

January 20, 2022

Sovereign bond yields begin to resist gravity



In our 2022 Investment Outlook, published back in November, we acknowledged that we were entering a global tightening cycle. However, the short-term continuation of this theme was very dependent on how Covid evolved over winter. The view from January suggests that Omicron could be less severe than previous strains, resulting in fewer hospitalizations. As the threat of this new wave derailing the global economic recovery retreats, central banks have more room to manoeuvre when it comes to dialling back support in order to cool red-hot inflation.

As such, sovereign yields throughout the world have begun to grind upwards again, with a major milestone reached this week: the yield on Germany's 10-year Bund (the Eurozone's benchmark bond) turned positive for first time since 2019, reaching 0.021%. The equivalent US Treasury note yield sits at over 1.8% after rising steadily in recent weeks.

The uptick in yields, led by the US, is largely founded upon the belief that central banks will need to act swiftly to curtail price increases. In December 2021, headline US CPI came in at 7%, the highest level since 1982, while the Eurozone reading came in at 5%, the highest level the single currency was created more than twenty years ago. The UK print, released on Wednesday, added to investor angst about price pressures, jumping to 30-year high of 5.4%. Oil price increases due to geopolitical tensions and an explosion affecting operations of a key pipeline between Turkey and Iraq have not helped either.

Central banks are under increasing pressure to act. In the US, the market is today pricing a Fed rate hike in March with almost 100% probability and at least 4 full hikes in 2022. It also expects the Bank of England (BoE) to raise interest rates three times by August, with a 92% chance of a hike at the its next meeting in early February.

The European Central Bank (ECB) has been more dovish. At its December meeting, Lagarde announced that the governing council had decided to continue its asset purchases after its Pandemic Emergency Purchase Program (PEPP) expires in March, albeit at a slower rate than had been anticipated. Markets are now pricing in two 0.1 percentage point interest rate hikes from the ECB by the end of 2022, despite the ECB's iteration that higher borrowing costs in 2022 are not consistent with its guidance. The ECB has a more arduous task of trying to ensure that the recovery continues to play out across *all* member states: A positive 10-year Bund yield could make German debt more attractive to investors, thus affecting borrowing costs in other Eurozone member states and the companies located therein.

Ultimately, we believe that 2022 will be the year when monetary policy turns more hawkish – albeit to differing degrees across regions. The Fed is a clear leader of the pack as it comes under increasing pressure to cap price gains, especially with the US Midterm elections just around the corner. Any move the Fed makes will not only affect US yields; other yields around the world are likely to move in sympathy, albeit to a lesser extent.

After years of suppressed yields, the sands are shifting in the investment landscape and investors have to be ready. So long as economic growth continues at a healthy pace, we believe equities can still deliver performance. Contrary to this view, some investors are concerned that higher yields could detract from the relative attractiveness of this asset class, and indeed, this could be the case if yields were to go much higher. For now, we would argue that because yields are rising from all-time lows, zooming out, they are still very low relative to historic levels.

Moreover, while history usually doesn't repeat itself, it tends to rhyme and past taper episodes have shown that equities can still go up as yields are rising. However, not all companies thrive in such an environment. Those that tend to do best are generally congregated in sectors like

Financials, Energy and Materials. We are overweight on all three, with the addition of Healthcare in order to strike a balance between cyclicality and defensiveness – particularly since we see the potential for higher volatility ahead. With yields poised to grind upwards, we are reluctant on government bonds and highly selective in other tranches of the fixed income market.

Upcoming central bank monetary policy meeting dates are as follows:

25th-26th January – The Fed

3rd February – the ECB and the BoE

Disclaimer

All financial data and/or economic information released by this Publication (the "Publication"); (the "Data" or the "Financial data and/or economic information"), are provided for information purposes only, without warranty of any kind, including without limitation the warranties of merchantability, fitness for a particular purpose or warranties and non-infringement of any patent, intellectual property or proprietary rights of any party, and are not intended for trading purposes. Banque Internationale à Luxembourg SA (the "Bank") does not guarantee expressly or impliedly, the sequence, accuracy, adequacy, legality, completeness, reliability, usefulness or timeless of any Data. All Financial data and/or economic information provided may be delayed or may contain errors or be incomplete. This disclaimer applies to both isolated and aggregate uses of the Data. All Data is provided on an "as is" basis. None of the Financial data and/or economic information contained on this Publication constitutes a solicitation, offer, opinion, or recommendation, a guarantee of results, nor a solicitation by the Bank of an offer to buy or sell any security, products and services mentioned into it or to make investments. Moreover, none of the Financial data and/or economic information contained on this Publication provides legal, tax accounting, financial or investment advice or services regarding the profitability or suitability of any security or investment. This Publication has not been prepared with the aim to take an investor's particular investment objectives, financial position or needs into account. It is up to the investor himself to consider whether the Data contained herein this Publication is appropriate to his needs, financial position and objectives or to seek professional independent advice before making an investment decision based upon the Data. No investment decision whatsoever may result from solely reading this document. In order to read and understand the Financial data and/or economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your relationship manager. This Publication is prepared by the Bank and is based on data available to the public and upon information from sources believed to be reliable and accurate, taken from stock exchanges and third parties. The Bank, including its parent,- subsidiary or affiliate entities, agents, directors, officers, employees, representatives or suppliers, shall not, directly or indirectly, be liable, in any way, for any: inaccuracies or errors in or omissions from the Financial data and/or economic information, including but not limited to financial data regardless of the cause of such or for any investment decision made, action taken, or action not taken of whatever nature in reliance upon any Data provided herein, nor for any loss or damage, direct or indirect, special or consequential, arising from any use of this Publication or of its content. This Publication is only valid at the moment of its editing, unless otherwise specified. All Financial data and/or economic information contained herein can also quickly become out-of- date. All Data is subject to change without notice and may not be incorporated in any new version of this Publication. The Bank has no obligation to update this Publication upon the availability of new data, the occurrence of new events and/or other evolutions. Before making an investment decision, the investor must read carefully the terms and conditions of the documentation relating to the specific products or services. Past performance is no guarantee of future performance. Products or services described in this Publication may not be available in all countries and may be subject to restrictions in some persons or in some countries. No part of this Publication may be reproduced, distributed, modified, linked to or used for any public or commercial purpose without the prior written consent of the Bank. In any case, all Financial data and/or economic information provided on this Publication are not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law and/or regulation. If you have obtained this Publication from a source other than the Bank website, be aware that electronic documentation can be altered subsequent to original distribution.

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of the date indicated in the matrix or the publication date. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof. Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch I L-2953 Luxembourg I RCS Luxembourg B-6307 I Tel. +352 4590 6699 I www.bil com

