Economics

DBS Flash

Navigating the sovereign bond landscape

Strategy/Rates

DBS Group Research | August 14, 2019

Duncan Tan
Strategist

Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

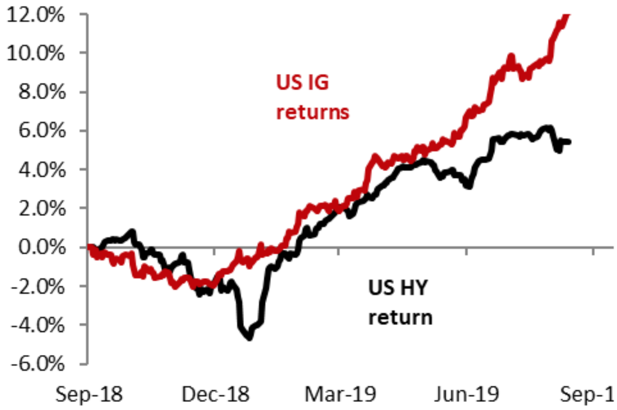
- *Without a material shift in the economic/monetary/trade backdrop, we look set for lower yields and flatter curves.*
- *We are wary of being too long on duration. Crowded positioning and higher rates volatility are key risks.*
- *EM Asia sovereign bonds have rallied on lower US rates, rather than compression of risk premiums.*
- *External environment turning less supportive. Outperformance of high-yielders may fade.*
- ***Implications for investors** – Favour shorter tenors in sovereign bonds.*

High levels of caution in markets

While central banks can certainly boost asset prices in the short term, their ability to support and turn around the growth outlook (by extension, lead to higher asset prices over the longer term) is increasingly being questioned by markets. Beneath the surface of high equity valuations and tight credit spreads, market confidence is weak. In interest rates, despite the recent bout of monetary easing across the world, curves have not steepened and inflation expectations (market-based) remain depressed. In FX, the USD remains strong against EM currencies despite declining interest rate support. In credit, lower-yielding US investment-grade have been outperforming high-yield bonds.

US investment-grade and high-yield bond returns have been diverging since May.

Base Sep 2018



Source: Bloomberg

Falling yields and flatter curves?

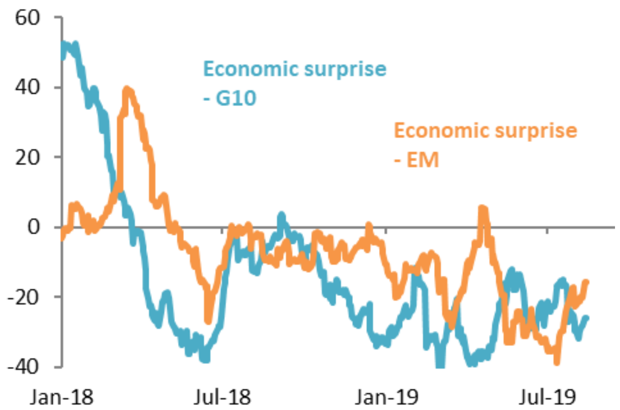
With global economic data trending weaker and possibility of a US-China trade deal looking remote, markets just keep pricing for more severe economic scenarios (which would also require central banks to ease even more). Investors keep buying sovereign bonds, both short tenors to position for monetary easing, and long tenors for portfolio protection. These forces can be difficult to overcome unless there is a material shift in the economic/monetary/trade backdrop. Below, we list the top 5 possible events that could drive yields higher and curves steeper:

1. Re-acceleration in global growth
2. Upside surprise in inflation
3. Significant fiscal stimulus
4. US-China trade deal
5. Central banks under-deliver against easing expectations

At present, the likelihood of any of the above events materializing appears to be low.

1. Recent global economic data have been poor and continue to point to a deeper slowdown.

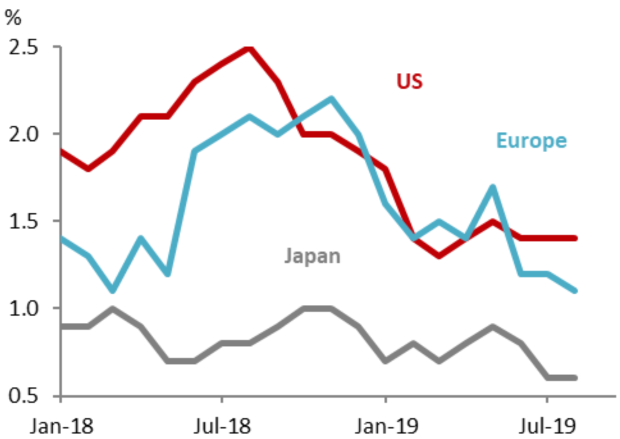
Economic data in DM and EM have been worse than expected for some time (surprise indices below 0).



Source: Bloomberg

2. Inflationary pressures remain subdued and falling oil prices are not supportive.

Key inflation measures in G3 have been trending lower.



Source: Bloomberg

3. Within G3, Europe has the most room for fiscal stimulus. However, German officials are reluctant to expand spending while other governments are unlikely to do much given the budget rules of the bloc.

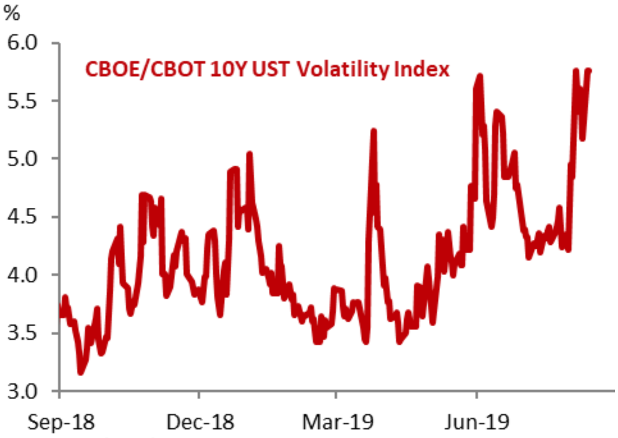
4. Chances of a US-China deal have been falling with recent escalations on trade and currency fronts.

5. Last week, several central banks delivered rate cuts that were either larger than expected (India, New Zealand, Brazil) or very much against consensus (Thailand). These decisions could be part of a broader trend by global central banks to actively surprise the market, so as to provide a greater boost against greater downside growth risks.

Favour shorter tenors in sovereign bonds

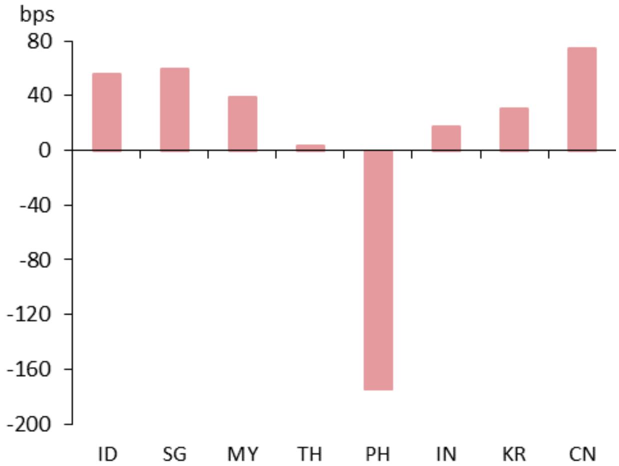
Though sovereign yield curves could move lower and flatter in the short term, we are wary of being too long on duration. Based on latest fund manager surveys, long duration (especially via US Treasurys) has become an extremely crowded trade and we are concerned that any reversal could be quite sharp. Most importantly, interest rate volatility has surged recently and could stay elevated around news flows on US-China and Brexit developments. The wide dispersion in markets' perception of forward Fed path could also be another source of volatility.

Interest rates could be entering a higher volatility regime.



Source: Bloomberg

YTD change in 10Y Asia Govvie-US Treasury spreads



Source: Bloomberg

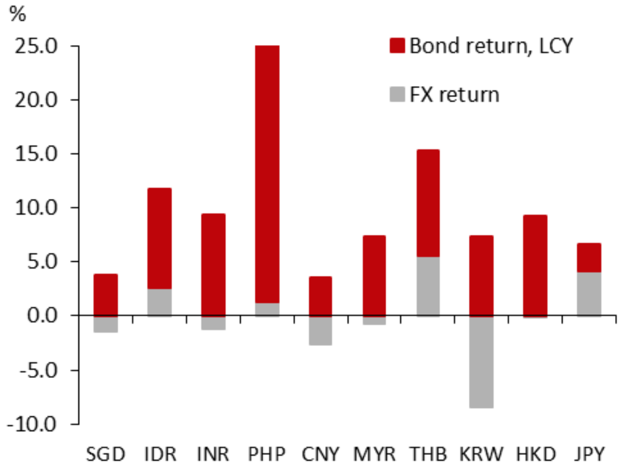
Therefore, we think the risk-reward for taking greater duration risks via longer tenor bonds (10Y and beyond) may be quite poor. Instead, shorter-tenor bonds (up to 2Y) could offer better risk-adjusted performance. With central bank easing bias firmly in place, shorter-tenor yields are likely to be more anchored.

EM Asia: less support for high yielders

Focusing on EM Asia sovereign bonds, the broad rally has been primarily driven by lower US yields rather than compression of risk premiums. In fact, spreads to US Treasurys, proxy for risk premiums, are wider except for Philippines (again, suggesting high investor caution). Broadly speaking, we think EM Asia sovereigns can continue to perform well. Increased prospects of Fed and ECB easing would give Asian central banks the cover to cut rates without much worries of depreciation pressures on their currencies, especially for high-yielders.

We are wary however that the outperformance of high-yielders (PH, ID, IN) vs low-yielders (KR, SG, TH) could reverse. Both fixed income and FX returns of high-yielders have disproportionately benefitted from the global reach for yields this year. The risk is that sentiments deteriorate ahead, either due to deepening of global slowdown or further escalations in US-China tensions. In that scenario, investors' yield-seeking appetite and hence, support for Asia high-yielders could fade.

High-yielders' bonds and FX have outpeformed in 2019.



Source: Bloomberg

Group Research

Economics & Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Chang Wei Liang
Strategist
+65 6878-2072 weiliangchang@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21 2988-4003 masyita@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist – Eurozone, India & Thailand
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Duncan Tan
FX & Rates Strategist - ASEAN
+65 6878-2140 duncantan@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).