AXA Investment Managers

25 October 2023

Investment Institute Macroeconomics

Monthly Op-ed

Gilles Moëc
AXA Group Chief Economist and Head of AXA IM Research

Chris Iggo,
Chair of the AXA IM Investment Institute and CIO of AXA IM Core

Bond pressure

Key points

- The recent rise in US bond yields is detached from the market's expected trajectory for the Federal Reserve. Higher equilibrium rate expectations and returning term premia add to yields.
- The case is much less clear-cut in the Euro area, but European yields move up under US contagion and the European Central Bank's balance sheet shrinking
- Rates risk premiums are back
- Higher yields point to better bond performance

A higher equilibrium rate?

10-year yields briefly breached 5% in the US, getting us back to levels last seen in July 2007, before the Great Financial Crisis of 2008-2009. Even cautious words from Federal Reserve (Fed) officials on the likely trajectory for monetary policy no longer tame the market.

At first glance, concerns over inflation would be the natural explanation. Consumer prices have been decelerating quite swiftly in the US, but the very latest prints signal the possibility that a "line of resistance" above the Fed's target may be emerging. Indeed, while core inflation is dragged down by the continued descent in manufactured prices – a function of the normalization of global supply lines, lower demand for durable goods and China exporting deflation – services prices excluding rents are up again. This would suggest the current resilience of the US economy, illustrated by still strong job creation, will impair the return of inflation to 2%. Still, recently, the further rise in long-term yields was driven by real rates, while inflation expectations were roughly stable and consistent with the Fed's inflation mandate in the longer-term.

While the Fed maintains a modest tightening bias (12 expected one more hike vs 7 in September) and regularly warning they may have to raise policy rates further, many members of the Federal Open Market Committee (FOMC) are calling for patience, trusting the cumulative effect of their swift series of hikes to gradually filter through the real economy and tame domestic inflationary pressure. What is striking actually is that the market can at the same time moderate its expectations of future hikes by the Fed and push long-term yields further up.

There is a risk that this reflects a belief in the market that the equilibrium rate has risen. There are two complementary approaches to defining this "cruise speed" rate. One is to see it as the rate consistent with inflation being at target when there is no

demand/supply imbalance in the economy (i.e., when the output gap is at zero). Another is to see it as the interest rate allowing savings to adjust to the economy's investment needs.

The very fact that inflation persists, and that the unemployment rate remains remarkably low, would suggest that the US still needs to deal with excess demand although policy rates have now exceeded 5%. That is one piece of evidence to add to the "higher equilibrium rate bucket." Assessing the saving/investment balance in real time is difficult, but arguably the fact that under a no policy change scenario US public debt will get to close to 120% of GDP in 10 years, according to the Congressional Budget Office (CBO) projections, raises the risk that the government will siphon out a growing share of savings to the detriment of the private sector, forcing a rise in interest rates to boost the savings ratio. The current dispute over the federal budget bill is forcing investors to take a harder look at the fiscal trajectory.

Still, the equilibrium rate is not observable in real time, and it would take a vast array of assumptions to estimate what contributions these factors are having on the current level of yields. We would not be surprised to see the current narrative on equilibrium rates change very rapidly as soon as the first tangible signs of an economic slowdown emerge. Yet, as long as resilience defines the dataflow, it will be difficult to see the market stance change.

How does this play out in the Euro area? The case for a higher equilibrium rate is not so obvious. True, the region needs to start its fiscal consolidation, but for the monetary union as a whole the fiscal trajectory remains under control. Cutting deficits won't be a walk in the park, but there is no major political or institutional impediment to stabilize public debt, unlike in the US where building a bi-partisan partnership on these issues is next to impossible. The case of governments siphoning a greater share of existing savings is weaker. True, Europe's less than rosy demographic situation could force accumulated assets to be sold by older generations to maintain their consumption, which would depress the aggregate saving ratio, but this could be mitigated, at least for some years, by a trend towards a longer working life.

Moreover, the Euro area is not displaying the sort of resilience so prevalent in the US. The economy is already stagnating if not in outright "shallow recession" across some member states. It's hard to argue that the quantum of monetary tightening already provided there has not had its usual impact on demand.

Yet, two forces may explain why the Euro area cannot fully escape the rise in long-term yields. One is the usual contagion from the US, given the still dominant role the US treasury market plays for bond pricing globally. The other is the European Central Bank (ECB) stance: the central bank is shrinking its balance sheet. There is a risk that the Governing Council goes too fast, seeking to reduce the deterioration in the ECB's profit and loss account which the persistence of excess reserves is triggering. We have already had a warning shot with some tension on the Italian bond market.

Higher yields, higher returns

Prior to the quantitative easing (QE) era, government bond, and other fixed income assets returns, were generally positive. Negative periods were limited in extent and duration – they tended to happen when economic growth was strong and interest rates were rising. When bonds formed part of a balanced portfolio, it was typically the case that if bond returns were negative because of economic strength, equity returns would be positive – hence balanced portfolios' popularity. When equity returns were negative, yields on bonds and subsequent declines in interest rates usually combined to deliver positive returns from the fixed income part of the portfolio, thus dampening losses from more economically sensitive equities. Tactically shifting the weight between the bond and equity allocation on the basis of the macroeconomic cycle could have contributed to investment performance. But on the whole, it was the asset combination and their inherent risk factors that was key.

Due to the shift in supply and demand that QE created, bond yields fell in the period following the global financial crisis when quantitative easing (QE) was introduced. This gradually undercut returns from fixed income assets as term risk premiums and bond volatility were gradually suppressed. The 2010s did not see long or frequent periods of negative returns from bonds but average returns declined. Over time, the attractiveness of bonds as an asset class in their own right diminished and their usefulness in balanced portfolios declined.

The three great shocks of 2020-2022 conspired to change market dynamics once again. COVID-19, the subsequent rise in inflation generated by the pandemic, and Russia's invasion of Ukraine were met by a monetary policy shock that comprised of aggressive interest rate hikes and an end to QE. The early stages of the pandemic did see a last wave of QE, taking global government bond

yields to extreme lows. With hindsight, a massive reset in valuations was on the cards. It has indeed happened. European and US government bond yields bottomed in the second half of 2020. Today they are 400-500 basis points (bp) higher. The impact on bond portfolio returns has been disastrous. The Bloomberg Global Aggregate Bond Index – made up of government and high-quality corporate bonds – delivered a negative total return in 2021 and 2022 and, at the time of writing, was in negative territory for 2023 as well.

There has been a paradigm shift since central bankers gave up on zero interest rate policies and QE. Persuading investors that now is the time to come back to bonds is a challenge though. Central bank buying is a thing of the past – so the "bond put" has gone. Governments are issuing more debt to finance increased fiscal deficits, so supply digestion becomes a market driver. Inflation continues to run above target levels that anchored inflationary expectations for the last 20 years or so. Central banks have taken overnight interest rates to levels that are restrictive on most measures but there is uncertainty about what the appropriate medium-term equilibrium level of rates is to ensure that inflation returns and stays at those target levels. For now, this means interest rates stay high for a long period of time. For the Fed, the ECB, and the Bank of England, market pricing rules out any meaningful rate cuts for most of 2024. There is a risk long-term bond yields will rise further to offer an even higher premium to reflect the uncertainty about where policy rates will be in the years ahead. In the short term, economic data volatility prevails over modest shifts in central bankers' rhetoric in terms of driving market price action.

A more positive view rests on the crucial assumption that inflation will revert to closer to the 2% target level than staying near the average it has been in developed economies over the last two years. If that assumption is wrong, then so much of our thinking on investment and economics will need to change. Let us assume it remains the strong base case. If so, then the argument for bonds is much more appealing. Historically, we are at yield levels in government bond markets that have subsequently generated positive total returns. The compounding of current yields is a strong force when yields are close to 5% – something that could not be used as a selling point for fixed income when German government bonds were trading at a yield to maturity of -85bps in mid-2020. Short-term maturities today offer attractive yields, delivering income, while long-term bonds are trading at such a huge discount to par that high medium-term returns can be locked in. Future liabilities can be more confidently hedged.

A consideration of corporate bonds brings with it the additional element of credit risk. Historically, looking at a global corporate bond index, the excess return from a credit portfolio relative to a government bond portfolio has been around 150-170bps. There are, of course, times when credit spreads widen and therefore reduce total returns. It's important to judge how to balance this risk with pure interest rate-sensitive bonds and much more economically sensitive equities. Nevertheless, over time and on the basis of today's prevailing credit risk premiums, corporate bonds should deliver mid to high single-digit total returns. For high yield bonds, today's 9% plus yield in the US market has rarely been topped outside of crisis periods. One potential development over the next few quarters is weaker economic growth and a rise in debtor problems that could lead to a widening of credit spreads on corporate bonds. Given where rates are, however, the downside to total returns may turn out to be relatively limited as any negative price return driven by wider spreads is likely to be offset to some extent by a positive price effect driven by lower rates.

The profile of bond returns going forward should look more like it did before the QE era. Higher yields mean there is more of a buffer to protect total returns. Hindsight tells us bonds were super expensive in 2020. The smart investor would have been out of bond markets entirely, or at least in very short-duration fixed income strategies that would benefit from constantly higher reinvestment rates. Today calling the market top in yields is difficult but setting out a medium-term strategy to take advantage of higher compound returns is sensible.

The last point is that for traditional balanced fund investors, bonds are once again a valuable driver of performance. They will generate more income, the total returns should be less volatile and they should provide more of a hedge against negative returns from equity markets. As the global outlook continues to face significant headwinds from slower growth, uncertain policy and geopolitical threats, this should become a very important investment theme.

(Performance data/data sources: Macrobond, as of 24 Oct 2023; Refinitiv and Bloomberg, as of 20 Oct 2023).

AXA Investment Managers

25 October 2023

Macro forecast summary

Real GDP growth (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.5		3.0		2.7	
Advanced economies	2.6		1.5		1.0	
US	2.1	2.1	2.2	2.1	1.4	0.8
Euro area	3.5	3.2	0.5	0.5	0.3	0.7
Germany	1.8	1.8	-0.3	-0.4	0.3	0.6
France	2.5	2.5	0.7	0.8	0.3	0.8
Italy	3.7	3.7	0.7	0.8	0.1	0.7
Spain	5.8	5.5	2.5	2.2	0.7	1.4
Japan	1.0	1.0	1.9	1.8	0.9	0.9
UK	4.1	4.1	0.5	0.3	0.2	0.4
Switzerland	2.7	2.1	0.7	0.8	1.0	1.3
Canada	3.4	3.4	1.1	1.3	0.9	0.7
Emerging economies	4.1		3.8		3.7	
Asia	4.4		4.9		4.4	4.0
China	3.0	3.0	5.0	5.0	4.5	4.5
South Korea	2.6	2.6	1.4	1.1	2.2	2.0
Rest of EM Asia	6.2		5.2		4.4	
LatAm	4.1		2.3		2.2	
Brazil	2.9	2.9	2.9	2.9	1.2	1.6
Mexico	3.9	3.9	3.3	2.9	2.0	1.8
EM Europe	0.9		1.7		2.2	
Russia	-2.1		2.2		1.1	1.3
Poland	5.1	4.9	-0.1	0.5	2.6	2.6
Turkey	5.5	5.6	2.1	3.4	3.1	2.0
Other EMs	5.1		2.4		3.5	

Source: Datastream, IMF and AXA IM Macro Research – As of 24 October 2023
**Forecast*

CPI Inflation (%)	2022		2023*		2024*	
	AXA IM	*Consensus*	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	7.4		4.8		2.8	
US	8.0	8.0	4.3	4.1	3.0	2.5
Euro area	8.4	8.5	5.7	5.5	2.9	2.5
China	1.9	2.0	1.0	0.7	2.0	1.8
Japan	2.5	2.5	3.0	3.1	1.5	2.0
UK	9.1	9.1	7.5	7.4	2.8	3.1
Switzerland	2.8	2.8	2.4	2.3	1.5	1.6
Canada	6.8	6.8	4.1	3.8	3.2	2.5

Source: Datastream, IMF and AXA IM Macro Research – As of 24 October 2023
**Forecast*

These projections are not necessarily reliable indicators of future results

AXA Investment Managers

25 October 2023

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q3-22	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24
United States - Fed	Dates	5.50	26-27 July 20-21 Sep	31-1 Oct/Nov 12-13 Dec	30-31 Jan 19-20 Mar	30-1 Apr/May 11-12 Jun	30-31 Jul 17-18 Sep	6-7 Nov 17-18 Dec
	Rates		+1.5 (3.00-3.25)	unch (5.50)	unch (5.50)	-0.25 (5.25)	-0.25 (5.00)	-0.25 (4.75)
Euro area - ECB	Dates	4.00	21 July 8 Sep	26 Oct 14 Dec	25 Jan 7 Mar	11 Apr 6 Jun	18 Jul 12 Sep	17 Oct 12 Dec
	Rates		+1.5 (0.75)	unch (4.00)	unch (4.00)	-0.25 (3.75)	-0.25 (3.50)	-0.25 (3.25)
Japan - BoJ	Dates	-0.10	20-21 July 21-22 Sep	30-31 Oct 18-19 Dec	22-23 Jan 18-19 Mar	25-26 Apr 13-14 Jun	30-31 Jul 19-20 Sep	30-31 Oct 18-19 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	+0.10 (0.00)	unch (0.00)	unch (0.00)
UK - BoE	Dates	5.25	4 Aug 15 Sep	2 Nov 14 Dec	1 Feb 21 Mar	9 May 20 Jun	1 Aug 19 Sep	7 Nov 19 Dec
	Rates		+1.00 (2.25)	unch (5.25)	unch (5.25)	unch (5.25)	-0.25 (5.00)	-0.50 (4.75)
Canada - BoC	Dates	5.00	4 Aug 15 Sep	25 Oct 6 Dec	24 Jan 6 Mar	10 Apr 5 Jun	24 Jul 4 Sep	23 Oct 11 Dec
	Rates		+1.00 (2.25)	unch (5.00)	unch (5.00)	unch (5.00)	-0.25 (4.75)	-0.25 (4.50)

Source: AXA IM Macro Research - As of 24 October 2023

These projections are not necessarily reliable indicators of future results

The information has been established on the basis of data, projections, forecasts, anticipations and hypothesis which are subjective. This analysis and conclusions are the expression of an opinion, based on available data at a specific date. Due to the subjective aspect of these analyses, the effective evolution of the economic variables and values of the financial markets could be significantly different for the projections, forecast, anticipations and hypothesis which are communicated in this material.

DISCLAIMER

This document is being provided for informational purposes only. The information contained herein is confidential and is intended solely for the person to which it has been delivered. It may not be reproduced or transmitted, in whole or in part, by any means, to third parties without the prior consent of the AXA Investment Managers US, Inc. (the "Adviser"). This communication does not constitute on the part of AXA Investment Managers a solicitation or investment, legal or tax advice. Due to its simplification, this document is partial and opinions, estimates and forecasts herein are subjective and subject to change without notice. There is no guarantee forecasts made will come to pass. Data, figures, declarations, analysis, predictions and other information in this document is provided based on our state of knowledge at the time of creation of this document. Whilst every care is taken, no representation or warranty (including liability towards third parties), express or implied, is made as to the accuracy, reliability or completeness of the information contained herein. Reliance upon information in this material is at the sole discretion of the recipient. This material does not contain sufficient information to support an investment decision.

© 2023 AXA Investment Managers. All rights reserved