BLUE HORIZON
Wealth Partner AG

A Bond sell-off when nobody expected it

- May was a month of nervous trading with many markets moving sideways, though with relatively large fluctuations. In May, the Japanese Nikkei index outperformed and rose by 5.3%, followed by the S&P500 index, rising 1.3%. European markets underperformed in May. The Euro Stoxx50 index was almost flat, up only 0.3% – albeit with large intra-month movements – and the German DAX even fell by 0.4%. Emerging markets were hit hard and lost 4%.
- Especially stronger US leading indicators and continued signs of rising wage inflation made a Fed rate-hike this year increasingly likely. Market-implied expectations suggest a 70% probability of a Fed rate-hike in September.
- The bond sell-off continued in May. German Bund yields climbed by another 12 basis points in May. The sell-off fiercely accelerated after the ECB meeting on 3 June, when Mario Draghi said that he would not be particularly worried about market volatility. Immediately after Draghi's press conference Bund yields rose to levels as high as 0.99%, compared with the lows of 0.05% mid-April. Meanwhile US Treasury yields rose to roughly 2.4% currently, which is less dramatic but also amounts to an increase of roughly 25 basis points since end of April. It is also remarkable that liquidity in bond markets has dried up, which partly explains the extent of the recent bond-market swings.
- Greece missed an IMF loan repayment of EUR 300 million, which was due on 5 June. This is an almost unprecedented move by a debtor country vis-à-vis the IMF. In June, negotiations will intensify since the IMF expects a debt repayment at the end of that month, and the second support program expires. Opposing positions, however, remain very wide apart. Since neither the Troika nor the Greek population is interested in a Greek exit from the Eurozone, we believe that the parties will find a compromise.
- Industrial metals fell 7.7% in May and gave back all their April gains. Oil prices stabilized in May. The Gold price rose by 1.9% in the month, but fell 2.1% in the first week of June.
- While bond markets remain unpredictable due to very low liquidity, diverging central bank policies should eventually lead to US Treasuries underperforming German Bunds again. We expect 10-year Treasuries to move towards 3% and Bunds to remain below 1%. We see the temporary EUR strength as short lived and expect the USD to strengthen again. Before that happens the EUR-USD exchange rate may stay range-bound for a while, since the USD just emerged from a very overbought market phase. In our base-case scenario we still expect the Fed to hike rates in September, and this will probably be accompanied by nasty market corrections. On balance, we stay cautiously positive for equity markets, but would not be surprised if in anticipation of a first Fed rate-hike, the equity markets should suffer from nasty corrections.

Macroeconomics and financial markets

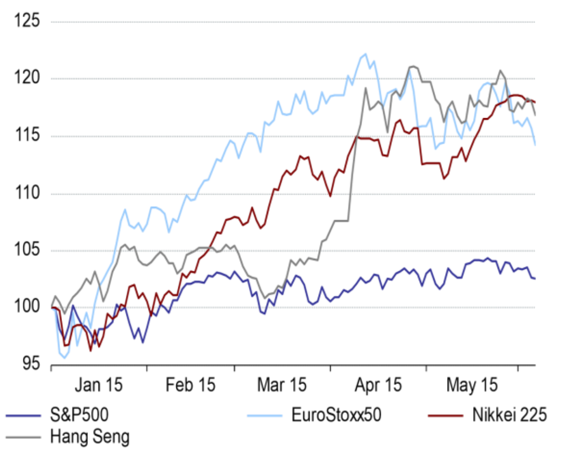
After disappointing US macro data in the first part of this year, we saw some encouraging leading indicators in May. The US ISM index climbed to 52.8 after 51.5 in April and non-farm payrolls rose by 280,000, exceeding expectations. In addition, construction and export data came in stronger. US wage inflation continued to rise. The US employment cost index as well as average hourly earnings continued their uptrend (see Figure 4). We regard this as an early sign of building inflation pressure, since rising wages will sooner or later push consumer prices up. In our view, this makes a September Fed rate-hike increasingly likely.

Meanwhile the European Market PMI output index fell slightly to 53.6 in May after 53.9 in April. Also, the German IFO business climate index fell slightly to 108.5 in May after 108.6 in the previous month. The change is, however, very moderate and absolute levels still look healthy.

Greece

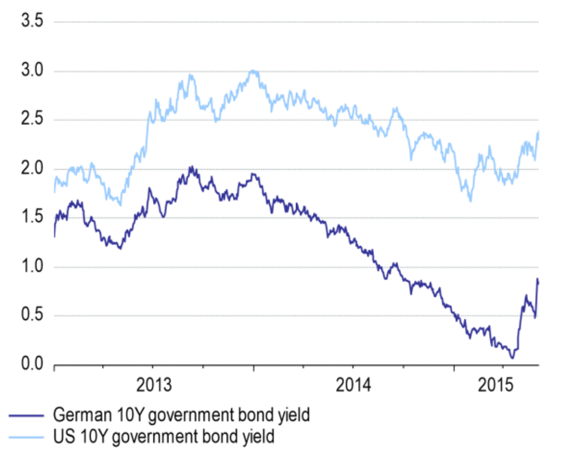
Greece delayed a EUR 300 million payment due to the IMF on 5 June. This is a highly unusual situation and almost unprecedented for IMF debtor countries. The Greek stock market fell after the announcement by about 5%. This does not qualify as a formal default by Greece, which may explain why reactions did not

Fig. 1: Major equity indices in 2015



Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner AG

Fig 2: 10Y bond yields



Source: Thomson Reuters Datastream / Blue Horizon Wealth Partner AG

spread widely to other markets. Although the Greek government follows a very hard negotiation strategy, which seems to allow for a Greek exit if negotiations should fail, a recent opinion poll shows that three out of four Greeks want to remain in the Eurozone, and a majority want their government to accept the offer from Europe and the IMF. At the end of June the bailout expires and a larger IMF loan is due. If Greece and the Troika do not agree on a deal, Greece risks an outright default with unclear consequences, which could even lead to a disruptive Greek Eurozone exit. Currently the opposing positions are far apart from each other. Since it seems that nobody seriously wants a Greek exit, we still believe that the parties will find a compromise.

Bond market sell-off

When in March the ECB announced details about its bond-buying program, it seemed to be clear that European yields would remain ultra-low for a long period. At the same time as the Fed has been moving closer to a first rate-hike, US treasuries have seemed to be poised to underperform. Looking back at the recent bond-market moves, with Bunds selling off by almost 80 basis points within only a couple of weeks, underperforming US treasuries by a wide margin, we end up being very surprised. The rapid increase in European yields was a result of overbought market conditions coupled with very low liquidity, amplified by Draghi's recent comments, which seem to suggest that the ECB would not care about the sell-off. After such market movements it makes sense to critically review and question one's own market assumptions. Figure 3 shows that nervousness

Fig. 3: Bond volatility exceeds equity market volatility

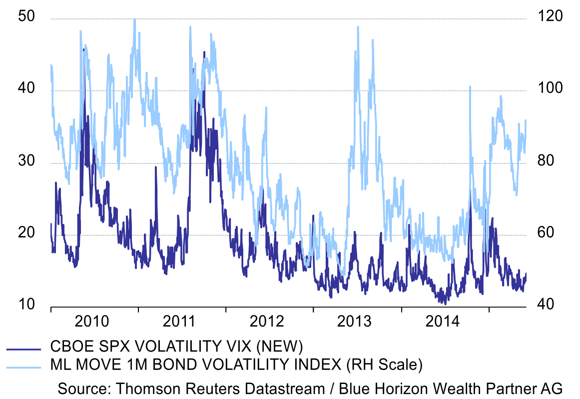


Fig 4: US wage inflation picks up

already increased in bond markets earlier this year. Bonds' implied volatility rose significantly early 2015 and exceeded equity market volatility by far. In our view, however, the recent Bund sell-off is due to a reprising of ultra-rich bonds, coupled with the outcome of special market conditions. In the medium term, we still believe that fundamentals as well as diverging monetary policies will lead to US Treasuries underperforming Bunds. Whether Bund yield levels are likely to fall back to April lows of 0.05% or stabilize around 1% is not clear to us. In doubt, we rather think that 10-year yields around 1% are more sensible than yield levels around 0%. With regard to recent ECB comments, we do not believe that the ECB is agnostic about a strong bond sell-off. Yield levels do change the monetary conditions in the Eurozone and could seriously dampen ECB's easing program. A continuation of the recent sell-off will, in our view, sooner or later lead to the ECB protesting. Our best guess with regard to notoriously difficult yield predictions is that 10-year Bunds may stabilize at or below 1% and that US Treasuries will continue to grind higher, towards 3% by year end.

Outlook

While bond markets remain unpredictable due to very low liquidity, diverging central bank policies should eventually lead to US Treasuries underperforming German Bunds again. We expect 10-year Treasuries to move towards 3% and Bunds to remain below 1%. We see the temporary EUR strength as short lived and expect the USD to strengthen again. Before that happens the EUR-USD exchange rate may stay range-bound for a while, since the USD just emerged from an overbought market phase. In our base-case scenario we still expect the Fed to hike rates in September, and this will probably be accompanied by nasty market corrections. On balance, we stay cautiously positive for equity markets, but would not be surprised if, in anticipation of a first Fed rate-hike, the equity markets should suffer from nasty corrections.

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