Outlook 2024 - Core government bonds

Attractive returns likely on the cards

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FLASH NOTE

27 NOVEMBER 2023, CIO OFFICE & MACRO RESEARCH

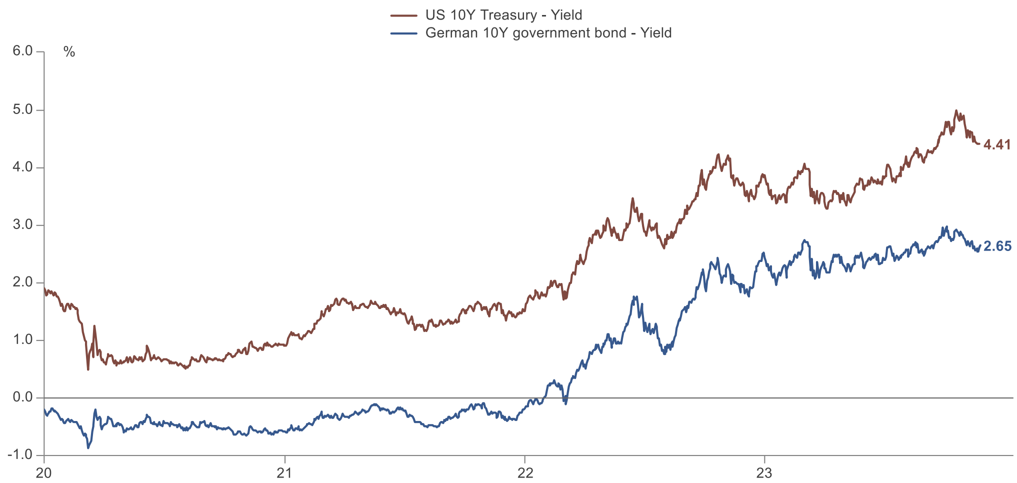
SUMMARY

- Fixed-income investors were surprised by the significant rise in core government bond yields in 2023. This was driven by higher real yields, reflecting surprising economic resilience. In the US, the fast increase in the term premium against the backdrop of elevated macroeconomic uncertainty and a growing fiscal deficit also played an important role.
- We expect the 10-year US Treasury yield to fall from its 23 November level of 4.41% towards 4% in June 2024. This is because the US economy could experience a mild recession in early 2024, possibly leading to rate cuts by the US Federal Reserve (Fed) that would likely cause a steepening of the US yield curve. We expect the 10-year yield to rise slightly to 4.3% thereafter as the US economy recovers moderately in H2. Uncertainties about the budget deficit and the future supply of US Treasury securities could also put upward pressure on yields.
- In the footsteps of US government bond yields, the 10-year German Bund yield is likely to decrease as the European Central Bank (ECB) is also likely to cut rates, possibly starting in June. We expect it to fall from 2.65% on 23 November towards 2% in H1 2024 before rebounding slightly to 2.3% by the end of next year.
- To take advantage of the expected decline in interest rates, we remain overweight US Treasuries going into next year. For the same reason, we have moved from neutral to an overweight stance on core euro government bonds. We expect US Treasuries and German Bunds to generate positive, mid-single-digit total returns in 2024 given the decline in yields and comfortable coupons.

POSITIVE FIXED-INCOME RETURNS EXPECTED

Following a negative year for fixed income in 2022, investors were again caught off guard by the large rise in interest rates this year. While we expected the cycle of rapid rate hikes to have a significant impact on economies, the transmission mechanism has been working slower than expected, particularly in the US. Even though major central banks seemed to have reached the end of their tightening cycle, US government bond yields continued to soar to their highest level since before the global financial crisis (GFC, *see chart 1*). The rise was primarily driven by higher real yields, reflecting more-resilient-than-expected US economic activity and the fast increase in the term premium (the compensation that investors require for the extra risk entailed in holding longer-term bonds) given elevated macroeconomic uncertainty and a growing fiscal deficit.

Chart 1: US and German 10-year government bond yields



Source: Pictet Wealth Management, FactSet, as of 23.11.2023

We remain convinced that the US will experience a mild recession in the first half of next year as previous rate hikes are transmitted to the real economy. While a slowdown will initially push US government bond yields lower, a moderate economic recovery in the second half of the year could send yields higher again. Additionally, uncertainties about the future path of the federal budget deficit and the supply of US Treasury securities remain and could put durable upward pressure on yields. The trend in German Bund yields is expected to mirror that of US Treasuries — initially declining due to sideway euro area economic growth and subsequently increasing modestly as the economy recovers.

Should disinflation continue, the Fed and the ECB may cut interest rates starting in June 2024, thereby supporting economic growth. While the Fed moves toward rate cuts, quantitative tightening (QT, the Fed's non-reinvestment of maturing government bonds in a bid to shrink its balance sheet) is expected to persist. However, given the increasing scarcity of bank reserves, QT could stop in Q4. The ECB is expected to continue reinvesting maturing securities from the Pandemic Emergency Purchase Programme (PEPP, the ECB's temporary asset purchase programme) until the end of 2024. Some hawks at the ECB could push for an early end to reinvestments, posing risk to the market's stability. Nevertheless, the winding down of its Asset Purchase Programme portfolio (APP, initiated in mid-2014) will continue and will gradually reduce the ECB's holdings of euro sovereign bonds by approximatively EUR15-20 bn a month in 2024.

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In conclusion, we expect US Treasuries and German Bunds to generate positive, mid-single-digit total returns in 2024 given a decline in yields and comfortable coupons.

NEW FRAMEWORK FOR FORECASTING THE 10-YEAR TREASURY YIELD

To establish our year-end forecast for the 10-year Treasury yield, we use a Fed model that breaks down the 10-year Treasury yield between the expected policy rate and inflation expectations in 10 years' time, with the real term premium (the D'Amico, Kim, and Wei (DKW) 2018 model, *see https://www.federalreserve.gov/econres/notes/feds-notes/tips-from-tips-update-and-discussions-20190521.html*) and the inflation risk premium added to the calculation (*see Table 1*).

Table 1: Nominal yield decomposition

10-year nominal yield	=	10-year future short-term real rate	+	10-year expected average inflation	+	10-year real term premium	+	10-year inflation risk premium
10-year nominal yield	=	10-year future short-term nominal rate			+	10-year nominal term premium		

Source: https://www.federalreserve.gov/econres/notes/feds-notes/tips-from-tips-update-and-discussions-20190521.html

The expected policy rate in 10 years' time and 10-year inflation expectations give us the future short-term nominal rate. As outlined in a previous Flash Note (see Uncertainties feed into higher Treasury yields), this can be estimated by looking at the Fed's 'dot plot' (which shows the longer-run federal funds rate at 2.5%, *see https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20230920.htm*) or at market participants' expectations (which stood at 4.1% as of 23 November). We believe that the Fed's forecast of 2.5% could prove too low, while the market forecast of 4.1% seems elevated given that 'higher-for-longer' policy rates could drastically cut growth in a highly indebted US economy. In this new post-pandemic regime, we believe that a fair estimate of the future short-term nominal rate is around 3.5%.

The second component of the 10-year Treasury yield is the nominal term premium, which consists of the inflation risk premium and the real term premium. The inflation risk premium represents the additional compensation received by investors for bearing future inflation risks. The inflation risk premium has been close to zero or negative since 2010, when a period of low inflation began. In our main scenario, we consider that while the Fed has maintained its credibility regarding long-term inflation expectations, it may be prudent to consider a slight rise in the inflation risk premium to 0-0.2%, as we foresee a structurally higher inflation environment ahead. Finally, while hard to estimate, the real term premium is an increasingly important factor in determining long-term Treasury yields. Like the inflation risk premium, the real term premium has been shifting from near zero or negative to positive territory since the reversal of quantitative easing (QE).

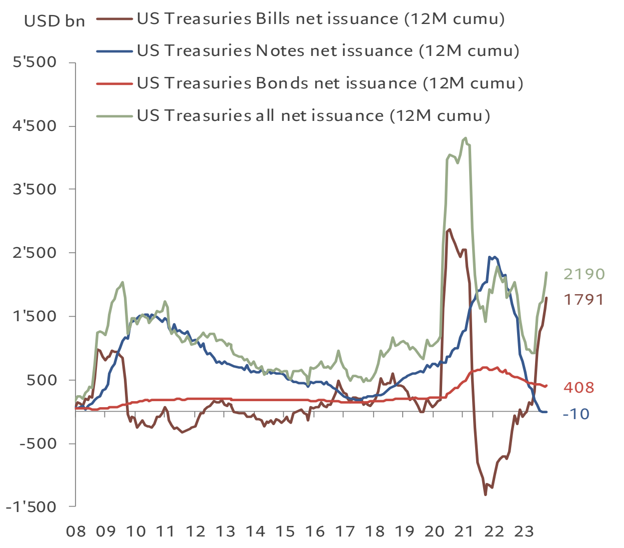
NORMALISATION OF THE US TERM PREMIUM

As we commented in a previous Flash Note (see Treasury yields could drop back, but remain structurally higher), the recent rise in the term premium, which led to a rise in the 10-year US Treasury yield in Q3, was triggered by elevated macroeconomic uncertainty and a growing US fiscal deficit.

The US fiscal deficit for 2024 is expected to increase to USD1.8 trn from USD1.7 trn in 2023, driven by higher net interest payments. To finance it, the US Department of the Treasury announced an increase in the size of Treasury auctions (bonds and notes) — although for long-term maturities ranging from 10-to-30 years, the increase will be less than expected (*see https://home.treasury.gov/policy-issues/financing-the-government/quarterly-refunding/most-recent-quarterly-refunding-documents*). Already in 2023, most of the US fiscal deficit has been financed by T-bills (Treasuries with maturities of up to one-year), while the issuance of T-notes (with maturities ranging from two to 10-years) has remained negative over the last 12 months (*see chart 2*).

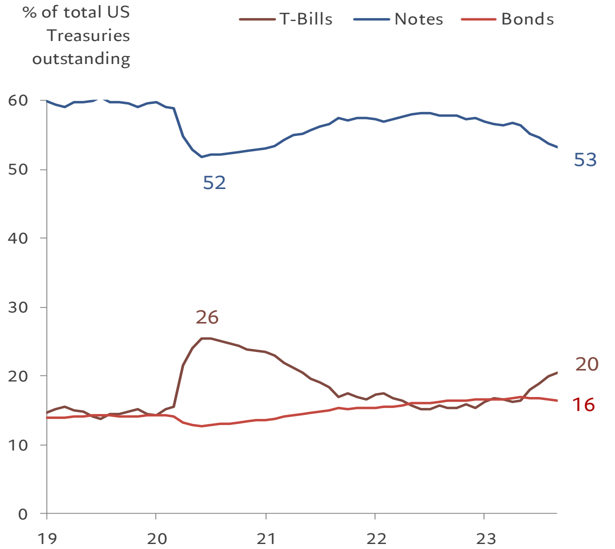
Considering the elevated cost of funding the US government is currently facing and the fact that the US Treasury yield curve is less inverted than this summer, it could make sense for the US Treasury Department to increase further T-bills' share of total US Treasuries outstanding from around 20% in September (*see chart 3*). A further rise in the share of T-bills next year could reduce the need for a large rise in the net issuance of US Treasury notes and bonds. This could in turn reduce the upward pressure on the 10-year term premium. Nevertheless, given the uncertainties surrounding the US fiscal deficit (the 2024 federal budget has not yet been ratified by Congress), a lot of unknowns surround the future supply of US Treasury securities.

Chart 2: 12-month cumulative net issuance of US Treasuries



Source: Pictet Wealth Management, FactSet, SIFMA, as of 31.10.2023

Chart 3: US Treasury securities segments in % of total outstanding



Source: Pictet Wealth Management, FactSet, SIFMA, as of 30.09.2023

To deepen our analysis of the 10-year term premium, we have empirically identified variables that are significantly influencing the nominal term premium (as calculated

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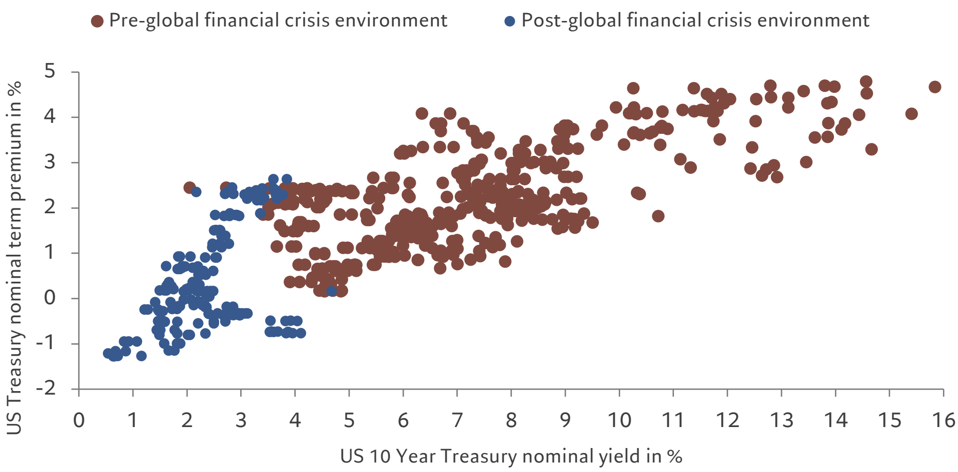
by the Adrian, Crump & Moench (ACM) model). First, we start from the premise that the term premium is correlated with macroeconomic uncertainty, especially periods of recession. For this reason, we can see that when the US ISM manufacturing index is low, indicating a slowdown in economic activity, the term premium shifts higher.

Second, the difference between the 10-year minus the two-year Treasury yield plays a significant role in this process. When the yield curve is steep, we generally see a shift higher in the term premium since it is usually associated with interest rate cuts (that tend to impact more short-term yields) and economic growth deceleration.

Finally, one must obviously consider the 10-year US nominal Treasury yield, as the term premium is a linear result of the yield level. Importantly, the relation between the US yield and the term premium has changed since the financial crisis of 2007-2008 *(see chart 4)*. In the years following the financial crisis, the term premium was close to zero or even negative. This was due to the Fed's QE programme, which reduced the supply of bonds available to market participants.

For our 2024 scenario, we have tried to estimate what the term premium could be once the Fed starts cutting rates and the US yield curve steepens again. If we assume that the 10-year US Treasury yield declines towards 4%, that the ISM manufacturing index stands at 50 and that the spread between two-year and 10-year yields is 50 bp, then the 10-year term premium would be at around 0.63%, according to our regression analysis. The premium would be around 0.44% if we assume these data are all at levels seen in the wake of the 2008 financial crisis.

Chart 4: US nominal term premium versus US 10-year Treasury yield before and after the global financial crisis



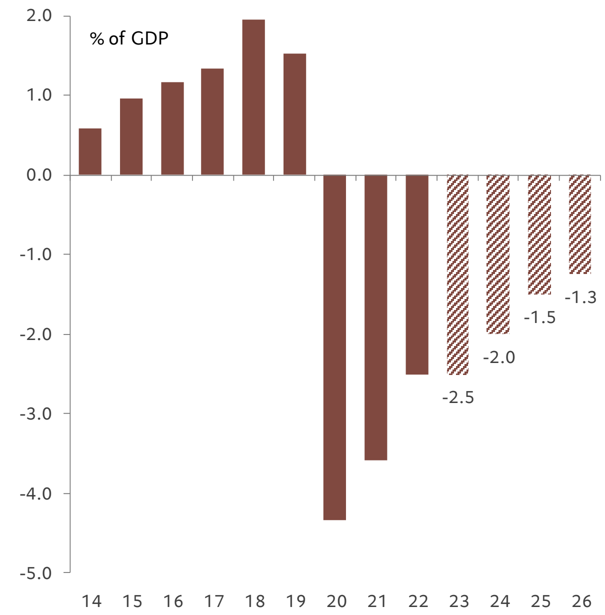
Source: Pictet Wealth management, federalreserve.gov, Bloomberg Finance L.P., as of 31.10.2023

In conclusion, the term premium is currently normalising after a decade of near-zero or negative levels. Since the end of August, it has moved up by 50bps to 0% (at 21 November), with a spike at 0.45% on 25 October. A mild recession that pushes the Fed to start a rate cutting cycle and lead to a steeper yield curve would argue for a term premium between 0.44% and 0.63%. However, taking account of the uncertainty surrounding the country's fiscal trajectory and unknowns surrounding the supply of US Treasuries, we estimate that the term premium could rise to approximatively 0.8%. Adding to that the future short-term nominal rate discussed earlier (3.5%), we reach a US 10-year yield forecast of 4.3% for end 2024.

BUNDS AND FISCAL CONSOLIDATION

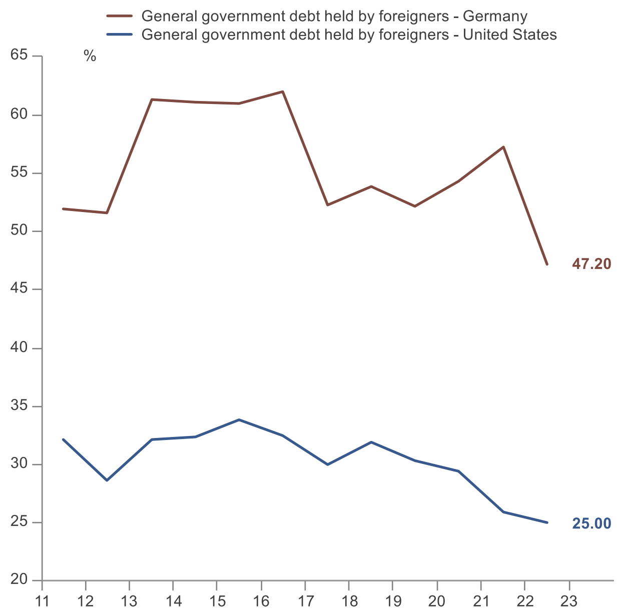
In Germany, the term premium picture is different given that fiscal policy is set to tighten in 2024 as emergency energy support is phased out and the government is forced to apply the constitutionally enshrined debt brake. Indeed, estimates for the German government budget deficit for 2024 stand at a healthy 2% of GDP compared to 6.4% for the US (*see chart 5*). Germany's fiscal solidity is contributing to the Bund's safe-haven status and ensures its 10-year term premium remains low. Fiscal consolidation means that Bunds remain attractive to foreign investors, who held 47.2% of total German government debt in 2022 compared to 25% of US general government bonds (*see chart 6*).

Chart 5: Germany: general government budget balance (with draft budget estimates)



Source: Pictet Wealth Management, Eurostat, German ministry of Finance, as of October 2023

Chart 6: Comparison of foreign ownership of German and US government bonds



Source: Pictet Wealth Management, FactSet, as of 31.12.2022

CONCLUSION

Anticipating a bond rally in the first half of the year to coincide with a mild US economic recession, our expectation is for the 10-year US Treasury yield to fall to 4% in H1 2024. We subsequently expect a small rebound to 4.3% by the end of 2024. To take advantage of the expected decline in interest rates, we remain overweight on US Treasuries going into next year.

European bond markets have been closely tracking US Treasuries this year, so we anticipate that trends in the 10-year Bund yield will closely resemble those for its US counterpart. The major difference is in terms of the fiscal trajectory, with fiscal consolidation in Germany maintaining the term premium lower than in the US. Overall, we expect the 10-year Bund yield to reach 2.3% by the end of next year, after touching 2% in H1 2024. Hence, we have moved from a neutral to an overweight stance on core euro government bonds.

In an alternative scenario, we see a risk that the Fed does not cut interest rates at all in 2024 should recession be avoided, and disinflation proves subdued. In fact, the Fed could even consider resuming its hiking cycle, potentially leading to a Fed funds rate of 6%. A relatively big increase in the term premium could also push up US Treasury yields if the fiscal trajectory deteriorates more than expected or if we see heightened uncertainty surrounding the US presidential election. In this case, the US 10-year government bond yield could reach 5% by the end of 2024.

While German government bond yields may also increase in this scenario (to 3%), a sharp economic slowdown is a greater risk for the 10-year Bund yield. This could force the ECB to cut rates earlier than expected, which would likely lead to the 10-year Bund yield falling below 2%. Similarly, a severe US recession could turn the term premium negative as US government bonds' safe-haven status attracts investors again. In this scenario the US 10-year government bond yield could decrease towards 3.8% by end-2024.

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