# WISDOMTREE FIXED INCOME OUTLOOK – MANAGING THE BOND WAVE AMID HEIGHTENED UNCERTAINTY

Wisdomtree EU
30 Sep 2021

**Cyclical economic recovery to continue but expect regional differences.**

Economic growth currently exhibits characteristics of an early to mid-cycle business phase with the US cycle ahead of the other regions. Exceptionally loose monetary and fiscal policy has done what it was intended to do and helped boost economic activity outside of government lockdowns. We expect supportive fiscal and monetary policy to continue to drive growth with markets increasingly focused on when asset purchase programmes will be pulled back, generating some repricing in bond markets.

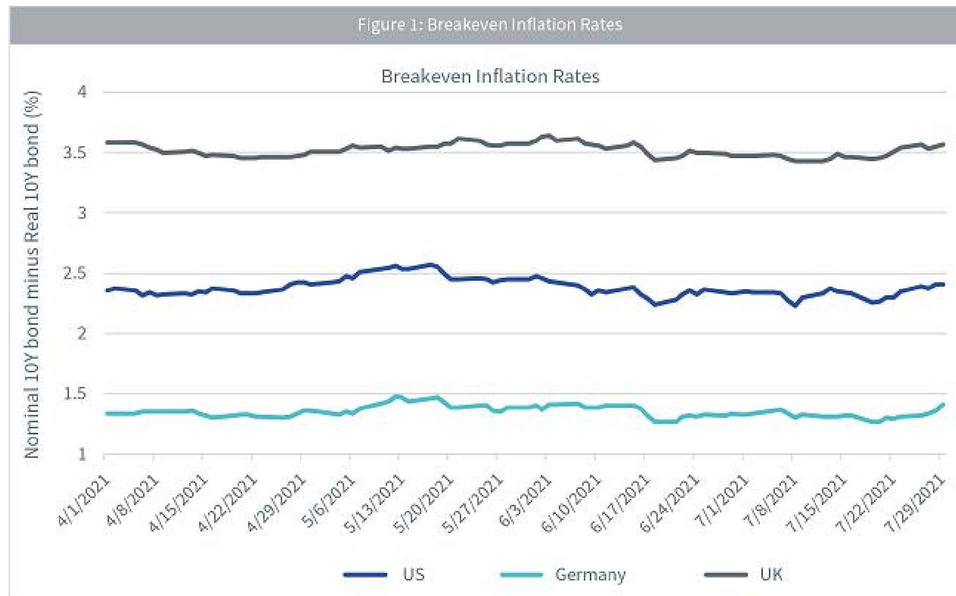
We forecast US economic growth to continue approaching pre-pandemic levels while the resurgence in Covid cases across the US and elsewhere will create some headwinds in the months ahead. There is no homogenous process that governments are following to manage the rising pressure on the healthcare system. Some governments are likely to remain more flexible in their approach by implementing fewer economic restrictions; meanwhile, others could reinstate many restrictions in the months leading into winter.

In Europe, we will continue to see a divergence between EU member states, with countries more dependent on the hospitality and travel sector lagging other regions unless there is a clear path away from economic lockdowns. A notable difference in the path to recovery from past crises will be the expansionary impact of the NextGenerationEU programme and the 2021-2027 long term budget, one of the largest packages ever financed through the EU budget. The combined resources can produce a positive effect on the immediate and longer-term growth prospects for the Euro-area. With growth in Europe at an earlier stage in the recovery cycle, we expect growth to pick up momentum in the second half of 2022.

In the UK, we expect a rebound in growth with the backlog in supply chains facing additional pressure in the region stemming from near-term complexities to business activity due to new cross-border rules post-Brexit. These supply shortages will put greater pressure on sectors already faced with pandemic induced global supply chain shortages. Companies with weaker fundamentals can see pronounced pressure going into year-end.

More generally, the growth outlook across these three regions over the next year will be navigated by the success of global vaccination programmes and their ability to ease capacity pressures faced within the health care system. Bond markets can shed light on investors' expectations for growth and inflation over the long term and serve as a barometer for economic recovery. If we focus on inflation expectations embedded in breakeven inflation rates for three key bond markets, inflation expectations have not changed materially during the second quarter of 2021; meanwhile, the respective

government bond yield curves flattened during the period (Figure 1). There appears to be a disconnect between economic data and bond yield levels. The focus then remains around when the US will begin tapering, which will have an upward pressure on bond yields.




Source: Bloomberg, WisdomTree as of 2 September 2021. Breakeven infla tion showed the embedded average inflation expectation over the course of the next ten years. Nominal 10-year bond yields minus real 10-year bond yields.

**Historical performance is not an indication of future performance and any investments may go down in value.**

The recovery will be choppy. Risk-on attitude could dissipate with heightened market uncertainty driven by a resurgence in covid cases that impacts the functioning of healthcare systems going into the flu season. Investors could consider portfolio segmentation by looking at short duration in rate-sensitive assets and high-quality long-duration bond exposures for potential volatility mitigation. Navigating complex bond markets with a tactical barbell approach can help balance the risk profiles of portfolios. Consider credit and duration barbell strategies.

**Bond markets remain swayed by the inflation fear tantrum, with some regions facing heightened pressure.**

The high correlation between the shifts noted across government bond yield curves will continue to ensue into the second half of 2021 but will unravel with the policy stance in the US becoming less accommodative in the year ahead. Globally, fears of persistent inflation have troubled bonds markets since the start of 2021, but the underlying premise for higher inflation remains mostly regionalised as core US inflation data prints continue to display a more persistent picture. Bond market investors will remain fixated on inflation prints, and we could expect more signals from US policymakers around the timeline for the tapering of asset purchases.

Historically, the market pricing of risk between the 2-years to 10-year part of the yield curve in periods of persistent inflation would reflect a steepening of the yield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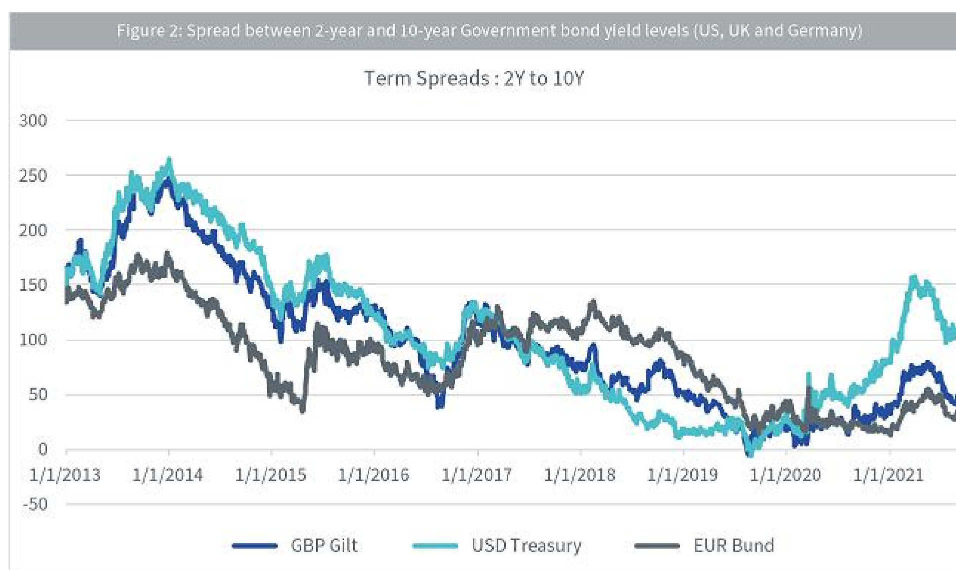
curve. We expect the recent flattening of the US yield curve to reverse in the months ahead. Recent moves lower in long term bond yields appear unwarranted given persistent inflationary pressures in the US tied to a policy stance that is likely to become less expansionary in the year ahead. We could expect more pronounced moves in US yields than in other markets where core inflation is persistently lagging that of the US, particularly as the market jitters around excessive inflation subsides elsewhere.

Markets should focus on energy prices and supply chain disruptions that could cause persistent upward inflationary pressures. Over the longer term, structural differences between the US, Europe and the UK will lead to inflation further diverging with Europe likely to lag. European inflation will be less of a threat than in the US and UK due to structural differences impacting EU member countries. With the European recovery at an early stage in the economic cycle, we expect the European Central Bank to be more conservative around tapering asset purchases in the year ahead.

For European bond markets, the long end of the German yield curve will reflect the more conservative stance of the European Central Bank led by fundamental differences between the pace of US and European recovery.

Looking historically at the term spread between 2-year to 10-year bonds (Figure 2), the US yield curve has exhibited the greatest repricing in the first half of 2021, with the most evident retracement in July 2021. The moves in bond markets remain at a disconnect to the rebound observed in the US economy. Similarly, the UK gilt curve steepness surpassed pre-pandemic levels in the first half of 2021, with some retracement around the same period. Continued robustness in US economic data could result in term spread widening once again. In Europe, considering the term spread premium noted in the German government bond yield curve, a notably muted yield curve steepening occurred when compared to the US and the UK supported by the expectation of a slower pace of stimulus withdrawal.

Figure 2: Spread between 2-year and 10-year Government bond yield levels (US, UK and Germany)




Source: Bloomberg, WisdomTree as of 2 September 2021. Term Spreads is defined as the difference in yield between 10-year bonds and 2-year bonds for a given yield curve. EUR Bund refers to German government bonds, GBP Gilt refers to UK government bonds and USD Treasury refers to US government bonds.

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Bond markets are likely to remain laser-focused on upward inflationary pressures in the near term. Over the longer term, structural differences between the US, Europe and UK will lead to inflation further diverging with Europe likely to lag. Consider more defensive duration exposure in US and UK assets, which face higher inflationary forces. In Europe, allocations to bond asset classes that have historically shown to provide downside protection in periods of equity market correction can help investors navigate European bond markets where yields are lower. Exposure to high-quality bonds with longer duration characteristics has historically provided risk mitigation and an uplift in periods of severe equity market corrections.

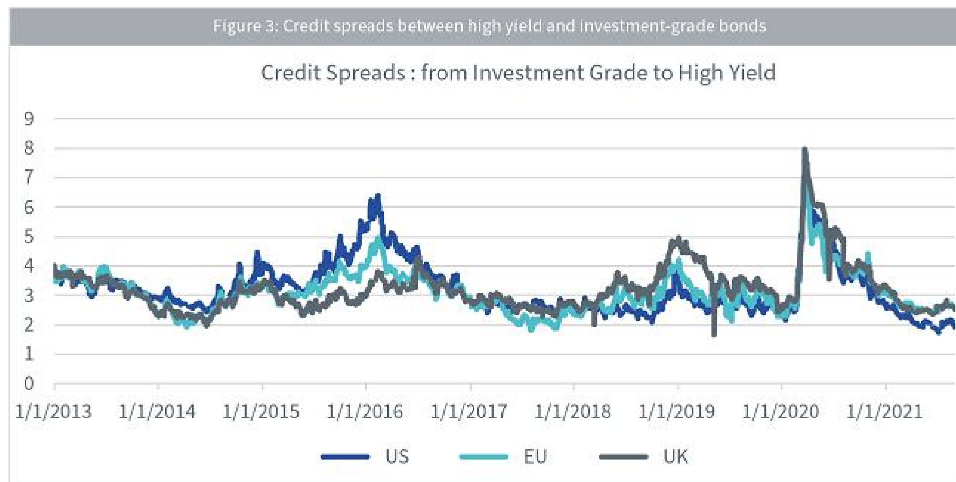
**Relative value opportunities between bond asset classes will become increasingly important as the path to recovery remains bumpy.**

Bond investors will need to find a balance between the fundamental strength and yield potential of different bond asset classes when making asset allocation decisions in the year ahead as the path to recovery remains choppy. Significant portions of the global economy, such as emerging markets, continue to lag developed markets in their respective mass vaccination programmes, and new variants could pose renewed threats to the path of economic recovery.

While credit spreads in most major bond markets remain tight relative to historical levels (Figure 3), we believe fundamental strength will play a role in which bond asset classes will outperform as investors increasingly seek exposure to pockets of the bond market that are more resilient to rising bond yields and economic uncertainty.

Banks remain a centrepiece of the economic recovery as central banks and governments continue to rely on the banking system to maintain loose fiscal conditions and support households and businesses amid the ongoing pandemic. A steeper yield curve environment is also supportive of bank profitability. Asset class diversification will be key in portfolios as investors become increasingly exposed to equity markets which could face a bumpy road over the next twelve months.

The banking system has exhibited resilience amid the health crisis; meanwhile, the yield enhancement available by investing in the subordinated instruments of banks' such as AT1 CoCos, is an example of a pocket of the market that has shown resilience to rising bond yields and economic uncertainty. This can be evidenced by an absolute performance of 11.81% in AT1 CoCos over the last 12 months . Thanks to the comparatively short duration of those instruments and the yield enhancement relative to other parts of the bond market, we expect continued demand for these types of exposures in the months ahead. The search for yield in bond markets will continue and underpin the spread between investment grade and high yield bonds which are now at the tightest level in the last ten years. Elsewhere in the portfolio, high-quality bond exposures can help balance equity risk exposure and will continue to find a place in diversified portfolios.




Source: Bloomberg, WisdomTree as of 2 September 2021.

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Relative value positioning to gain yield enhancement in pockets of the markets where there is fundamental strength could be a consideration. We could continue to see a rotation into risk assets that have historically benefited from a steepening yield curve. Barbell strategies to balance the risk profile of portfolios allocating to risk assets in the short end and high-quality exposures in the long end of the yield curve are also something investors could consider going forwards.

**This blog was drafted in collaboration with Piergiacomo Braganti and Didier Haenecour.**

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