Focal Point

Correction in Bund yields does not herald sell-off

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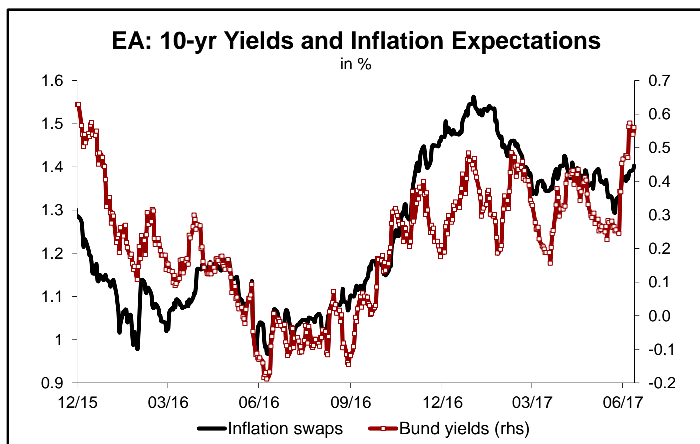
- Since the end of June, 10-year Bund yields have soared by 30 bps triggering concerns of a pronounced sell-off.
- However, according to our analysis a 'taper tantrum' is not on the cards and the scope for a further significant upward movement of core yields appears to be limited in the short term. Market doubts about long-term inflation, the ongoing ECB bond buying, scarcity and political risks will keep a lid on bond yields in the months to come.
- Further down the road, the way is paved for higher euro area yields. Solid economic growth and less monetary policy accommodation are forecast to lift 10-year Bund yields. In addition, the expected increase in US yields will also be a key driver for Bund yields going forward.
- From a long-term equilibrium perspective we view 10-year Bunds still as overvalued. With an expected yield of around 0.85% on a 12-month horizon we see this overvaluation to be reduced but not eliminated.

After trading in a rather tight trading range between 0.15% and 0.50% for more than six months, the 10-year Bund yield broke out of this corridor at the start of the month. The sharp increase of 30 bps in less than three weeks triggered concerns of a more pronounced rise in yields. In the following, we analyze the outlook for Bunds. In sum, we view the back-up in yields as a healthy correction from too low levels and see the way paved for higher euro area core yields, but an outright sell-off is not on the cards.



Considerable steepening of Bund yield curve

Triggered by ECB comments perceived as more hawkish and a growing confidence in the economic recovery, long- and medium-dated euro area core yields have increased since the end of June. Therewith, the 10-year Bund yield has reached the highest level since the start of 2016. While long-dated yields rose by more than 30 bps to 0.55%, the short end of the curve did not move at all.

It is noteworthy that the increase is stronger than in the US (10-year US yields up by only 13 bps) and that inflation expectations have not recovered considerably. Since the end of June, 10-year inflation swaps have increased by a mere 5 bps. Notwithstanding the increase in real yields to the highest level since spring 2016, its current reading of -0.80% is still low from a historical point of view. This depressed level and the fact that inflation expectations are still below the historical levels consistent with the ECB's inflation target have triggered concerns that the correction has not run its course yet and yields have scope to rise considerably further going forward.

A sell-off is not on the cards in the short term

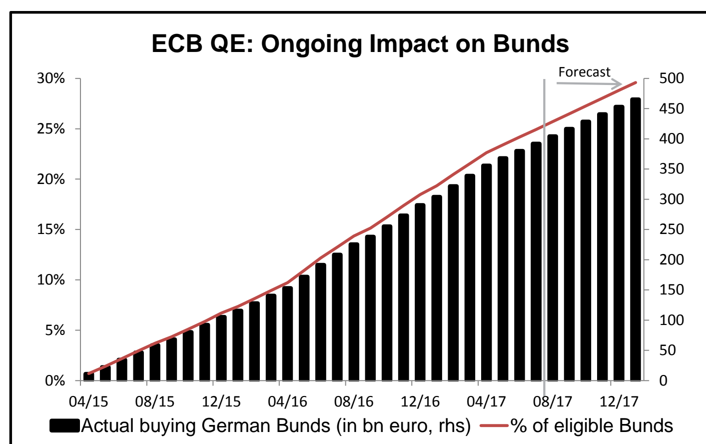
After the recent increase from too low levels, the risks regarding the near-term outlook for yields have become more symmetric. While the market positioning appears to remain long and risky assets are holding up rather well – thereby limiting any safe haven flows – there could be scope for a continuation of the recent rise in yields. However, an outright sell-off is unlikely for several reasons.

To start with, the near-term outlook for inflation remains rather muted. Euro area headline inflation was at 1.3% yoy in June while the latest weakness in oil prices does not hint at a significant rise in inflation. Likewise, underlying inflation (ex energy and unprocessed food, currently at 1.2% yoy) will trend upwards only slowly in the months to come given that there is still slack in the economy and that an acceleration of wage growth is not on the cards.

What is more, the ECB will continue its QE program. It reduced the amount of monthly purchases under the Asset Purchase Programme to € 60bn by April, but will maintain this volume at least until the end of 2017. This implies monthly purchases of government bonds of around € 47bn per month with about € 9bn being devoted to Bunds, taking the April to June average as a reference. At the start of next year, we do not expect the ECB to abruptly stop QE but rather look for some form of measured tapering in order to avoid tantrum-like market reactions. We assume that tapering will last until September 2018. This implies that the ECB will in 2018 still buy around € 40bn of Bunds while net issuance will be negative as the German fiscal balance will likely record a small surplus for the fifth consecutive year.

The yield dampening effect of future ECB buying is amplified by the fact that the scarcity of German Bunds is expected to come to the fore again. Until the end of June, the ECB bought already nearly € 400bn of German Bunds (almost 25% of all eligible bonds). By the end of the year, the ECB will hold nearly 30% of all eligible German papers. Given the self-imposed limit of 33% and our expectation that the central bank will only taper in 2018, the scarcity will become increasingly binding and stands in the way of a strong increase in yields. Already in recent months the purchases of German Bunds fell short of the theoretical level and the falling average remaining maturity of government bonds bought reflects the increasing scarcity at the long end of the curve, too. Also, the increase in yields has a curbing effect on future yield increases. With the spread between long-dated Bund yields and money market rates back to around 100 bps, the high carry will dampen the potential rise in long-dated Bunds.

Finally, we are currently in a period of reduced political stress. Frexit concerns have even morphed into hopes for structural reforms and higher growth in France and improved EMU governance. However, in the months to come there are again political risks at the horizon. The tensions over the proposed Catalan independence referendum, a likely hung parliament following the Italian elections in spring 2018 as well as political risks related to the implementation of Trump's economic agenda are all factors giving tailwind to safe haven assets like Bunds.

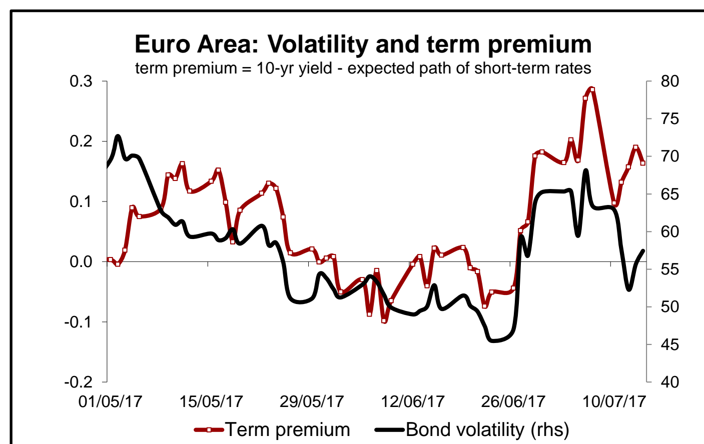


Medium-term way is paved towards higher yields

Looking further down the road, the conditions for an additional increase in euro area core yields are met. The ECB is likely to announce an exit strategy from its QE program in September. Although this is widely expected by market participants, entering the exit phase will have an impact on international bond markets. For several years the ECB has supported bond markets and a corresponding announcement will mark an important turning point. Once these distortions fade, yields will gradually trend higher.

Due to the international yield connection euro area core yields are strongly influenced by US ones. Currently, less than two further Fed rate hikes until the end of 2018 are discounted. This is at odds with the Fed's willingness to hike four times by the end of next year. In addition, there has been a strong build-up in speculative US Treasury long positions (close to a record high). If history is any guide, a normalization of the position will lead to higher US yields. Finally, financial markets appear too negative on the US economic outlook. Although the Trump administration is unlikely to implement its originally planned projects completely, a mildly expansionary fiscal policy will keep the US economy afloat for the time being. Hence, there is scope for higher US yields in the months to come which will at least partially spill over to the euro area.

Furthermore, the underlying inflation pressure will increase in an environment of stable growth. According to the European Commission the output gap will close in 2019 while we see oil prices trending mildly higher. Headline inflation will likely average 1 ½% in 2018 – roughly unchanged from 2017 – and at the end of 2018 markets will look for core inflation to move from a reading of 1 ½% in the vicinity of 2% over the next three years



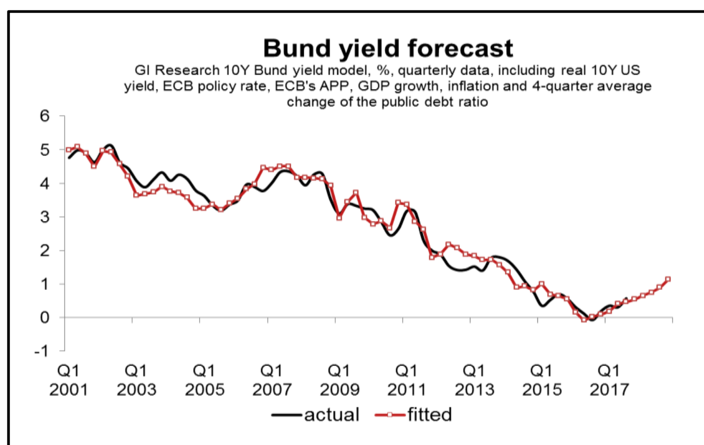
On top of these fundamental factors, more technical reasons are worth mentioning. Although the volatility has risen from very low levels in recent weeks, it is still close to historical lows. There are several potential sources for an increase. Among others, the extreme low inflation environment will likely end, the expected end of the current ECB policy stance, and also the yield increase itself is seen to trigger a normalization of bond market volatility. Furthermore, taking into account the political and economic environment the term premium is hardly positive (+15 bps) and still below the historical average (despite the recent increase). Although it is difficult to forecast the timing of normalization, both, the term premium and the bond market volatility, are expected to rise in the future. This is usually accompanied by an increase in yields.

Bunds to remain overvalued

From a long-term equilibrium perspective 10-year Bund yields are overvalued. Yields should in the long run equal

nominal growth (currently at 2.6%) plus a risk premium (average 1998-2013: 68 bps). Also, approaches based on real economic growth models suggest that long term yields should be above 3%. The key reason for the disconnection from these levels is that the ECB responded with an unprecedented stimulus to the low growth and deflationary environment following the crisis pushing the risk premium on Bunds down to about -200 bps (2014-2016). Also, yields in the US are still low albeit the Fed has started to normalize rates. Incorporating these factors as well as the current macroeconomic situation (growth, inflation, and government debt) explains most of the latest surge in Bund yields. The current yield level is only about 10 bps above what is implied when taking into account the actual macroeconomic and monetary policy environment.

Looking ahead, a further increase in Bund yields due to fundamentals is on the cards. According to our quantitative framework the expected ECB tapering will be the major driver. We found that empirically € 1bn of QE (in terms of monthly purchases) reduces 10-year Bund yields by almost 1 bp. Until the end of 2018 the ECB's exit from QE will lift Bund yields by about 50 bps. The second driver for higher yields will come from the US where we see 10-year nominal yields rising towards 3% at the end of 2018 (from 2.3% at present) pushing Bund yields about 10 bps higher. These factors are consistent with our view that 10-year Bund yields will likely be at 0.85% on a twelve month horizon. That said, a longer lasting rise in political uncertainty could trigger safe haven flows and dampen the expected rise in yields. In any case, we expect Bund yields to remain overvalued from a long term equilibrium perspective.



Bunds to experience negative total return

Although we look only for a moderate rise in Bund yields towards 0.85% over the coming twelve months, given the still very low yield level the total return will remain negative. Particularly long-dated bonds are expected to suffer as the ECB will not, in our view, change its policy rates as long as tapering is not completed. Therefore, Bund investors should continue to prefer shorter maturities.

Looking beyond the twelve month horizon, in an environment of stable but not exceptionally strong growth the pace of yield increase will to a high degree be determined by the central bank's behavior. We expect the ECB to only carefully adjust key rates in order to avoid a too fast deterioration of financing conditions. Therefore, we expect Bund yields to rise in a measured way in the post QE period and deem worries about a sell-off overdone.

Imprint

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