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Fixed-income market perspectives

Moving back to risk-on? Beware the law of unintended consequences.

The first half of 2015 was a turbulent one. In the first few months, Russia, the Ukraine and Brazil were in the headlines, as were commodity prices and the abandonment of the EUR/CHF peg. The second quarter was then dominated by the Greek crisis and China. U.S.-Treasury and Bund yields hit new lows in April before increasing significantly and causing negative absolute returns. Credit spreads widened. Volatility increased.

As we move into the second half of the year, some of these geopolitical issues seem to be almost miraculously resolved. Greece appears willing to accept the tough conditions required by its creditors. China has halted the sell-off in its equity markets. An unexpected bonus has been a sanctions-lifting deal with Iran.

This leaves the timing of the first Fed hike as the key source of near-term uncertainty. But, with most agreeing that it will be in September or December and that the pace of hiking will be slow, the possibility for upset appears limited.

In this environment, we believe that it may be appropriate[1] to start re-entering into some riskier positions in high-yield (excluding energy), euro investment-grade and emerging-market sovereigns. We are not overly concerned about an immediate sharp sell-off in rates as lower commodity prices should keep inflation expectations contained.

But any sense of calm could be deceptive. Big differences of opinion between Eurozone member states about the nature of monetary union remain. As their market intervention reminded us, the Chinese authorities also still do not really trust free markets, which may have implications on foreign investment.

Another topic which needs to be closely monitored relates to the unintended consequences of regulatory restrictions. Note, for example, Value-at-Risk (VaR) limits. These have to be followed by trading desks and various institutional investors. Rising VaR therefore leads to lower level of risk appetite and can turn into lower trading activity and exacerbate price movements – not what was intended.

[1] Not suitable for all investors. Potential investors should seek professional financial advice before investing.

The chart shows the German sovereign-bond VaR since 2000. Note the recent sharp increase in VaR to a multi-decade high. Rising VaR may have led to a lack of demand for German sovereign bonds in late April and early May, perhaps contributing to a sharp rise in Bund yields. As this shows, a decent risk-management approach which considers the possible impact of such factors remains highly important.

German sovereign-bond Value at Risk (VaR)*

In late April and early May German sovereign-bond VaR rose to a multi-decade. Rising VaR may have been linked to a lack of demand and a sharp increase in yields.

* Markit iBoxx Euro Sovereign Bond Germany Index, total return, in euro. One-day holding period with 99% confidence.
Sources: Bloomberg Finance L.P., Deutsche Asset & Wealth Management Investment GmbH, as of 7/2015

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