

## Video Transcript

**CIO Academy:** Rate moves have caught investor attention, but looking forward this could be for the right reasons

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### **Georgios:**

Hello, and welcome to today's new edition of the CIO Academy.

My name is Georgios Leontaris, and I'm the Chief Investment Officer for Switzerland and EMEA at HSBC Private Bank and Wealth.

Today's session is going to deep dive on global bond yields, which in recent sessions have touched multi-year highs. And to do that, I'm joined by Laurent Lacroix, our Switzerland and Global Head of Fixed Income.

So, Laurent, can you tell me, what has driven the recent move in terms of yields, and should we expect that to persist?

### **Laurent:**

Sure. Thanks, Georgios. Hi, everyone.

As we know, the conflict in the Middle East has put upward pressure on oil prices, which contributed to higher government bond yields, as concerns, of course, on inflation has grown quite considerably.

The chart, as you can see, highlights the strong positive correlation between oil prices and yields, which is at a multi-year high.

Central banks are also becoming more aware of inflation risk, or sometimes frustrated on the slow progress of disinflation, like in the US.

### **Georgios:**

So now, just coming back to a key driver of yields, Laurent, what's our assumptions for oil prices?

### **Laurent:**

That's a tough question, Georgios, because in the short term, oil continues to remain at the mercy of geopolitical developments. And we cannot rule out any further volatility to extend.

We construct scenarios, therefore, and attach probabilities to the potential outcomes.

Our base case scenario anticipates disruption to continue, oil prices essentially to remain at elevated levels and only see a mild deceleration heading into next year.

That environment still leaves us with a relative resilience in terms of global growth.

Yes, we should expect a gradual deceleration due to sticky utility bills, a fading fiscal impulse and elevated interest rates compared to the previous environment.

However, the transmission mechanism is still likely to be relatively slow.

**Georgios:**

Indeed.

**Laurent:**

Thanks, Georgios.

As you mentioned, government bond yields across the G7 have generally reached multi-year highs, as you can see on this chart.

I think it's important to mention that behind inflation concerns, several other factors are driving yields higher.

For example, we have a heavy bond issuance from the AI ecosystem to fund their capital needs. That may have intensified the recent rise in longer-dated yields, but also we have seen more price-sensitive investors, such as hedge funds, buying US Treasuries in recent years.

So this change in the investor base may have pushed long-term yields above levels justified by fundamentals. This may have also reinforced the negative market narrative around the US fiscal outlook.

As this chart shows, yields in recent years have been driven more by real rates, which is the grey area in this chart, than by inflation expectations, which is the red area.

So we believe this may be the result of markets expecting stronger long-term growth and higher neutral policy rates, which is quite new over the last ten years.

Some central banks have already delivered interest rate hikes, and others, like the Bank of England, are expected to follow.

At this juncture, we believe that too many rate hikes seem to be priced in by the markets. And while there are, of course, uncertainties to our outlook, we find it quite difficult for major central banks to beat these expectations.

**Georgios:**

Indeed. That's a very crucial point you just made, Laurent.

Because when we're thinking about potential returns for bond investors, you don't actually need yields to drop sharply to generate returns. At current levels, you're actually generating quite a healthy income as well.

And while correlations with oil still remain quite elevated, the good news is that investors can lean on a more hefty yield cushion that has been built, thanks to the repricing of this hawkish scenario that has already been built in, in terms of what central banks may ultimately deliver.

Now, this yield cushion was totally absent in 2022, when interest rates were rising from rock-bottom levels.

This is not the case today, when yields are elevated to begin with, and ultimately, that leaves investors with a more asymmetric return profile that could materialise depending on potential yield moves, and that can ultimately offset some of the short-term concerns that investors are facing.

Now, Laurent, if I can also ask, can you be a little bit more specific in terms of where we find the most compelling opportunities within the fixed income space?

**Laurent:**

Yes, sure. Indeed. As you mentioned, we clearly like this yield cushion which has been building up over the last few months.

So, we continue in terms of investment strategy. We continue to see opportunities in quality issuers, mostly within the corporate investment-grade bond market, and we remain positioned at the median part of the yield curve, as opposed to being on the short or longer end of the curve.

I think another interesting point is that while bond yields have been rising gradually, as we mentioned earlier on, a tipping point may come eventually, when the risk-adjusted returns become more attractive than those of equities.

This could trigger a shift between asset classes and support bond markets in the medium term.

We understand it's quite difficult to call the peak in yields, and we believe that balance of risk here may still shift towards lower yields over time.

**Georgios:**

Going back to some of the points that we touched upon before, we talked about oil. There's obviously been AI supply that has weighed on yields, but budget deficits have also come into focus with recent developments in France and upcoming events in the UK.

We also know that the debt outlook is quite complex and fragile.

In other areas, we've got deteriorating debt trajectories, for example, in areas like the US and Japan.

So how does that deficit discussion factor into your outlook in terms of yields?

**Laurent:**

Yes, thanks, Georgios.

Definitely a topical sort of issue. But as you know, budget deficit concerns are not new.

I mean, probably the rising interest burden and the fiscal trajectory have probably brought this back into the front line.

But what is very interesting is that historically, larger budget deficits have not always led to higher bond yields. So this relationship remains quite blurred.

We still expect governments to approve their budgets in the end and hopefully investors eventually shifting their focus to other topics, even though we still expect short-term rate volatility to remain.

**Georgios:**

Okay. Thank you, Laurent.

So, while it has been a challenging year for bond investors, that does leave us with a reassuring message in terms of the outlook.

So, to sum up, we do continue to have that overweight in high-quality bonds, by emphasising a medium-duration stance.

Now, we do recognise that corporate spreads are towards the tighter side of historical ranges. But that is also for good reasons.

We're currently underway through the earnings season, and we continue to witness the same trends extend into this quarter as well, with that corporate resilience essentially justifying the fact that spreads are still anchored at relatively low levels.

So ultimately, we lean on income generation and take comfort by the fact that the market is already pricing in quite a hawkish outlook in terms of central bank trajectory.

Now, that brings us to the end of this video.

I would like to thank you for your attention, and should you wish to extend this discussion and dive a little bit deeper into some of the topics that we touched upon, please don't hesitate to reach out to your relationship manager.