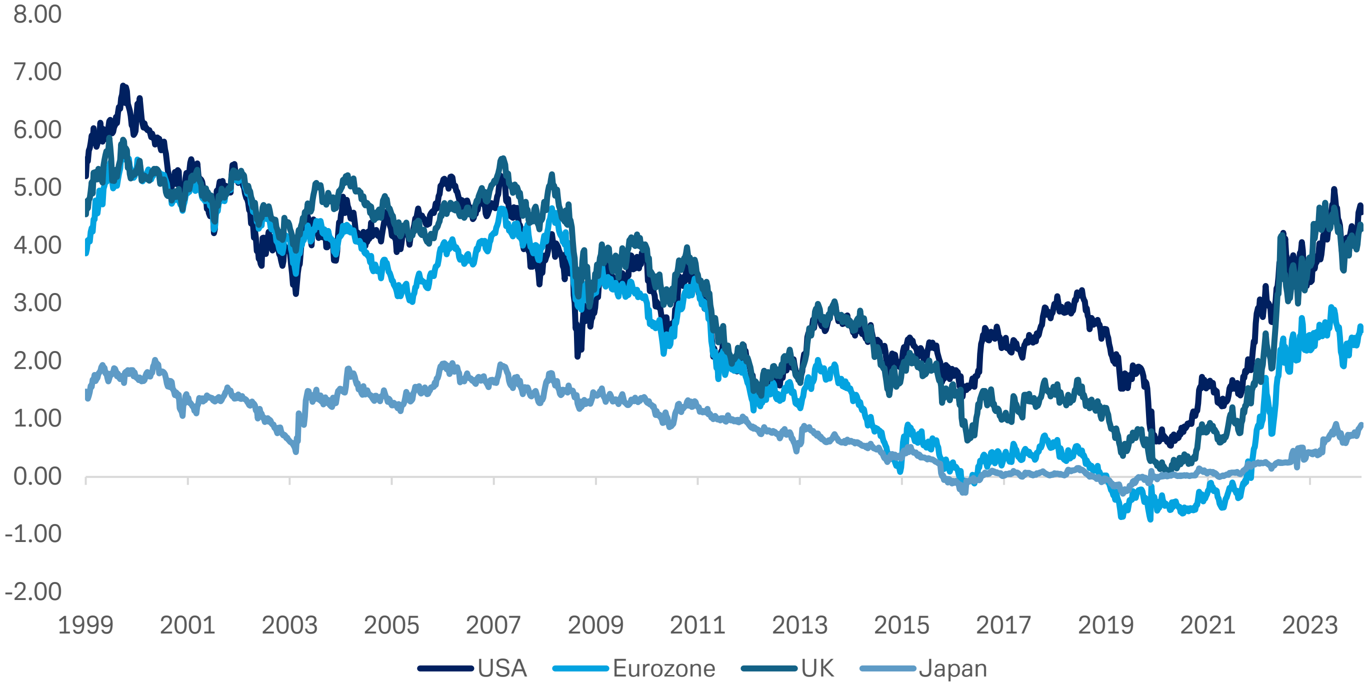
Source: Deutsche Bank AG, LSEG Datastream; Data as of May 3, 2024.

Chart 2: Central bank balance sheets (billion USD)



Source: Deutsche Bank AG, LSEG Datastream; Data as of May 3, 2024.

Chart 3: 10-year government bond yields (in %) over the past 25 years

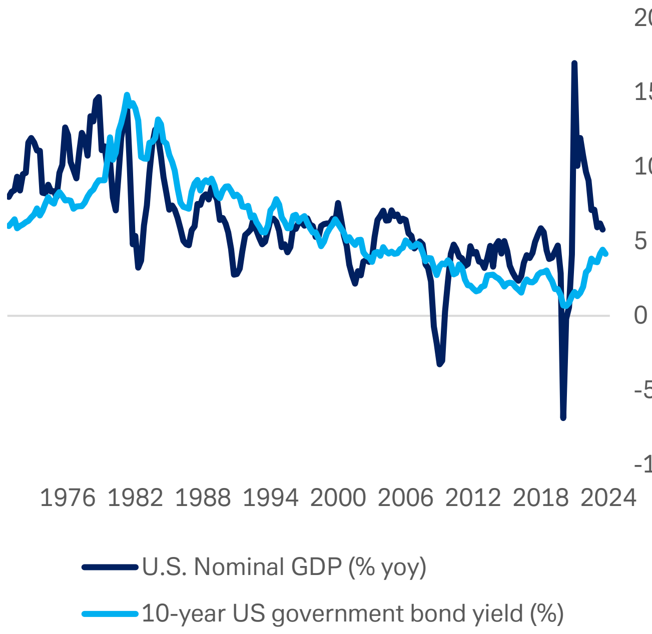


Source: Deutsche Bank AG, LSEG Datastream; Data as of May 3, 2024.

Chart 4: 2-year government bond yields (in %) over the past 25 years

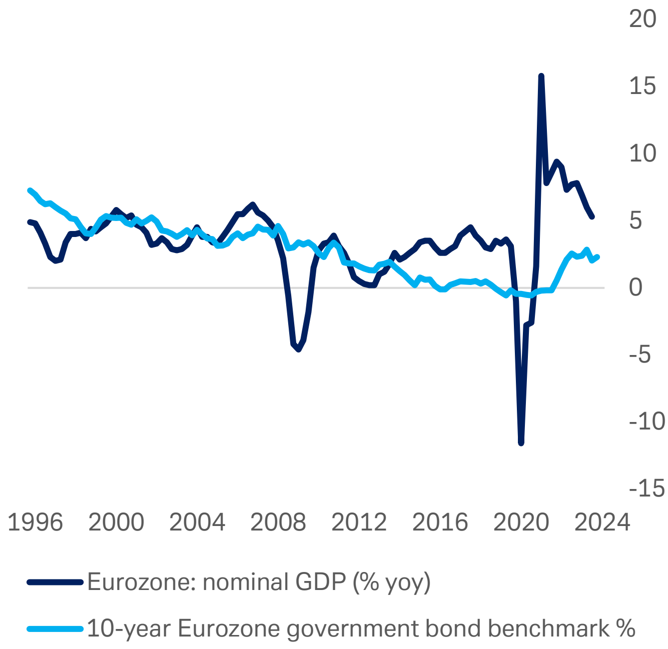
Source: Deutsche Bank AG, LSEG Datastream; Data as of May 3, 2024.

Chart 5: U.S. Nominal GDP and bond yield



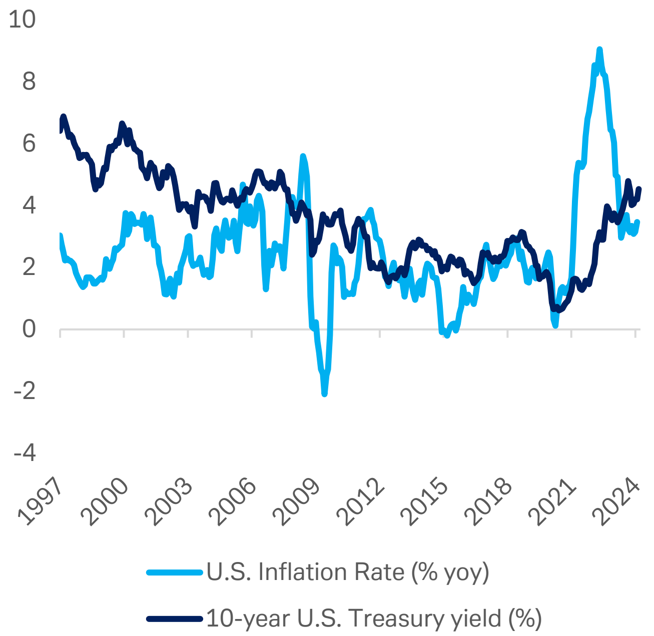
Source: Deutsche Bank AG, LSEG Datastream; Data as of May 3, 2024.

Chart 6: Nominal GDP and bond yield in the Eurozone



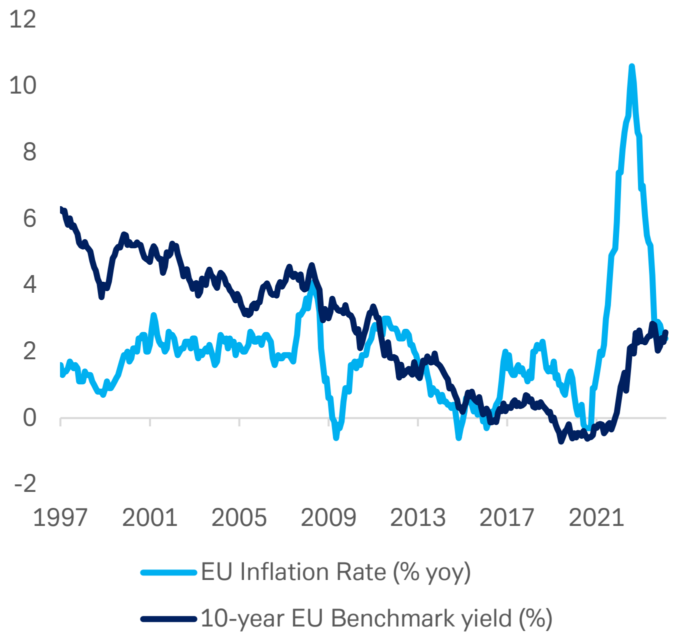
Source: Deutsche Bank AG, LSEG Datastream; Data as of May 3, 2024.

Chart 7: 10-year U.S. government bond yield and inflation rate



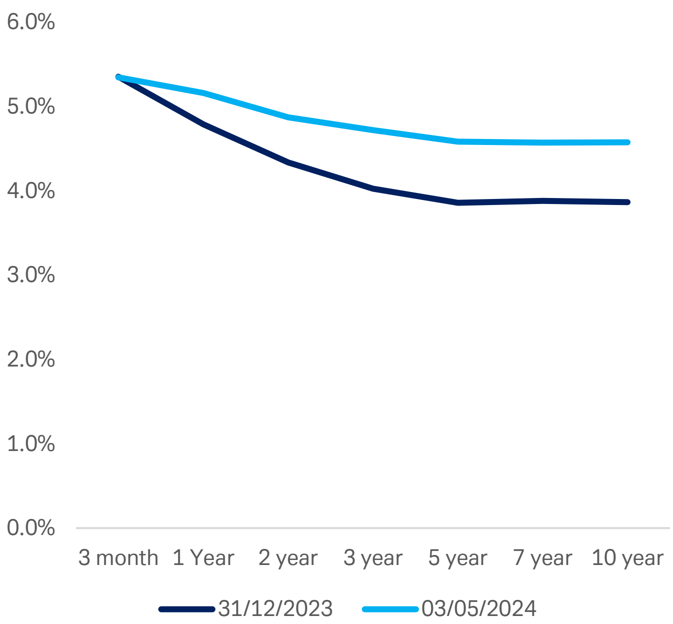
Source: Deutsche Bank AG, LSEG Datastream; Data as of April 16, 2024.

Chart 8: 10-year EU government bond yield and inflation rate



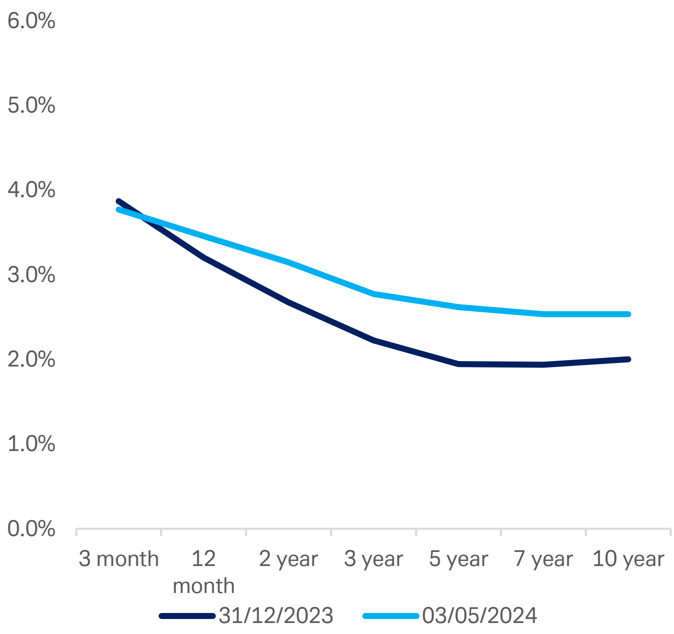
Source: Deutsche Bank AG, LSEG Datastream; Data as of April 16, 2024.

Chart 9: Yield curve USA



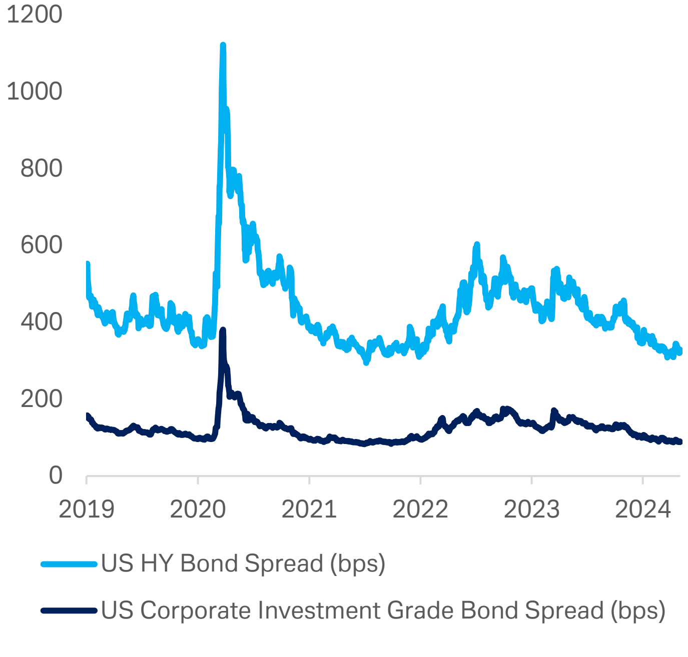
Source: Deutsche Bank AG, LSEG Datastream; Data as of April 16, 2024.

Chart 10: Yield curve Germany



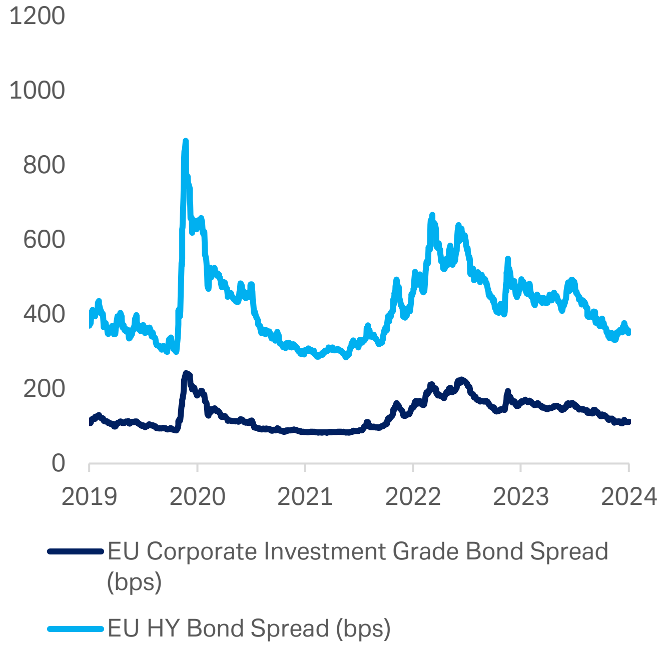
Source: Deutsche Bank AG, LSEG Datastream; Data as of April 16, 2024.

Chart 11: Spreads of U.S. IG and HY bonds



Source: Deutsche Bank AG, LSEG Datastream; Data as of April 16, 2024.

Chart 12: Spreads of EU IG and HY bonds



Source: Deutsche Bank AG, LSEG Datastream; Data as of April 16, 2024.

Historical Performance

Performance	3.5.2019 - 3.5.2020	3.5.2020 - 3.5.2021	3.5.2021 - 3.5.2022	3.5.2022 - 3.5.2023	3.5.2023 - 3.5.2024
10 year U.S. Government Bonds	22,4%	-6,4%	-10,5%	0,6%	-6,1%
2 year U.S. Government Bonds	5,3%	0,2%	-3,0%	1,1%	2,2%
10 year EMU Benchmark Bonds	6,4%	-3,3%	-9,7%	-8,7%	0,1%
2 year EMU Benchmark Bonds	-0,4%	-1,0%	-1,9%	-2,0%	1,6%
10 year U.K. Government Bonds	10,6%	-5,1%	-8,3%	-11,4%	0,2%
2 year U.K. Government Bonds	1,4%	-0,1%	-2,1%	-2,4%	3,2%
10 year Japanese Government Bonds	0,1%	-0,7%	-0,9%	2,0%	-3,1%
2 year Japanese Government Bonds	-0,2%	-0,1%	-0,2%	0,0%	-0,3%
10 year German Government Bonds	6,4%	-3,3%	-9,7%	-8,7%	0,1%
2 year German Government Bonds	-0,4%	-1,0%	-1,9%	-2,0%	1,6%
ICE BofA Euro Corporate Index	-0,5%	4,8%	-8,3%	-4,1%	5,1%
ICE BofA Euro High Yield Index	-5,5%	16,1%	-6,9%	-0,8%	10,3%
ICE BofA Euro Financial Index	-0,4%	4,5%	-7,0%	-3,7%	6,1%
ICE BofA Euro Non-Financial Index	-0,6%	4,9%	-9,0%	-4,4%	4,5%
Bloomberg U.S. Corporate IG Index	10,0%	5,1%	-11,2%	1,2%	1,8%
Bloomberg U.S. Corporate HY Index	-4,5%	21,1%	-5,9%	1,4%	10,2%

Source: Deutsche Bank AG, LSEG Datastream; Data as of May 3, 2024.

Glossary

Automatic Data Processing, Inc. (ADP) is an American provider of human resources management software and services, headquartered in Roseland, New Jersey.

A basispoint (bp) corresponds to 1/100 percent.

Duration measures show the sensitivity of the price of a bond to a change in interest rates, expressed in the number of years that a bond takes to be repaid through its internal cash flows.

The European Central Bank (ECB) is the central bank for the Eurozone.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

GDPNow is an unofficial nowcasting model for gross domestic product (GDP) growth published by the Atlanta Fed.

High yield (HY) bonds are higher-yielding bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds.

The International Monetary Fund (IMF) was founded in 1994, includes 189 countries and works to promote international monetary cooperation, exchange rate stability and economic development more broadly.

An investment grade (IG) rating by a rating agency such as Standard & Poor's indicates that a bond is seen as having a relatively low risk of default.

JOLTS (the U.S. Job Openings and Labour Turnover Survey) gives alternative perspectives on the state of the U.S. labor market.

OAS (options adjusted spread) is the yield premium that needs to be added to the spread over a benchmark yield to account for options that can vary interest or prepayment rates in order to adjust for deviations in maturity.

The Organisation for Economic Co-operation and Development (OECD) has 35 member countries and has the objective of encouraging economic progress and world trade.

Personal Consumption Expenditure (PCE) is a price index for goods and services, particularly relevant in the context of U.S. GDP.

Risk premium refers to the return in excess of the risk-free rate of return that an investment is expected to yield. It is a form of compensation for investors who tolerate the extra risk.

Quantitative tightening (QT) is the progressive removal of monetary support through the reduction of a central bank's balance sheet.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The S&P U.S. Aggregate Bond Index measures the performance of publicly issued U.S. dollar denominated investment-grade debt.

Spread on bond markets is in general the difference of the yield of two bonds with similar maturity. It can be interpreted as a risk premium.

Treasuries are bonds issued by the U.S. government.

U.S. is the United States.

USD is the currency code for the U.S. Dollar.

The VIX Index is a measure of equity market volatility implied by S&P 500 Index options.

Volatility measures the degree of variation of a trading-price series over time.

The yield curve shows the different rates for bonds of differing maturities but the same credit quality.

Yield curve inversion is a situation where longer-term bonds have a lower yield than short-term bonds.

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