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Sovereign bonds markets: which opportunities for 2024 in a context where US & European governments debts have more than doubled in a decade?

Dieudonné Djimi

Global Interest Rates & Currency
Portfolio Manager

As mentioned in Ostrum AM's 2024 global outlooks, the fixed income market will have to deal with an unprecedented rise in net bond issuance, as the central banks aim to ease their rates. This situation should lead towards a record year for sovereign issuance. In this environment, how can we ensure that market makers are able to fulfil their role as principal liquidity providers to the bond markets? How can trading protocols and enhanced connectivity create new sources of liquidity? What is the role of transparency in underpinning market resilience? How do conditions in the repo and derivatives markets impact underlying bond markets?

Dieudonné Djimi, Global Interest Rates & Currency Portfolio Manager at Ostrum AM, discusses the outlook for sovereign bond markets in 2024.

Bond markets have become more challenging since summer (bearish steepening, US spillovers etc). As a large active asset manager, how does Ostrum AM cope with this environment?

Liquidity remains adequate across euro area sovereign bond markets. Market participants sometimes complain about "liquidity" when volatility makes a trade go wrong. In our opinion, volatility has indeed been a real issue. Markets have had to adjust to higher volatility after a decade of low and stable rates and successive quantitative easing. Pricing differences across the curve are simply a reflection of higher yield volatility. Quantitative tightening (QT) reduces excess liquidity and takes out the biggest buyer of bonds of the last decade. Fund management must be nimble in this environment, pay more attention to market positioning to implement market views. Changes in monetary policy in Japan and the US must be factored as well as euro area fundamentals and ECB policy. Nevertheless, the infrastructure and the liquidity of the treasury market is absolutely more fragile than it's been in the past. The liquidity of US treasury is worsening and now sits at its worse level since 2011.

Will investors be willing to move out on the curve next year, or is cash just unbeatable in the current environment?

Cash should remain hard to beat in the first quarter or so as the European Central Bank (ECB) maintains status quo longer than currently expected by markets. Money markets rates should rise towards the ECB deposit rate as excess liquidity declines (due to Quantitative Tightening - QT). QT and pre-funding via bond syndications (in Q1) will continue to put pressure on back-end yields. That said, as inflation settles in (not quite on target but below 3%) rate cuts look likely. Ostrum AM forecasts Bund yields around 2,5% at the end of the year. Duration should perform better from the end of the first quarter.

What are main convictions for next year?

The main convictions are that central banks are unlikely to rush rate cuts. Inflation remains above target and should hover about 2,5% at the end of 2024. Markets may be too optimistic on the timing: in 2024, Ostrum AM foresees four decreases in Fed funds, the first one probably occurring in the second quarter. Furthermore, quantitative tightening will continue as Asset Purchase Programs (APP) holdings mature. This may keep sovereign spreads wide in countries as net bond supply will increase significantly next year. Ostrum AM thinks that PEPP holdings will continue to be reinvested in full throughout the year. Maturities provide flexibility to the ECB to intervene in markets if undue pressure on spreads emerge.

What are the largest risks?

The largest risks remain the geopolitical backdrop with potential escalation of conflicts in Ukraine, the middle East or tensions in Taiwan. Escalation should be conducive of volatility. The main risk within the euro area pertains to low growth and fiscal slippage. There will be European elections next spring. Several large countries (France, Italy) have run deficits of the Maastricht rules that will be reinstated in 2024 in their existing form or a revised format. Hard discussions between the European Commission and governments will take place.

In a structural view, marketable US government debt or European government debt have more than doubled over the past decade to reach respectively $26 Trillion and €8 Trillion Treasuries. For decades the market was depending on primary dealer to maintain order during times of stress, but new rules have set a limit on bank's leverage reducing their capacity to take asset. To fill up the void, new players emerged to take a bigger role like principal trading firm, hedge funds and other nonbanks with no obligation to step up during dire periods and activities less visible to regulators. At Ostrum AM, as a stakeholder in European sovereign market, our goal is to be vigilante to keep our market healthy.

Additional notes

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