PICTET WEALTH MANAGEMENT

Updated German Bund 2023 outlook

Safe-haven status in question

AUTHOR
LAURÉLINE RENAUD-CHATELAIN
lchatelain@pictet.com

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FLASH NOTE

SUMMARY

- Our new scenario sees the European Central Bank (ECB) hiking the deposit rate to 3.5% by the end of May 2023. We also expect a complete halt to Asset Purchase Programme (APP) reinvestments to begin in Q3 2023.
- Euro sovereign bond yields were sharply up after the ECB's December meeting. By signalling its intent to continue hiking to a "significantly higher" level, the ECB risks prompting a more severe and protracted recession. We expect the German yield curve to invert further so long as the economic backdrop deteriorates, and the ECB keeps hiking.
- Although the surge in the inflation rate in the euro area and the ECB's efforts to bring it back to its 2% target by hiking its policy rate aggressively mostly explain the rise of the 10-year Bund yield from -0.18% at the end of last year to 2.29% (on 21 December), there also seems to be the build-up of some risk premium at play in part due to the German government's announcement of large fiscal spending.
- This structural shift from net-saver to net-borrower leads us to fear that the Bund's safe-haven status could be eroded, compounded by an environment of elevated inflation and a hawkish ECB. The 10-year Bund yield may peak at around 3% in the coming months before falling back to 2.5% at the end of 2023.

ECB IS "IN FOR THE LONG GAME"

The European Central Bank (ECB) sees inflation staying high with a brief recession in the euro area. It is hard to see this assessment changing soon. As a result, we have changed our scenario and we now see the ECB hiking the deposit rate by 50bp first in February and 50bp again in March and May, before it marks a pause. **This will bring the deposit rate up to 3.5% by the end of May 2023.** We think it will be difficult for the ECB to go further given the lagged impact of monetary tightening, particularly on countries with high debt and the likelihood that the US

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Federal Reserve will have paused its own rate hikes by then. Nonetheless, **we think persistently high core inflation will preclude any rate cuts from the ECB until H2 2024.**

In parallel with the latest rate hike this month, the ECB announced the general principles that will guide quantitative tightening (QT). The ECB will start QT in March 2023 by not reinvesting all the securities maturing under its Asset Purchase Programme (APP) (currently around EUR30 bn per month) at an initial monthly pace of EUR15 bn from March until the end of June. **We expect a complete halt to APP reinvestments to begin in Q3 2023.**

MARKETS ARE NOW EXPECTING A TERMINAL RATE ABOVE 3%

Last week, central banks endeavoured to propel upwards market participants' expectations for future rate hikes. The **ECB was the most successful, with the peak rate priced in at 3.33% in July 2023** (on 21 December). Indeed, futures pricing for the Federal fund rates show a peak at 4.85% in May next year, and lower than the 5.1% projected by the US Federal Reserve's (Fed) dot plots.

Not surprisingly, **euro sovereign bond yields were sharply up after the ECB meeting**, with the 10-year German Bund yield at 2.29% (on December 21) (*see chart 1*), while the 10-year US Treasury yield remains broadly stable at 3.66%. This dichotomy is likely linked to the very different inflation picture in the US (where some core components like goods are decelerating), while in Europe mostly energy price rises are decelerating, with the rest still experiencing the pass-through of higher energy costs.

Moreover, the German real yield curve (based on inflation-linked government bonds) has become positive (up to ten years) after the latest ECB meeting but remains close to zero. This means that contrary to the US, where US real yields are well in positive territory, the **ECB's monetary policy is only starting to translate into more restrictive monetary conditions** once markets' inflation expectations are taken into account.

This is corroborated by our estimate that the euro area neutral rate (i.e. the level at which the policy rate is neither restrictive nor expansionary for the economy) likely lies between 1.5% and 2.0%. By signalling its intent to continue hiking to a "significantly higher" level, the ECB is also at risk of prompting a more severe and protracted recession in the euro area. This risk seems to be increasingly discounted by market participants as the German ten-to-two-year yield curve has become more negative, falling to -21 bp (on 21 December). **We expect the German yield curve to invert further so long as the economic backdrop deteriorates, and the ECB keeps hiking.**

BUND'S SAFE-HAVEN STATUS IS IN QUESTION

The sharp rise in the 10-year Bund yield, along with the volatility that has accompanied this upward movement, means that it is has been painful for investors to own them this year. As of 21 December, the total return performance of the 10-year Bund was -16.4%. Although the surge in the inflation rate in the euro area and the ECB's attempt to bring it back to its 2% target by hiking its policy rate

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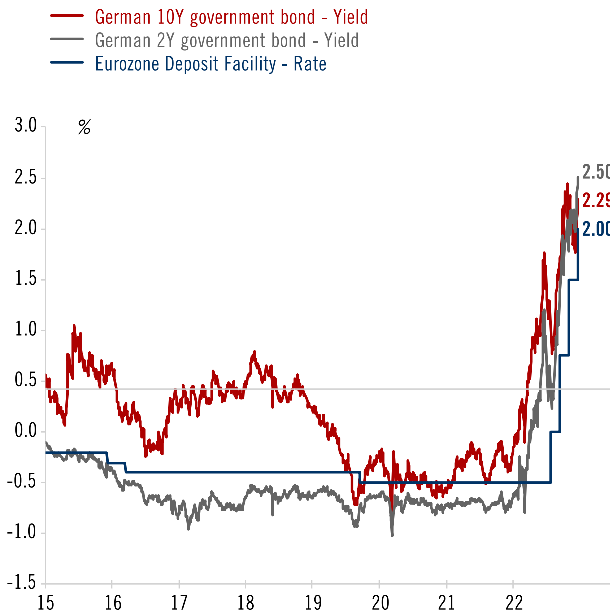
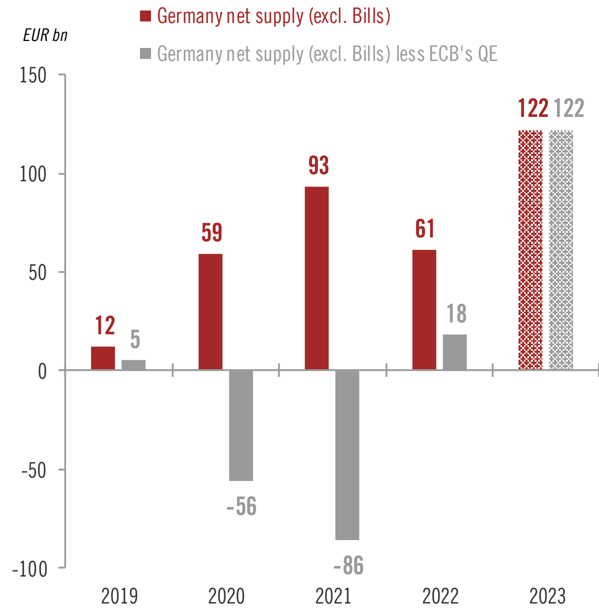
aggressively mostly explain the rise from -0.18% at the end of last year to 2.29% (on 21 December) **there also seems to be a build-up of some risk premium at play in part due to the German government's announcement of large fiscal spending.**

Chart 1: German two- and 10-year government bond yield and ECB's deposit rate



Source: Pictet Wealth Management – FactSet, 21 December 2022

Chart 2: Past and forecasted German government bonds yearly net issuances



Source: Pictet Wealth Management – ECB, Finanzagentur, own estimates, 14 December 2022

According to the Finanzagentur, net issuances of German government bonds (excluding Bills) should rise to EUR122 bn in 2023, a level significantly higher than the one seen during the pandemic (*see chart 2*). This surge in issuances will come at a time when the ECB is reducing its presence in the euro bond market by launching QT. This means that **market participants will need to absorb an unusually high amount of German government bonds**.

Although Germany's public debt-to-GDP ratio remains low (at 68.6% in 2021) in comparison to its euro peers, the significant headwinds faced by German industry from higher-for-longer energy prices and the need for significant investments in energy transition could mean that the government moves from a position of historically showing budget surpluses to deficits in the years ahead. **This potential structural shift from net-saver to net-borrower leads us to fear that the Bund's safe-haven status could be eroded, compounded by an environment of elevated inflation and a hawkish ECB.**

As such, we have adjusted our 10-year Bund yield forecast higher. We now see risks that the **10-year Bund yield peaks at around 3% in the coming months before falling back to 2.5% at the end of 2023** (against 2.1% previously). This also means that we foresee a further tightening of the 10-year US-German government bond yields differential to 100 bp (from 135 bp on 21 December). In this more challenging context for euro core sovereign bonds, **we remain neutral on this segment, while being overweight US Treasuries.**

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