



CIO Flash

Bond-market turmoil – specific or systemic risks?

October 2, 2015

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After equity and foreign-exchange markets, now bond markets are behaving badly

- Increasing investor risk aversion has become even more evident in late September. While equities started their pronounced correction back in August, high-yield (HY) bonds, and a couple of investment-grade (IG) bonds took deeper dives in September. Higher risk assets are the main targets for sell-offs. The volatility measures for both the S&P 500 Index as well as the Euro Stoxx 50 Index remain at elevated levels.
- High volatility, widening risk premia and bid/ask spreads as well as deteriorating liquidity are unnerving investors.
- Central banks are also contributing to rising risk aversion. The U.S. Federal Reserve Board's (Fed) decision to postpone the rate hike led to a further leg down in markets, as investors had hoped for clearer guidance, and especially equity markets have started to question the benefits of further quantitative-easing (QE) measures. Japanese stocks did not profit from rumors of further monetary easing by the Bank of Japan (BOJ).
- Spreads for both IG and HY in U.S. and European markets had already been widening since the spring. IG spreads (U.S. and European) are now back to the levels seen back in early 2012 before Draghi's "whatever-it-takes" speech.
- We see a combination of long-term and short-term reasons for the recent bond sell-off: concerns about Chinese growth take center stage, including the implications for commodity demand and prices. Oil is a separate issue affecting markets. The pending rate hike (and the uncertainty surrounding the Fed's decision not to raise rates in September) also hurt both developed-market (DM) and emerging-market (EM) bonds. General growth concerns for EM and DM call for risk repricing. Shorter-term general issues include heavy supply in the United States, liquidity and portfolio issues. Finally the market has been hurt by idiosyncratic events from companies such as Volkswagen, Glencore and Petrobras, the latter also falling victim to lower commodity prices. Furthermore, bond investors are taking note of the credit implications of high merger-and-acquisition activity and share-buyback activity in the United States.
- We believe that, with its recent sell-off, the market has got ahead of itself, overpricing risks that we believe will not materialize to the extent feared. Most credit-risk metrics remain benign.
- We see further risks in the short term as sentiment could turn more negative (also as a result of the sell-off), as momentum is still negative and volatility still high. Cautious investors will wait to see markets stabilizing before entering.
- However, we stay strategically constructive on risk assets, and believe that the market might show good opportunities quite soon, as:
 - Liquidity could improve at the start of the fourth quarter, as quarter-ends (as just experienced) often suffer from funds getting rid of assets for performance and risk-measurement reasons and as bank books do not want to take on risk.
 - Third-quarter (Q3) reporting season could actually surprise on the upside compared to recent market pessimism.
 - The European Central Bank (ECB) might talk more openly about extending and expanding its quantitative-easing (QE) program, which through influencing funds' portfolio reallocations should also support corporate bonds. On a mid-term horizon direct ECB buying of corporate bonds also remains an option.
 - Within bonds, contagion has led to indiscriminate selling within entire sectors, which opens up opportunities.
 - Valuations now offer more upside to our target levels.
 - Globally, funds have increased cash positions, possibly for both protecting and also profiting from further volatility.

Please note asset-class implications are to be found on the next page.

Investments are subject to various risks, including market fluctuations, regulatory change, counterparty risk, possible delays in repayment and loss of income and principal invested. The value of investments can fall as well as rise and you may not recover the amount originally invested at any point in time.

Deutsche AWM expectations 2015. Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect. No assurance can be given that any forecast or target will be achieved; Deutsche AWM Investment GmbH, CIO Office; Deutsche Bank AG; As of October 2, 2015



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