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Time to bond with bonds

Yields not seen in 15 years, central banks almost done with hiking and tepid growth expected ahead – a lot speaks for bonds these days. And if you fear inflation, equities might be worth a look.

> “We expect equities to face some reality checks over the coming months, after their strong YTD performance. Fixed income is the main beneficiary of an environment in which inflation and interest rates are peaking and growth is tepid.”

Björn Jesch
Global Chief Investment Officer

Compared to the years 2020-23, the past couple of months have been rather uneventful in terms of major political or economic shocks. But there were particularly intense discussions during our third CIO Day of the year, in which we formulate our view on the global economy and capital markets for the next 12 months. The main uncertainties in the markets can be boiled down to the following questions: How deep of an economic slowdown is needed to bring inflation down? And what role will labor markets play? What is the reaction function of the central banks, who are just as data dependent these days as we are? And how far ahead are bond markets looking?

These questions are made more complex by the fact that the world is dealing with a handful of major structural shifts: easy money has turned into Quantitative Tightening; China is struggling with various internal and external problems, including deteriorating relations with the West; and the Ukraine war has brought instability to Europe. On the positive side, the advance of digitalization and Artificial Intelligence (AI) could raise potential growth in many countries.

Our outlook for equities is influenced by AI and by the outsized role it has played in U.S. equity markets, which we demonstrate below. This is one of the main reasons why we expect higher returns for European than for U.S. equity markets. But we also see macroeconomic factors as being in Europe’s favor. We expect Europe to escape the (mild) recession we are forecasting for the U.S., and we expect Europe’s economy to grow more than twice as fast as the U.S. in 2024 (0.9% vs 0.4%). At the same time the U.S. will suffer another year with a hefty budget deficit (our forecast is 5.6% of GDP) and needs to issue vast amounts of Treasuries that might be met with decreasing external demand, pushing bond yields up[1].

The further problem for U.S. equities is that the market is split into two. There are the often cited seven U.S. mega caps, mostly from IT and media/internet related sectors, that have benefitted from the AI boom this year. The Nasdaq 100 is up YTD by some 40% and the Dow Jones by just 4%[2]. This in turn means that the valuation gap between growth and value stocks, or between Big Tech and the rest has become significant. U.S. Technology trades at a premium of 47% to U.S. stocks excluding the TMT sector, while the 30-year average for this gap is 20%. And the U.S. market premium to Europe is 56%, against a 30-year average of 20%, and to Germany – the value market par excellence - 70%, compared to an average of 18%.[3]

[1] As the mounting number of geopolitical enemies might be less inclined to borrow from the U.S.
[2] As of 9/11/23.
[3] Based on next 12 months earnings estimates, and regional Datastream indices. As of September 11, Source: Refinitiv Inc.

These gaps from the historical norm are very big and are the grounds for our caution on U.S. equities. U.S. mega-large caps have on aggregate become too expensive to drive meaningful market upside from here.

At the same time, a change in market leadership towards cheaper value stocks does not seem imminent. That would require higher than currently forecast GDP growth in the U.S., Eurozone and China. Our relative preferences within equities are: Communication Services, which offers AI exposure at a reasonable valuation and double-digit earnings per share (EPS) growth; Discretionary Consumption, currently supported by robust labor markets; and European small and mid-caps (SMID), as Europe offers "value within value" and SMID caps have a particular high discount to the S&P 500.

Holding back equity valuations are real interest yields last seen in 2009 – the U.S. TIPS yield is now almost 2%, compared to a 10-year average of just 0.28%[4]. And while we believe that the central banks' hiking cycles[5] are coming to an end this year, the rate cuts we are expecting for next year[6] constitute an interim rate adjustment and not the beginning of a full-blown easing cycle. Inflation will likely come down significantly by 2024 but still not be low enough for central banks to return to neutral rates. This scenario – our central one – is very positive for bond investors. They are benefiting now from interest yields not seen since 2008[7] and might even, the icing on the cake, benefit from slightly decreasing interest yields, which will increase bond prices. We expect more of a decrease at the shorter end than the long end, which means we expect the 2y10y yield curve to flatten in 12-months' time. For 10-year yields we expect 4.2% for Treasuries and 2.7% for Bunds, for 2-year yields we expect 4.35% and 2.7%. In terms of maturities, we currently prefer the 2-to-5-year segment: although the initial yields are similar, the reinvestment risk[8] is lower (as it is shifted to the back) than it is for shorter maturities such as money markets.

We believe corporate bonds offer a nice interest yield premium to sovereign bonds. We slightly prefer investment grade (IG) to high yield (HY) bonds, as they will be more resilient should the economic downturn prove more marked than we expect. But given stronger fundamentals than in previous cycles, we believe HYs have some yield cushion for the coming months. On Emerging Market (EM) bonds, heterogeneous as they are, we are slightly cautious because of the drag from China, and marginally favor corporates against sovereigns.

In Alternative assets we are not dropping our positive stance on gold, which has held up pretty well over the past 12 months despite strong headwinds from real interest rates – helped by support from central bank buying. The rate increases are ceasing while the latter looks set to remain. Our target price for gold is USD 2150/oz. Oil supply will be more than sufficient over the coming 12 months, with growing contributions from the U.S. and Iran, while China weighs on demand growth. This means we expect that the benchmark Brent crude will trade about evenly over the next year (USD 88/b by next autumn.)

Within the Infrastructure space we see continued strong performance due to inflationary and interest rate pressures. Private markets valuations are holding up well. We expect fundraising and transaction slowdown to reverse in Q3/Q4 2023 as the market settles. Our preferred sectors are Energy, Transport, and Digital, where data centers are appealing.

In real estate, higher interest rates are pricing into valuations with a 6-12 month lag relative to listed markets. But fundamentals remain solid, with low vacancy rates and healthy rent growth across most sectors and regions. Recession might dampen leasing, but construction is also falling amid labor shortages and lack of financing. We prefer logistics due to increasing demand, and residential buildings due to housing shortages.

In summary, we believe that market volatility will increase from now on. Some reality checks are due, not least for China, which is struggling with long-term challenges. Nevertheless, we believe that current sentiment towards China might have reached rock bottom. For investors the good news is that they have a wide range of asset classes that can offer income, upside or protection, according to their preference and market outlook.

[4] 10-year Inflation Protected Treasury Yields. German inflation linked 10y Bunds yield 0.17% compared to a 10-year average of -0.5%. Bloomberg Finance L.P. as of 9/11/23.
[5] We believe the Fed is already done for this cycle, with the risk case being one more hike to come. For the ECB we expect a hike this week or at the latest in November, with the risk case being no hike.
[6] For our forecasting horizon, we expect one rate cut each from the Fed in 2Q and 3Q 2024 and no ECB cut before 4Q24.
[7] Based on the Global Aggregated Index which yielded 4% on 11/9/23, Source: Bloomberg Finance L.P.
[8] The risk of not being able to reinvest your money at a similar yield once your original investment expires.

GLOSSARY

Artificial intelligence is the theory and development of computer systems able to perform tasks normally requiring human intelligence

Brent crude is a grade of crude oil dominant in the European market.

A budget deficit is created whenever the spending in a public budget exceeds the income within a given time period

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

The Dow Jones Industrial Average (DJIA) is a price-weighted equity index that aims to track the development of the U.S. equity market.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The 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.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

The MSCI Europe SMid Cap Index represents mid and small cap stocks across 15 developed markets countries in Europe (Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the UK). The Index covers approximately 28% of the free float-adjusted market capitalization in each country.

The Nasdaq-100 is an equity index which contains the 100 biggest common stocks listed on the Nasdaq Stock Market.

Quantitative Tightening (QT), as opposed to Quantitative Easening, describes the process of a Central Bank reducing its monetary stimulus by shrinking its balance sheet.

The real interest rate is the nominal interest rate adjusted for inflation as measured by the GDP deflator.

A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

Treasury Inflation-Protected Securities (TIPS) are a form of U.S. Treasury bonds designed to protect investors against inflation. These bonds are indexed to inflation and pay investors a fixed interest rate as the bond's par value adjusts with the inflation rate.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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