FOCUS

The Recent Bond Market Sell-Off

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10-year German Bunds bottomed around 0.08% on 15 April 2015, around the same time that Tanguy Le Saout was telling investors at our client conference in Boston that "European bonds offered no value" and that they should reduce their duration exposure. Cosimo Marasciulo was also featured on Bloomberg TV in Asia giving the same message at the same time. Today that same 10-year German Bund now yields 0.73%.

In addition, it's not just German yields that have risen – peripheral European yields have sold off aggressively as well (30-year Italian bond yields are 100bps higher), U.S. 10-year yields have risen by over 30bps despite a weak Q1 2015 GDP reading, and Australian 10-year bond yields have risen by about 65bps despite a rate cut in Australia. Clearly, something has happened, but exactly what?

Why did bonds sell off and yields rise?

Numerous reasons have been advanced for the rise in bond yields, ranging from credible to not very credible. Let us look at some of the suggested reasons:

1. Fears that the European Central Bank (ECB) might cut short their Quantitative Easing (QE) programme – not very credible in our opinion. President Mario Draghi discounted this possibility at the recent ECB meeting press conference. The programme will run until September 2016 and amount to €60bn per month.
2. Concerns about lack of progress on Greek negotiations – not very credible in our opinion. If it was only European assets selling off, then Greek worries might be a reason. However, that does not explain why U.S. Treasuries, the U.S. Dollar and Australian bonds are selling off as well.
3. Recent Chinese rate cuts should support Chinese (and by extension) world growth – not very credible in our opinion. No doubt the Chinese authorities will take whatever measures are necessary to support Chinese growth, but Chinese rate cuts shouldn't impact long-dated peripheral European government bonds
4. Better economic data in Europe – credible in our opinion. Economic forecasts for the Euro area have consistently been revised higher in the first 4 months of the year, and now average 1.5% for 2015 and higher for 2016.
5. More government bond supply in Europe – credible in our opinion. The combination of ECB buying and a favourable supply dynamic in Europe for the first quarter left many investors wondering who would sell their bonds to the ECB. We believe that the question is more who will not sell their bonds to the ECB. Net sovereign bond supply is strongly positive in Europe in May so far, which should put further upward pressure on bond yields. However, it turns sharply negative in June and July[1], meaning we could see a rally in bond yields during those months.
6. Inflation surprising to the upside – very credible in our opinion. The almost-unnoticed bounce in the oil price means that inflation globally should recover from negative number to positive numbers, and kill any talk about deflation.

[1] Based on the issuance calendars of European Sovereign Entities.

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Inflation-protected bond markets have noticed this, and inflation break-evens in Europe and the U.S. have bounced higher.

7. Valuations – very credible in our opinion. With between 30%-35% of the European sovereign bond market trading at negative yields, and some corporates even able to issue at negative yields in Swiss Francs, investors were really starting to ask questions about buying bonds with negative yields.
8. Positioning – very credible in our opinion, and probably the biggest reason for the sell-off. The major moves have come in the most favourite trades of 2015 – long European bonds (especially long-dated peripheral bonds), long the U.S. Dollar vs. the Euro, long U.S. Treasuries and Australian bonds (because of their relatively high yields) and long European equities. That suggests that investors had many similar positions, so a small sell-off sparked a rush to exit these trades, which then snowballed into capitulation selling.

Is this the start of the big bear market?

It is very difficult to say for sure when this move in yields is less than a week old. Typically, after such a violent sell-off, we would expect to see some “bounce” or fall in yields as investors take advantage of lower prices / higher yields. However, from the perspective of the European Investment Grade Fixed Income team, many of the same problems that we have observed over the last 12 months remain in place. We believe that yields are still too low from a fundamental perspective, inflation should slowly move higher and undermine current valuations, economic activity should recover and growth should get stronger, and finally we still believe that the vast majority of market participants are overweight fixed income, and long the higher-yielding (and riskier) segments of the fixed income markets.

So overall, we still believe that yields could end the year higher than current levels, and would not consider increasing exposure now that yields have risen. Indeed, were we to see any significant rally in bond prices and a fall in bond yields, investors may consider either reducing their duration exposure or making an allocation to Absolute Return Bond funds.

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