Global Markets Daily: European Bonds in a Growth-Driven Market (Cole)

- The rally in bonds this year signals increasing investor comfort with the risks to duration given the reduced likelihood of runaway inflation.
- Part of this may reflect increased asset allocation towards bonds given the improved hedge value of bonds for risk assets in a market where growth (in either direction) will play a bigger role vs last year.
- But even considering this potential one-off reduction in bond risk premium, we see valuations in long-end European bonds and risk premium as too rich, with a further decline in long-end yields depending on a front-end rally. We forecast higher German yields and a steeper curve.

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European Bonds in a Growth-Driven Market

The reduction in the right-tail risk for high inflation outcomes is a clear driver of the year-to-date fall in yields and rates volatility. Inflation pricing is substantially lower, and the option-implied distribution of inflation outcomes has shifted sharply lower alongside lower prices. So far, there has been little impact on yields from rising growth expectations despite the outperformance of cyclical equities and the upward revisions to our economists' growth estimates. But although we expect yields to rise as major G10 economies, including the US and the Euro area, avoid recession, the reduction in inflation risk likely means the market is getting more comfortable with the hedge value of bonds in a more growth-driven market. While it is true that 2023 is likely to see a larger role for growth in setting asset prices, we think there is only limited room for bond risk premium to fall further. And in the absence of an imminent repricing lower in front-end rates (which we think ongoing growth and inflation pressure will prevent), we expect 10y yields to rise with German 10y rates hitting 2.75% later in Q1.

The decade following the financial crisis saw a significant decline in bond risk premium related to the fall in risks to policy rates and the unconventional monetary policy of that decade, which saw huge quantities of duration removed from the market by central banks via asset purchases. But this period was also associated with a decline in the bond / equity correlation (Exhibit 1), due to decline in the volatility of policy & supply shocks – namely, macro developments that push bond and equity prices in the same direction. This is not to say that these types of shocks did not impact the market, but simply that they were typically outweighed by the

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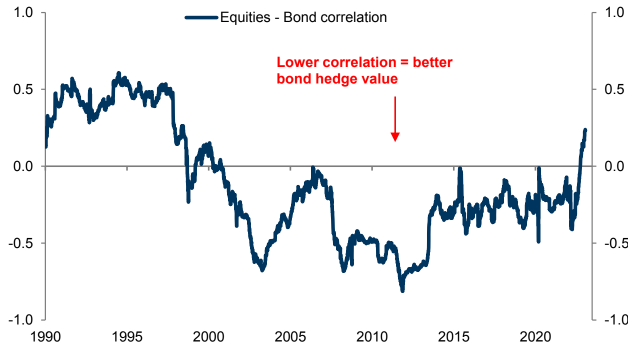
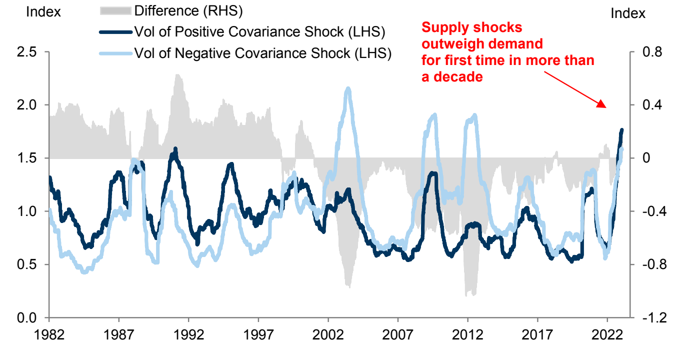
volatility of demand shocks, namely shocks that sent equity and bond prices in different directions (Exhibit 2)[1]. In such a regime, bonds serve as a valuable hedge for risk assets, because when prices tend to move in opposite directions, bonds provide a correlation benefit for diversified portfolios.

Exhibit 1: Higher bond / equity correlation in 2022
1y Rolling correlation between STOXX50 and 10y Bund Returns



Source: Goldman Sachs, Goldman Sachs Global Investment Research

Exhibit 2: "Supply" shocks reduced hedge value of bonds last year
1y Rolling volatility of positive ("Supply") vs negative ("Demand") covariance shocks based on decomposition of 10y Bund and Dax returns



Source: Goldman Sachs, Goldman Sachs Global Investment Research

In 2022, impaired supply chains and the tightness in European gas markets following the Russian invasion of Ukraine left a clear imprint on asset markets, with the inflation surge and resulting policy repricing lowering the prices of both equities and bonds. Supply shocks were measurably more volatile, and the hedge value of bonds was much reduced. Despite this reduction in the relative volatilities of demand vs supply shocks, bond risk premium has only repriced slightly higher in the last year. The bulk of the repricing of rates has been of interest rate expectations, which follow the abrupt hikes taken by almost all major CBs. Exhibit 3 also shows that term premium has also lagged the repricing in inflation risk premium, which has remained fairly robust despite the repricing lower in front-end inflation distributions.

In 2023, we expect a larger role for growth to determine where asset prices settle. As a result, there may be a modest risk premium benefit from an improving inflation / growth mix and bond / equity correlation – this may be behind a reallocation towards Global and European fixed income since the start of the year. We think this argument is attractive, but the difficulty of measuring the concepts, both of the term premium and the volatilities of covariance shocks, means the real world militates against an easy translation of the shift in correlations onto yields. What does seem clear is that the impact of changing macro correlations onto risk premium is not immediate, but likely takes time for the weight of evidence of a new regime to accumulate (Exhibit 4).

[1] To estimate the relative volatility of these shocks we orthogonalize the timeseries of bond and equity returns using a sign restriction technique, in which 'demand' shocks push bond and equity prices in different directions, and 'supply / policy' shocks push prices in the same direction. See here.

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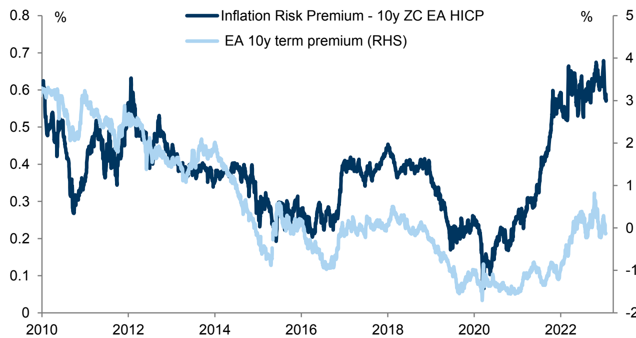
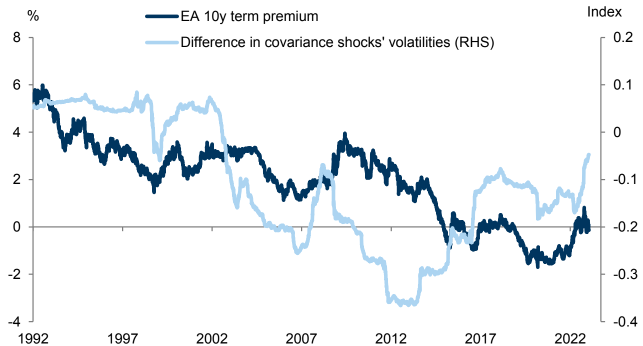
Exhibit 3: Term premium low relative to repricing of inflation risk
GS TSM term premium estimate vs inflation risk premium



Source: Goldman Sachs, Goldman Sachs Global Investment Research

Exhibit 4: Limited room for term premium compression
GS TSM term premium estimate vs difference in covariance shocks' volatilities ("Supply" - "Demand" shocks)



Covariance shocks' volatilities are based on decomposition of 10y Bund and Dax returns and estimated of 5y rolling samples.

Source: Goldman Sachs, Goldman Sachs Global Investment Research

And so while this method gives little clear guidance to short-term market moves, it does help to determine the prevailing winds of a macro regime. This year, we estimate the Euro-area term premium has declined 40bp of the 45bp of total decline in yields. Perhaps this reflects the bigger role of growth as a macro factor this year and the willingness to reallocate some risk to bonds. However, given the elevated supply of bonds (and in particular safe bonds in the Euro area) via both issuance and QT, as well as improving growth expectations and sticky core inflation, we think that we are unlikely to return to a world of clear dominance of demand shocks over supply. For this reason, we think bond risk premium is unlikely to compress further, and we do not expect any relief from front-end rates now that Europe is moving away from a recessionary base-line. As we argued here, we expect the growth upgrades for the European economy this year to boost yields by around 20-25bp. As a result we think there is increasingly good risk reward both to short duration and enter core rates steepeners in Europe.

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Best Trade Ideas Across Assets

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1. Stay long CMBX 14 BBB- index vs. CMBX 10 BBB- index, opened on July 29, 2022, at a 1 to 1.4x notional ratio, with a target of 3% and a stop of -3%, currently trading at 1.46%.
2. Sell 6m 10s30s USD curve floor vs. long 6m 2y payer, opened on September 30, 2022, at 0bp, with a target of 12bp and a stop of -8bp, currently trading at 9bp (value as of Jan 20).
3. Sell 6m2y receivers, opened on November 11, 2022, at 0bp, with a target of 20bp, and a stop of -15bp, currently trading at -4bp (value as of Jan 20).

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4. Sell SFRZ3, opened on November 11, 2022, at 4.37%, with a target of 4.70%, and a stop of 4.15%, currently trading at 4.42%.
5. Receive BRL DI Jan25s and pay CLP 2-year Camara, opened on November 14, 2022, at 5.94%, with a target of 3.5%, and a stop of 8%, currently trading at 5.79%.
6. Receive SGD 2y SORA OIS vs pay basket of global 2y rates, opened on November 18, 2022, at 67bp, with a target of -50bp, and a revised stop of 30bp, currently trading at -6bp.
7. Pay PLN 2-year IRS, opened on November 30, 2022, at 6.84%, with a target of 8.25%, and a stop of 5.75%, currently trading at 6.33%.
8. Stay long Ecuador vs a basket of B/CCC-rated oil exporters (Angola, Gabon, Nigeria) on index-level spreads, opened on December 5, 2022, at 693bp, with a target of 300bp, and a revised stop of 550bp, currently trading at 498bp.
9. Sell 6m5y5y USD midcurve receivers, opened on December 9, 2022, at 0bp, with a target of 25bp, and a stop of -20bp, currently trading at 7bp (value as of Jan 20).
10. Stay short GBP/CHF, opened on December 16, 2022, at 1.135, with a target of 1.10, and a revised stop of 1.15, currently trading at 1.142.
11. Stay long 10y US Breakeven, opened on December 16, 2022, at 0bp, with a target of 25bp, and a stop of -20bp, currently trading at 19bp.
12. Stay long AUD/NZD, opened on January 6, 2023, at 1.083, with a target of 1.12, and a stop of 1.06, currently trading at 1.083.
13. Pay CNY 5Y ND-IRS, opened on January 6, 2023, at 2.77%, with a target of 3.30%, and a stop of 2.50%, currently trading at 2.93%.
14. Pay THB 5Y THOR ND-OIS, opened on January 6, 2023, at 2.22%, with a target of 2.80%, and a stop of 1.95%, currently trading at 2.13%.
15. Stay long the USD bonds of Indonesia, the Philippines, South Africa, Oman, Bahrain, Jordan and Costa Rica as an equally weighted basket, opened on January 9, 2023, at 0%, with a total return target of 2%, and a revised stop of 0.25%, currently trading at 1.8%.
16. Stay long Korean equities (KOSPI) in USD terms, opened on January 11, 2023, at 0%, with a target of 15%, and a stop of -8%, currently trading at 2.40%.
17. Stay long Poland (WIG) against MSCI World (FX unhedged), opened on January 11, 2023, at 0%, with a target of 9%, and a stop of -5%, currently trading at -0.79%.
18. Stay short 10y OATs, opened on January 13,2023, at 2.63%, with a target of 3.05%, and a stop of 2.35%, currently trading at 2.65%.
19. Stay short SGD/MYR, opened on January 13, 2023, at 3.28, with a target of 3.05, and a stop-loss of 3.40, currently trading at 3.24.
20. Stay short TWD/KRW, opened on January 13, 2023, at 40.95, with a target of 38.0, and a stop-loss of 43.0, currently trading at 40.61.
21. Stay long MXN, BRL and HUF vs EUR, opened on January 18, 2023, at 100, with a total return target of 108, and a stop of 96, currently trading at 99.77.

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