

## Going on a steep slope

**Bottom line:** Global bond markets are facing heightened volatility, with long-term yields rising sharply due to fiscal concerns. Investors are demanding higher risk premiums, leading to a bear steepening of yield curves. With rise in term premiums, we expect the curve steepening trend to continue and maintain our preference for short-duration and high-quality assets.

- ▶ Long duration bonds have come under pressure on growing debt concerns
- ▶ Rise in term premium as investors demand extra compensation for holding long-term bonds
- ▶ We expect curve steepening trend to continue, driven by volatility in long-dated bonds
- ▶ We advocate a short-duration stance and maintain preference for European and UK bonds

### A global bond market steepening

- ▷ Long-term bond yields have been rising worldwide, particularly among developed market (DM) sovereigns, as concerns grow over increasing debt levels and widening fiscal deficits in the US.
- ▷ The 30-year US Treasury (UST) yield has surged past 5%, its highest level since 2023, with the UST curve bear steepening (long-term bond yields are rising more than short-term bond yields).
- ▷ US credit default swap (CDS) spreads have widened due to concerns over US sovereign risk. The 1-year CDS spread has reached its highest level since 2023, now comparable to spreads seen in Israel, Brazil, and South Africa, while the 5-year CDS spread is at its widest since 2011.
- ▷ The US-led bond market selloff has not only spread globally but has intensified in other regions. Long-dated bonds in Japan, UK, Germany, and Australia have also faced selling pressure, with yield curves bear steepening across these markets.
- ▷ One of the most notable developments has been the extreme moves in Japan's long-maturity bonds. The 30-year Japanese bond yield hit its highest intraday level since 2006, while 40-year Japanese bond yields also reached record highs last week.

### The Term premium effect

- ▷ Long-term UST yields are influenced primarily by real yields and inflation expectations. However, the key factor driving recent movements has been the term premium—the additional yield required by investors to hold long-term bonds.
- ▷ Demand for a higher term premium has intensified due to rising US debt levels, a widening fiscal deficit, and increasing scepticism about UST's safe-haven status.
- ▷ Moody's downgrade of US sovereign credit rating brought these concerns to the forefront, further exacerbated by the passage of the "Big Beautiful Bill" in US congress, which is expected to contribute to ballooning US debt. Federal debt, already projected to rise to 117% of GDP by 2034, is estimated to increase to 125% of GDP by 2034 due to the tax cut bill.
- ▷ Investors are not only demanding higher risk premiums in USTs but also in other DM bond markets. This includes Japan, where supply-demand imbalances are pushing term premiums higher. The Bank of Japan (BOJ), historically the largest buyer of Japanese government bonds (JGBs), has been reducing its purchases, and other traditional buyers of long-term JGBs have remained on the sidelines, failing to compensate for the gap. Meanwhile, prospects of higher fiscal spending amid trade uncertainties have further increased risk premiums at a time when Japan already faces high debt servicing costs.
- ▷ German yields have also risen this year, driven by the country's commitment to spend billions on defence and infrastructure over the next decade.

### Negative impact of excessive curve steepening

- ▷ Higher yields increase borrowing costs for businesses, potentially dampening corporate investment and profitability, which could, in turn, weigh on equity valuations. This trend is particularly concerning for sectors that rely heavily on debt financing, such as technology and real estate.
- ▷ Japanese government bonds (JGBs) and German bunds have become more attractive than USTs on a currency-hedged basis. As a result, international investors may find it unappealing to buy USTs, resulting in reduced foreign demand. This could potentially trigger a buyers' strike in the UST market.

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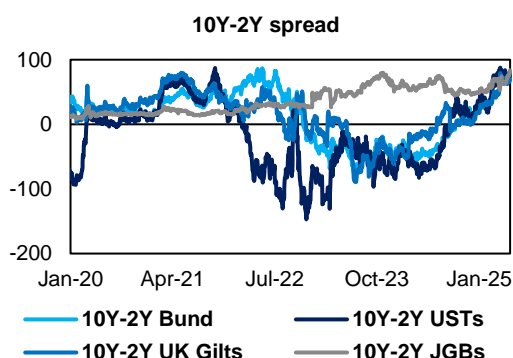
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- ▷ Persistent sell-off in the bond markets could threaten the bond market liquidity. Reduced trading activity can lead to wider bid-ask spreads while a prolonged liquidity squeeze could further tighten financial conditions. We will watch out for dislocation in the USTs market in the form of more negative swap spread, wider bid-ask spreads and tightening financial conditions.

## How to navigate curve steepening?

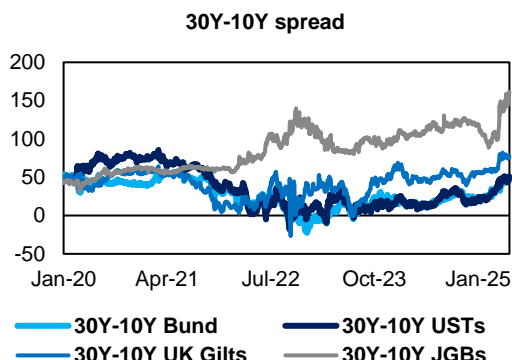
- ▷ We anticipate that the curve steepening trend will persist, driven by continued fiscal expansion. Typically, during economic downturns and DM central bank easing, UST yield curve tends to bull steepen. However, given the higher term premium and prospects of lower Fed terminal rate, we will continue to see periods of bear steepening. As a result, maintaining a short-duration stance remains critical unless government spending is significantly reined in to stabilize debt levels.
- ▷ Beyond focusing on short-duration securities, we also recommend sticking to high-quality fixed-income assets. Despite the recent correction in long-term yields, short-intermediate investment grade bonds are trading attractive, providing more stable and relatively favourable risk-adjusted returns.
- ▷ Within the credit space, having exposure to short-duration bond aggregates is recommended. This includes European credit which has a shorter duration compared to US credit. Financials, as a sector with relatively short duration, is also attractive.
- ▷ Given the uncertain outlook for USTs, diversifying into European and UK bonds looks prudent. Long-dated German bunds are expected to be less susceptible to fiscal pressures, as Germany maintains a relatively disciplined fiscal approach, limiting excessive debt accumulation. Meanwhile, UK gilts remain well-positioned despite fiscal concerns, as the Debt Management Office (DMO) has adjusted its issuance strategy, reducing the supply of long-duration bonds to support investor demand.

Exhibit 1: Yield curves have steepened



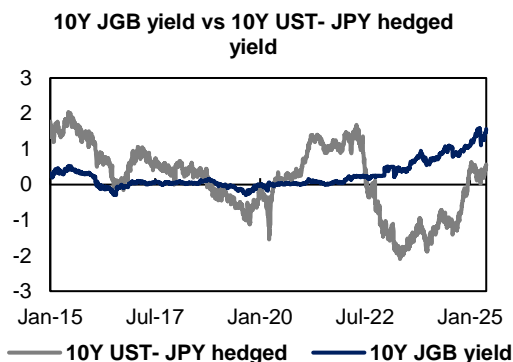
Source: Bloomberg, and ADCB Asset Management

Exhibit 2: Especially in the extreme long-end



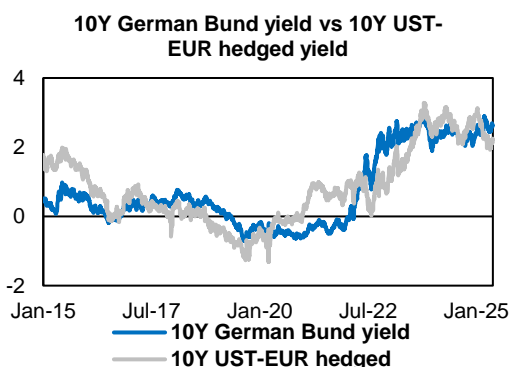
Source: Bloomberg, and ADCB Asset Management

Exhibit 3: JGBs offer higher yield vs JPY hedged USTs



Source: Bloomberg and ADCB Asset Management

Exhibit 4: Bunds offer better yield vs EUR hedged USTs



Source: Bloomberg and ADCB Asset Management

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