Union Investment

Inflation and the renaissance of the bond markets

19.06.2023 | The gradual slowdown in inflation and the prospect of an end to key interest rate hikes by central banks in the near future are creating a good environment for the bond markets. Good-quality Pfandbriefe, corporate bonds and securitizations are again offering attractive interest rates.

Christian Kopf,

Head of Fixed-Income Portfolio Management and a member of the Union Investment Committee (UIC)

The most important facts for you in brief

- Prospect of "soft landing" and declining inflation supports bond markets
- Road to further declining inflation bumpy, however
- Interesting yield spreads on covered bonds, good quality corporate bonds and securitizations
- Increased inflation and volatility in the longer term due to "Great Transformation

The capital market is dominated by contradictory expectations. At present, a soft landing of the economy seems possible - the basic scenario of our economic experts. At the same time, however, there are concerns in the market that a deeper recession could occur after all. Inflation could also develop less favorably and the downturn could falter. Interest rate expectations and thus share price developments will remain correspondingly volatile for the time being.

growth is losing momentum - and with it
cording to our experts, the disinflationary trend
ent. The probability of interest rate cuts in the
near future is therefore low.

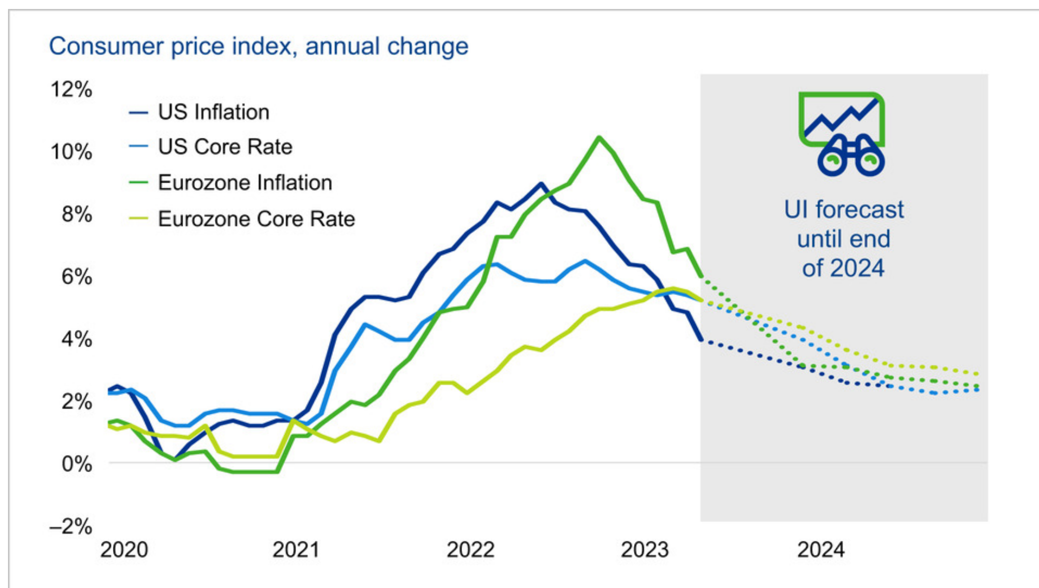
Where are we today in terms of inflation?

Declining price momentum (disinflation) can be seen in particular for energy, food and core goods, while a decline in services is still waiting to happen. As a result, overall inflation rates are declining faster than core rates, which central banks look at when making monetary policy decisions.

And the picture varies from region to region: In the USA, the decline in inflation is further advanced, which is why we expect interest rates to peak in July at a fed funds rate of 5.25 to 5.5 percent. In the UK, inflation is falling less than in Germany, while in Spain disinflation is more pronounced, also due to less state-regulated prices. We expect the ECB deposit rate to peak this year at 4.00 percent.

Inflation rates come back significantly

Core inflation in the euro area still ahead of the peak



In the medium term, the return of supply and weakening demand - due to weakened growth - argue for decreasing pressure on producer prices and thus also for further declining inflation. Most of the price increases by companies are now likely to have been passed on to end customers.

However, there is uncertainty about an additional drag on the economy from the turmoil in the banking sector in the spring and the associated more restrictive lending conditions for private households and companies. Fortunately, the situation has calmed down as a result of the rapid and decisive intervention by the supervisory authorities and central banks. The banks have tightened lending standards considerably. However, there has been no disorderly development. We expect financial stability to remain assured, even though the crisis may not yet be over in some segments of the banking sector. Although it is too early to pass final judgment, we do not expect this to result in a deeper slump in economic performance. What does this mean in the short and medium term?

> “The combination of weak but still positive growth and falling inflation rates makes for a friendly capital market environment. All in all, this makes us very confident for the bond markets.”

Christian Kopf,
Head of Portfolio Management Bonds, Union Investment

We also expect the correlation between equities and bonds as an asset class to decline again - and risk diversification across both asset classes to become possible again.

No rapid cuts in key interest rates

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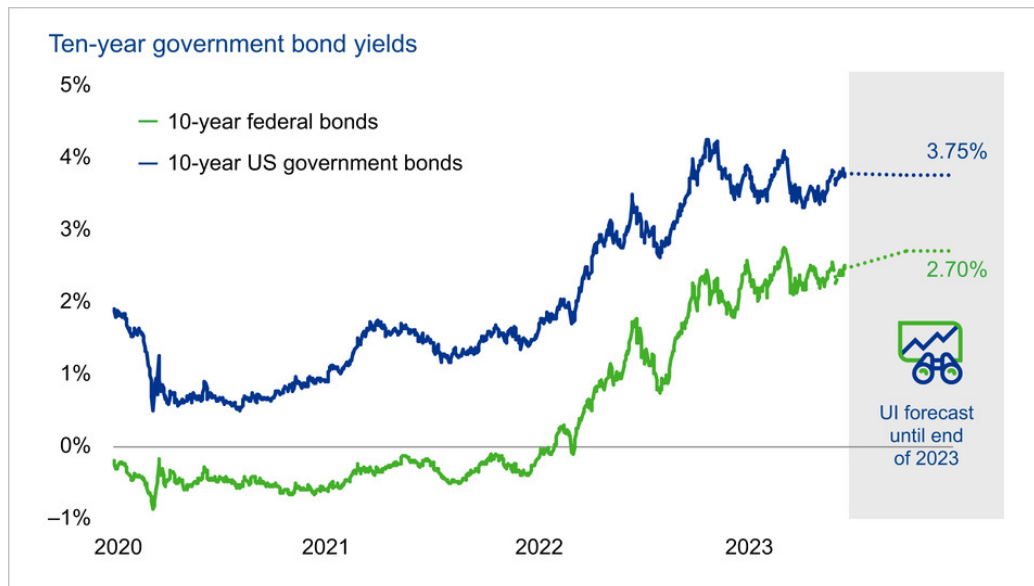
r future. Ten-year US Treasuries are likely to yield

hardly compensated, if at all, for interest rate risks - the yield curves are inverse. This is mainly a consequence of the sharp increases in key interest rates last year, which led to a rapid rise in yields at the short end. Long-dated bonds, on the other hand, are pricing in economic concerns. In the short term, we would not recommend building up duration, as there is still uncertainty about the timing and level of interest rate peaks.

Yield increases largely settled - prefer short maturities

Yields more or less sideways until end of 2023



Yield increases largely settled - prefer short maturities

On the other hand, it is important to exploit relative value opportunities between individual bond markets and to pay attention to carry. This allows attractive yields to be collected at the short end, for example in the case of covered bonds (Pfandbriefe), which offer a yield premium over government bonds with first-class ratings, usually with relatively low fixed interest rates. In Europe in particular, there is also a wide range of sustainable covered bonds. Demand for such high-interest and comparatively low-risk investments should mean that prices remain well supported despite the central banks' balance sheet reduction.

Do not forget corporate bonds

Euro-denominated corporate securities with an IG rating (good to very good investment quality) also remain attractive. Apart from the interesting yield of over 4.1 percent (as of mid-June), the good fundamental data of many issuers speak in favor of this. Many companies have come through the crises better than expected and are now being relieved somewhat on the debt side by the high nominal growth due to inflation, as debt ratios have fallen across the board. Here, too, a shorter duration is attractive, while at the same time many stocks are trading well below par.

Corporate collateralized loan obligations (CLOs) also offer a yield pick-up. With comparable ratings, they offer interest rate immunity due to floating interest rates as well as an increased risk premium due to recession concerns. The CLO tranches rated by credit agencies each provide a substantial buffer against loan defaults in the underlying loan pool.

More overshooting of inflation, higher returns

Our macro team expects inflation to fall to around three percent by the summer of 2024. Thus, the aforementioned investments in our baseline scenario also offer an opportunity to capture returns in the medium term.

In the longer term, bond markets are likely to remain driven by the structurally changed capital market environment - what we call the "Great Transformation." The great power competition between China and the USA and the associated regrouping of supply chains (keyword "friend shoring") as well as the transformation to a more climate-friendly economy are creating more investment and innovation pressure. This is likely to result in higher growth, but also higher inflation due to shortages of raw materials or on the labor market, for example.

The Great Transformation - a new era for the global economy and capital markets

real economic development. This means that again, but also an effect that will boost inflation, but also a normalization of term premiums on the bond market, which were heavily depressed by the ultra-loose monetary policy. Overall, the Great Transformation environment thus offers the prospect of higher bond yields in the longer term.

Inflation rates could therefore settle at levels above central bank targets in the medium term. We see the nominal equilibrium interest rate in the USA at around 3.5 percent in the longer term (see super figure).

3.5 percent

Long-term nominal equilibrium interest rate in the USA

It is not visible on the market - but can be derived theoretically: The natural interest rate brings supply and demand into equilibrium, in the financial, goods and labor markets. Union Investment estimates that the long-term nominal equilibrium interest rate in the U.S. has risen to around 3.5 percent as a result of higher investment, higher inflation and higher volatility. A U.S. key interest rate of more than 3.5 percent should therefore lower economic growth and inflation in the medium term.

If the maturity premium in the U.S. Treasury market were also to rise again, a yield of around 4.4 percent on ten-year paper would be conceivable in the medium term. In view of the higher interest rate and inflation volatility, a tactical addition of real interest rate bonds to a portfolio instead of a portion of government bonds would also appear to make sense in the longer term.

The steepening of the yield curves is more likely to occur via a slow decline in yields at the short end than via strong yield expansions at the long end. Since we do not expect interest rate cuts until 2024, yields at the short end are likely to remain stable for the time being - in Europe even comparatively longer than in the US, since the interest rate cycle there is more advanced. Since we expect inflation to remain elevated in the longer term, adding real interest rate bonds to a bond portfolio could provide a cushion against higher than expected inflation rates.

An article by Christian Kopf.

As at 19 June 2023.

Your contact person

If you have any questions or would like to obtain further information, please find your dedicated contact below.

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To our latest expert views

Comeback of the Covered Bonds

They are one of the most successful German export items: Pfandbriefe, also known as covered bonds in their general form in Europe. Due to the interest rate turnaround, this bank refinancing instrument again offers attractive and low-risk returns for investors.

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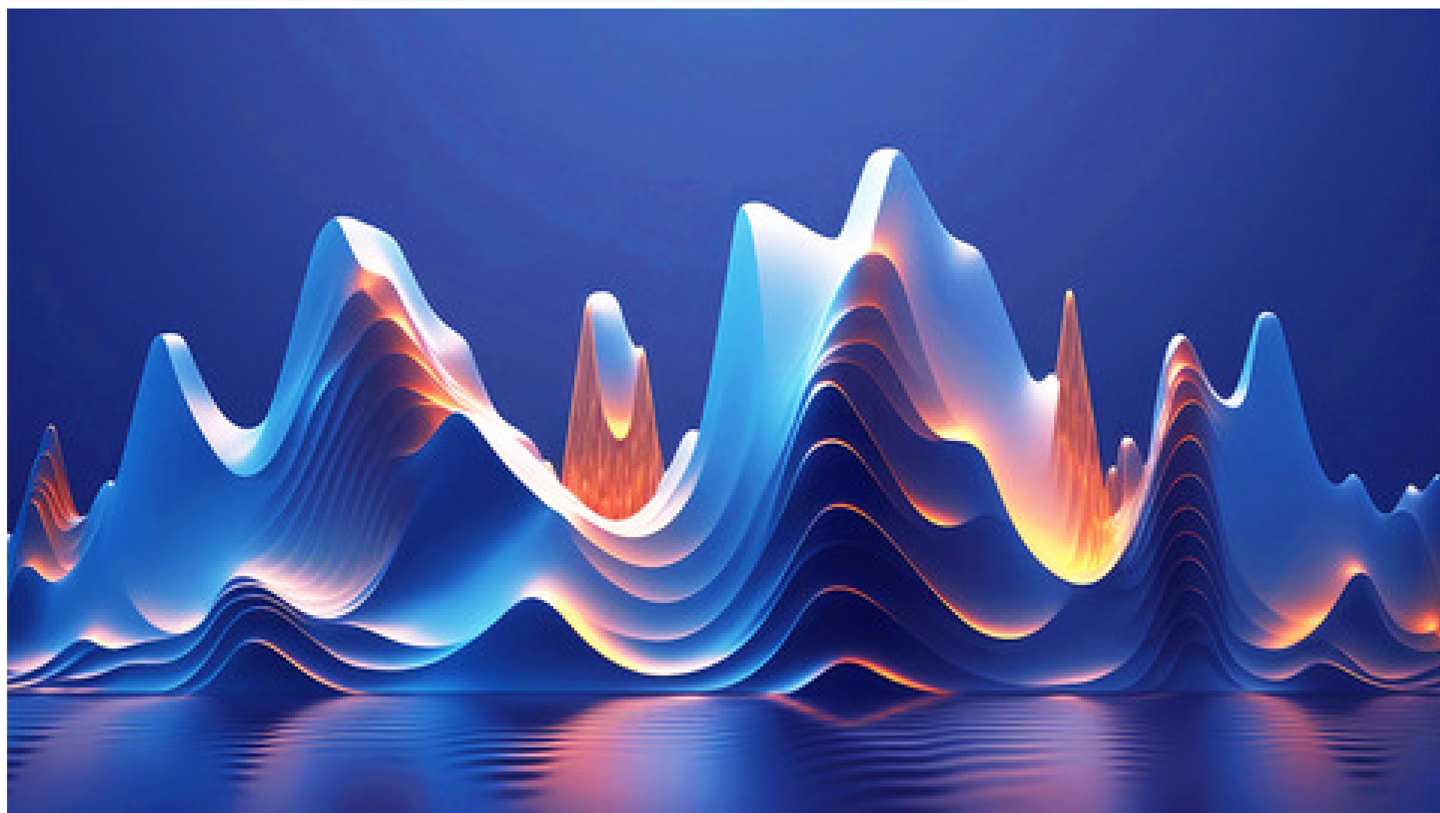
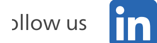


Volatility: come to stay?

While the bond markets show high fluctuations, the volatility on the stock markets is currently rather low. This should change towards the second half of the year. On the equity side, price setbacks offer an opportunity, while on the bond side, a gradual increase in duration presents itself. In the long term, capital market volatility is likely to remain elevated.

Find out more



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