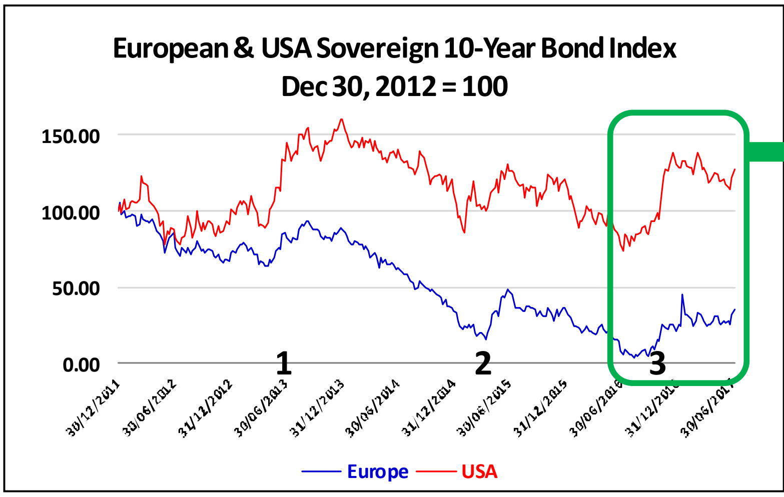
Central Bank Rhetoric...A Problem For Bonds

- **Bond yields experience a third yield tantrum in five years.**
- **Global reflation and policy tightening are the current drivers.**
- **Critical levels ahead could let loose the bond bears.**

One year ago, we suggested that European sovereign bonds were entering what we called the "*Blowout*" stage. To illustrate this please consider the 12-Month alteration in our European and US 10-Year sovereign bond indices as illustrated in Figure and Table 1. We use the US Treasury as a global reference.



	Europe	USA
08/07/2016	5.29	73.4
07/07/2017	35.81	127.13
Change %	576.94	73.20

Yield Increases:

1: Taper Tantrum 6/2013
2: Bund Tantrum 6/2015
3: Reflation, Trump Tantrum 11/2016

Figure 1: European and US Sovereign 10-Year Bond Index
Table 1: Percentage Change, Past 12-Months
Source: Spotlight Indices © Spotlight Group

During the past year the 10-year European index has increased over five-fold whereas the US index, based on the "*on the run*" 10-Year Treasury yield has not quite doubled.

This significant development illustrates the fact that the US Treasury market has anticipated steady increases in the Federal Funds Rate for longer than European markets have consider any tightening action from the European Central Bank, (ECB).

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Looking beyond the fact that yields have increased, we must consider that when interest rates have risen this rapidly in the past it has typically led to turbulent times for risk assets.

Bond Market Breadth

One way to consider this is to track "*sovereign bond market breadth*". This captures the proportion of government bond yields that have moved higher or lower i.e. weekly basis points change (δW), cf. their 50 or 200 day moving averages. This is illustrated in Table 2 below.

		Weekly Change	50 DMA	200 DMA	δW-50DMA	δW-200DMA
United States	USA	11	2	-1	9	12
	GERMANY	16	3	1	13	15
Liquid	AUSTRIA	10	2	1	8	9
Eurozone	BELGIUM	12	2	1	10	11
	FINLAND	0	14	3	-14	-3
	FRANCE	11	2	0	9	11
	GREECE	0	-4	-7	4	7
	IRELAND	9	2	0	7	9
	ITALY	17	3	1	14	16
	NL	11	3	1	8	10
	PORTUGAL	11	-1	-2	12	13
	SPAIN	20	4	1	16	19
Liquid	DENMARK	9	2	1	7	8
Non-Eurozone	SWEDEN	2	2	0	0	2
	SWITZ	6	3	0	3	6
	UK	5	4	0	1	5

Table 2:
US, European Sovereign 10-Year Bond Market Breadth Weekly Change
cf. 50 and 200 Day Moving Averages
Source: Spotlight Indices © Spotlight Group

Figure 1 shows that yields, as captured by the indices show that there were 3 significant bond market tantrums during the past 5 years occurred where yields in both Europe and the US rose aggressively.

This point is raised as bond breadth crashed in the "*Reflation/Trump Tantrum*" that began in November 2016 on an expectation that there would be a rebound in global growth. Looking at Table 2 one can see that by comparing the weekly change between July 7 and June 30 with the 50 and 200 day moving averages bond market breadth is breaking down once again.

In all markets, except well managed Finland, (Budget Deficit 1.90% of GDP and Debt to GDP 63.6%), an Sweden (Budget Surplus 0.9% of GDP and Debt to GDP 41.6%), one can see that last week's yield increase outstrips both moving averages.

This has occurred in both Europe and the US as positioning in the futures market has become somewhat stretched and as we have suggested in November, the reflation prospect would boost equities and undermine bonds.

Therefore, the recent steady increase in yields, driven by taper talk from the Fed and ECB, plus a rather muddled month of communication from the Bank of England leads us to consider that the rise in bond yields has further to run.

For European bonds, where will yields stop rising?

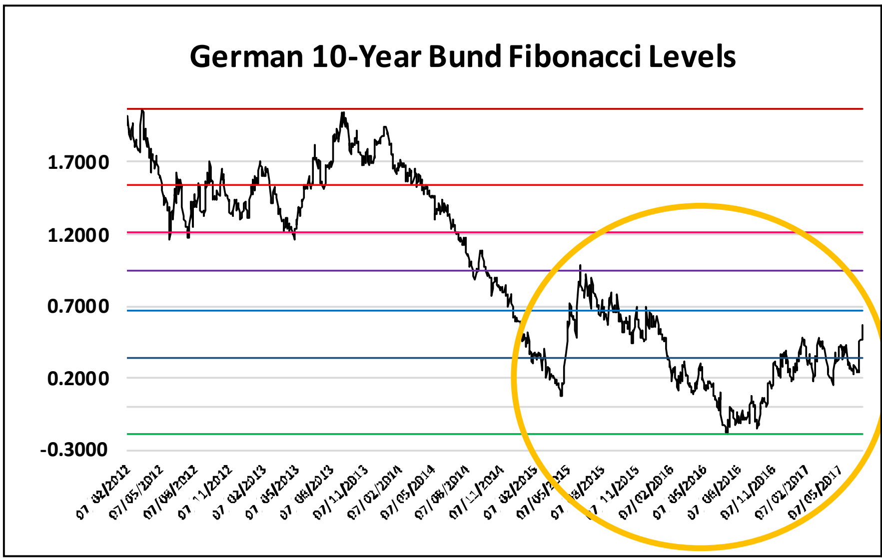
In the European space, all bonds whether they are issued by Eurozone nations or not tend to be evaluated as a spread relative to the German 10-Year Bund. Therefore, in Figure 2 we plot the path of the German 10-Year and its historical Fibonacci retracement points.

One will see on the next page that the German 10-Year Bund, which as at 17:00 GMT yesterday carried a yield of 0.546%, lower by 2.4 bps from last weeks close, (0.570%) will next encounter serious support at the yield level of 0.677% i.e. the 38.2% retracement level of the featured range.

This recovery is not to be unexpected given to recent back up in yields and we note that in the market the near-term technical sentiment supports a degree of buying on the recent dips. However, move out to longer levels of five hours to one month and one can see the sentiment swings back toward aggressive selling.

Clearly the prospect of the ECB starting to pair back its balance sheet holdings will have an impact across the entire European bond spectrum. Indeed, the smaller date range within the orange circle would offer the more active investor a closer target level of the next support point which we estimate at 0.661%.

It is crucial that the two targets levels are just one basis point apart and so any break above the 0.66% to 0.67% area will prove crucial as the pathway will be laid wide open to either 0.943% on the long-term or passive analysis and 0.922% under the more proactive approach.

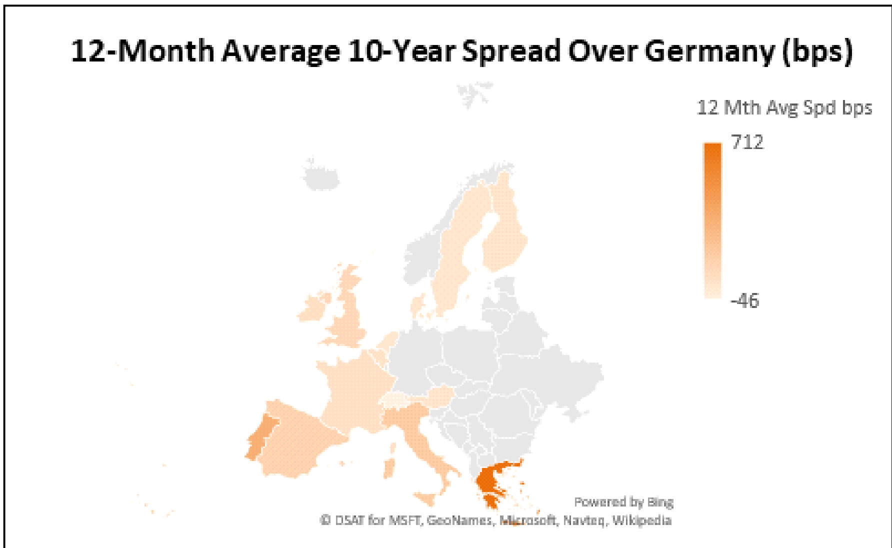


Germany 10-Year	Technicals
100.00%	2.069
76.40%	1.537
61.80%	1.208
50.00%	0.943
38.20%	0.677
23.60%	0.348
0.00%	-0.184

Levels above cover the full five-year window.

Active investors may prefer to analyse the smaller time zone inside the amber circle.

Figure 2: Technical Analysis of German 10-Year Bund   Source: Spotlight Ideas



	12 Mth Avg Spd bps
AUSTRIA	26
BELGIUM	40
FINLAND	28
FRANCE	48
GREECE	712
IRELAND	58
ITALY	173
NL	15
PORTUGAL	340
SPAIN	127
DENMARK	21
SWEDEN	19
SWITZ	-46
UK	96

Figure 3: 12-Month Average Spread Over German 10-Year Bund   Source: Spotlight Ideas

From here we map in Figure 3 the average spread that the selected European bonds in our European 10-Year Bond Index has in the past 12-months. This will provide a reasonable, first glance guide as to where one might expect the yields to find a degree of support.

It should be noted that if any client were to consider acquiring a specific security then a Fibonacci analysis of that asset would be recommended to enhance the granular aspect that this first glance analysis can provide.

The line in the sand for the German 10-Year yield will be about the 0.677% mark where the previous surge in yields topped out in November 2015. At that level, one might expect a battle between buyers and sellers develop at the following yields across Europe. These will be pivotal in colouring our buy or sell recommendations; target yields are listed in Table 3..

	07/07/2017	Avg Spread	Target
GERMANY	0.57	0	0.677
AUSTRIA	0.81	26.24	0.939
BELGIUM	0.92	39.53	1.072
FINLAND	1.45	27.90	0.956
FRANCE	0.94	47.54	1.152
GREECE	5.36	711.77	7.795
IRELAND	0.96	58.19	1.259
ITALY	2.33	172.60	2.403
NL	0.77	15.00	0.827
PORTUGAL	3.13	340.35	4.080
SPAIN	1.84	127.13	1.948
DENMARK	0.76	21.08	0.888
SWEDEN	0.68	19.19	0.869
SWITZ	0.01	-46.29	0.214
UK	1.38	95.60	1.633

Table 3:
European Sovereign Bond Market Yield Targets, Based on 12-Month Average Spread Over Germany
Source: Spotlight Ideas

Of course, we will have to wait for further data releases and indications of central bank sentiment to see if this line is to be breeched.

If the 10-Year German yield does cross the line it will imply that market participants have embraced the growing sense that the new hawkish central banking stance means normalisation and an end to the market distortions are on the agenda. In that case it will be time to avoid the bond market bears. If exposure has to be held in sovereign fixed income we would recommend the front end. Using the German 2/10 spread as a reference it has steepened during each of the three tantrums marked in Figure 1.

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