AEGON Befektetési Alapkezelő

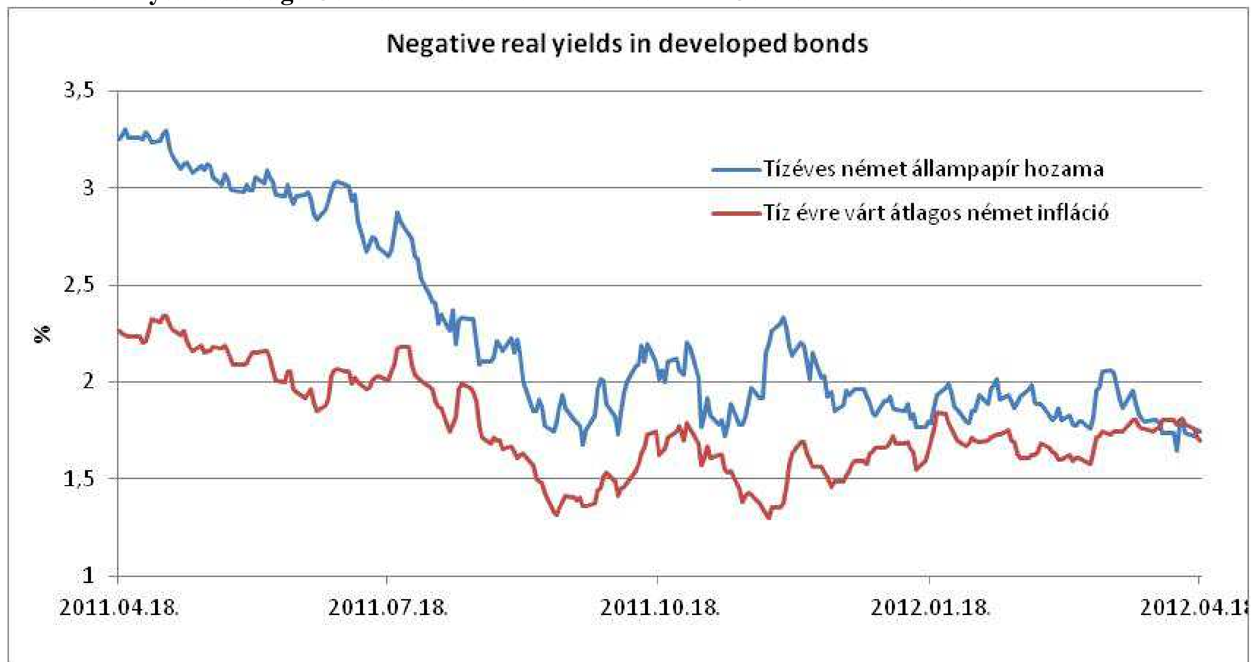
Monthly analysis – April - May

Ádám Bakos: German government bond yields plunge to unprecedented depths

Prospects favourable in the world economy, but many do not yet believe in a European recovery

Low yields in the developed markets are the "by-products" of the 2008 crisis, as poor economic prospects, central-bank bond purchases and high demand for secure government securities with good ratings have all pushed yields in the same direction: downwards. In the meantime, the movements and levels of German and US government bonds have become one of the indicators of the prevailing risk appetite, or aversion to risk, in the market.

Red line: 10 years average German inflation vs. Blue line: 10 Y German Bunds Yields

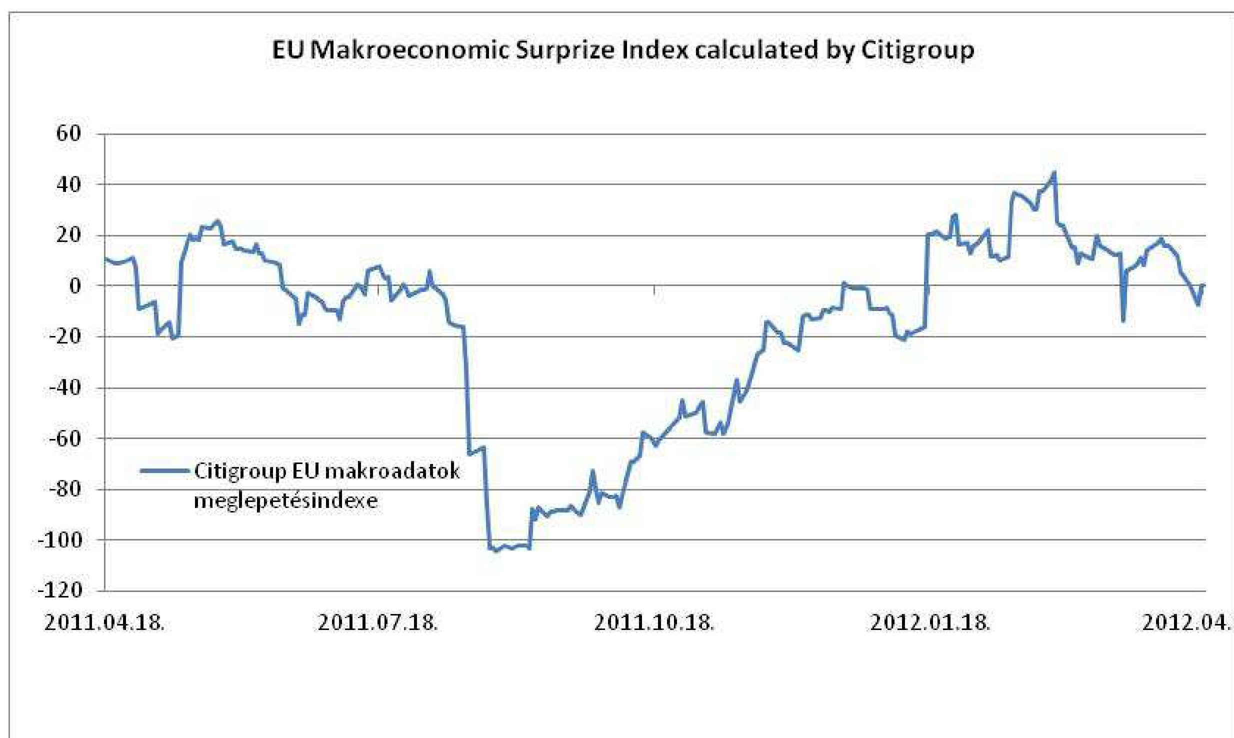


Source: AEGON Magyarország Befektetési Alapkezelő Zrt. (AEGON Asset Management)

The previous lowest return on German government bonds was registered last September, when the yield dropped to 1.67% amid a raging European sovereign debt crisis and rapidly deteriorating prospects in the global economy. At the beginning of last week the yield on 10-year German government bonds sank back again to 1.64%, and investors have never asked for so little compensation for lending to Europe's largest economy. However, the performance of most of the risk-laden markets over the past seven months presents a much more positive picture. Compared to last September, the DAX is riding 30% higher while the MSCI World index has risen 16%. On premium bond markets the period of strengthening triggered by ECB tenders seems to be passing, while even in the emerging markets bond spreads have declined by approximately 100 basis points since the end of last September. We shouldn't forget that markets were even stronger than this in March.

At the same time, the record-low German government bond yield shows that risk avoidance has reached similar levels to seven months ago, and this may indicate that European government bond investors are just as pessimistic as they were back then. However, it could also be worth taking a look at how the market environment has changed since then and whether the fears are justified. Which market is right?

The global economic outlook appears more favourable. US labour market data attests to stable growth since last August, so it comes as no surprise that, for example, the University of Michigan's Consumer Sentiment Index has risen considerably higher (75.7 vs. 59.4). Although the Chinese economy is slowing somewhat, purchasing managers' indexes (PMIs) have developed encouragingly in the first quarter of the year. While PMI figures are not so healthy in Europe, they cannot be said to have changed dramatically, as the composite indicator for the eurozone reveals a somewhat better performance in the first quarter than the dismal figures for the last quarter of 2011. At the beginning of April, the IMF amended its forecasts for 2012 global economic growth upwards for the first time in four quarters, although it does expect a far more modest expansion than last September. With the exception of Spain, it has predicted improving prospects in every significant region relative to the January figures. We should also note that the stability of the financial sector has been bolstered in the meantime by the successful Greek debt swap and the ECB's two-year tenders, which – among other things – indicates a narrowing of the EURIBOR-OIS spread.



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Despite these positive developments, a great many investors still do not believe in a European recovery. George Soros, for example, spoke recently of an ever-deepening European debt crisis, while ECB President Mario Draghi warned again last week that the rising Spanish yields indicate that the market is still watching like a hawk to see if the Spanish government can actually deliver the undertaken reforms.

I find it hard to imagine, however, that Spain could become another Italy, given that European decision-makers – albeit in a roundabout fashion – have taken significant steps to arrest the crisis. The market perhaps recognises what has proven to be true in recent years, namely that a greater number of political and economic interests are attached to saving the eurozone than to seeing its disintegration. I have another argument to support the assumption that the bond market is overly pessimistic. Last September inflationary expectations also declined substantially as the prospects for European growth collapsed, so against the backdrop of a 1.67% yield on 10-year bonds at the time, German inflationary expectations also hit a new low of 1.36%, thus assuring bond investors of a minimal real yield. Now, on the other hand, government bond yields have sunk to record lows just as inflationary expectations began to decline, but only to a level that is still higher than nominal yields. Consequently, the real yield expected over ten years is negative – something unprecedented for a good number of years.

I don't believe that this odd state of affairs will change quickly, and the differences in the markets' assessment of the situation may persist for months to come. As long as the central banks continue to pursue such lax monetary policies, no rapid increase can be expected in the yields on bonds in developed markets. Nevertheless, the current record low levels appear exaggerated in light of the above.

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