Trading places

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A growing divergence between US and European bond yields reflects the shifting strategies of global central banks. But as markets look towards further change in 2015 what implications does this hold for global investors and wider bond markets? Here, Raman Srivastava, co-deputy chief investment officer at Standish and Meriten chief economist Holger Fahrinkrug consider the likely outcomes.

An unfamiliar pattern is emerging in global bond markets. Toward the end of 2014 benchmark yields on a swathe of European government bonds, from German Bunds to Spanish bonds, fell to new lows[1]. In contrast, five-year US Treasury yields have more than doubled since 2012[2].

These moves partly reflect the contrasting monetary policies of the US Federal Reserve (Fed) and the European Central Bank (ECB). While the Fed wound down its quantitative easing (QE) programme in October Europe is still loosening its monetary policy and looking for ways to stimulate growth in a flagging regional economy. As part of these efforts the ECB announced a multi-billion euro initiative to buy covered bonds and asset-backed securities[3] in September 2014.

Commenting on the origins of recent divergence, Standish's Srivastava cites the 2013 market 'taper tantrum' – which followed the Fed's announcement it was to start reducing QE – as a key trigger for interest rate and bond yield divergence between the US and Europe.

"Taking a global view, it is clear that following a period of a number of years where many interest rates moved together, the taper tantrum initiated a new environment where interest rates and central bank policy have begun to diverge, in some cases meaningfully. This environment now looks set to be with us for the foreseeable future," he says.

Divergent paths

Commenting on the impact of central bank policy divergence on bond yields, Meriten's Fahrinkrug says the shift also reflects a deeper underlying economic divergence of the US and European markets. He contrasts the sustained economic recovery in the US – and also the UK – with the economic stagnation, near record unemployment levels and deflation fears still evident in the eurozone.

Commenting, he adds: "This combination of real economy slack and deflation woes in the euro area has pushed the ECB into unconventional policy territory, sent German Bund yields lower, and spreads of other European Union member government bonds over Bunds to historical lows."

Central bank strategy and bond yield divergence have already led the dollar to strengthen against the euro and could have wider implications, according to Srivastava, although he expects their impact to vary widely across a range of markets.

"Looking ahead – for emerging markets in particular – there will be an extreme amount of difference between rates of growth and responses to potential reforms and this is likely to create a lot of market dislocation," he says.

"Even in developed markets a lot of the trends that were in place for a number of years are shifting. Chinese economic growth is slowing, commodity prices are lower and the fact some major central banks will almost certainly begin to tighten policy in the short term are all very different dynamics and will affect bond markets in different countries in different ways."

Market response

A key question in the current market is how fixed income managers can best respond to the changes ahead in 2015 given growing US/European bond yield and interest rate divergence and the varying approaches to monetary policy being taken by central banks. Srivastava anticipates more market volatility ahead as investors adjust to shifting trends.

He believes this environment will make country selection increasingly important but could also create a range of potential opportunities for nimble investors.

Commenting, he says: "For investors in global bonds growing divergence means two things. Firstly, country selection will become a lot more important than it used to be. Secondly it means investors may need to be a lot more active in terms of their asset allocation.

"We anticipate more volatility as the market struggles to adapt to shifting central bank activity. Such bouts of volatility can provide opportunities to benefit from dislocations caused by market technicals where fundamentals remain sound. In future investors will have to pay a lot more attention to the countries they are investing in. Investors may also have to be a lot more active with their yield curve and duration position than they perhaps used to be."

A watching brief

With US QE now concluded, Fahrinkrug says global investors will be closely watching the ECB asset purchase programme in the months ahead to determine its success or failure, likely market impacts and potential investment opportunities and pitfalls.

"Assuming that the US cycle moves ahead as expected, the key focus must be on the factors determining ECB success. Perversely, its failure based on the measures already announced might be as good, or even better, than its success, for investors in euro area government bonds. However, the market's verdict will be straightforward, with the result getting either a straight thumbs up or the thumbs down. Consequently, investors and managers should be highly alert and analyse the parameters of the bank's success very carefully.

"In the event of ECB success, the likelihood of full-blown QE in Europe will decline sharply, and this could cause both yields and volatility to rise. Investment managers therefore need to be aware that euro area government bonds might not be as low-risk and the low-volatility assets they used to be in the first three quarters of 2014," he says.

Despite some degree of market uncertainty, Fahrinkrug remains hopeful the ECB will implement its support programmes as planned and uphold the threat to expand even into purchases of European Economic and Monetary Union (EMU) government bonds if other measures do not assist market recovery.

"This combination should be sufficient to keep German Bund yields at or around current levels, and to contribute to further, albeit gradual, tightening of peripheral spreads in the months ahead. Consequently, we trust that euro area government bonds will still have value for domestic investors though they will need to carefully consider the currency factor as gradual euro depreciation is a part of the ECB's strategy." he says.

The next 12 months hold the potential for further significant bond yield movements and volatility as central banks fine tune their strategies. However, these shifting sands could hold present opportunities for investors able to adapt their tactics to capitalise on specific market moves.

Commenting on the broader global investment market outlook Srivastava adds: "In the near term we see a challenging investment landscape related to low growth in Europe, slowing growth in China, a stronger dollar and a rolling over of commodity prices. While sector fundamentals remain generally strong, we do believe bouts of volatility associated with market technicals will make tactical, rather than structural sector allocation especially important."

[1] Draghi is bonds' best friend as yields fall to records. Bloomberg. 06.06.14.
[2] Rising yields give bond buyers and issuers pause for thought. The Wall Street Journal. 28.12.13.
[3] ECB bond-buying scheme begins. FT. 21.10.14.