

Duration has lost its sting

On the bond market the risk-to-reward profile appears to favor medium- to long-term maturities

IN A NUTSHELL



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- After years of heightened nervousness and consequent high volatility, the global bond market seems to have normalized
- Global yield curves are steepening again, which should make attractive to extend duration
- We see potential in building exposure to the medium-dated segment

After a difficult couple of years, the outlook for the bond market is once again constructive

Global bond markets have exhibited mixed performance in 2024. While German 10-year government bond yields oscillated between 2.00% and 2.60% since the year's start, characterized by significant intraday volatility, spreads on investment-grade and high-yield corporate bonds narrowed considerably, reaching multi-year lows in some instances. This divergence suggests a heightened level of investor nervousness, yet simultaneously underscores a robust demand for fixed income assets. 2024 did not prove to be the year for fixed income that was widely heralded twelve months ago. Looking ahead, however, we are optimistic that the attractiveness of the bond market could become more apparent in the coming months. We expect that the narrative of recent years, that duration is inherently bad or dangerous, might no longer be tenable in the future. Quite the contrary.

1 / Income generation has returned to the fore

1.1 With sharp interest rate hikes by global central banks, the bond market experienced some 'years to forget'

Bonds have been anything but boring in recent years. The low interest rate environment that the financial world experienced in the aftermath of the global financial crisis 2008 changed completely in a very short period of time. First a pandemic, then disruptions to global supply chains and finally the outbreak of war in Europe were the factors that turned the market upside down. Each of these factors contributed, directly or indirectly, to a resurgence of inflation that many observers thought impossible. In response, central banks aggressively raised interest rates to slow the runaway price increases. However, we now seem to be slowly entering a phase of recovery in which the various distortions, both in the economy and in the bond market, appear to be returning to normal. Above all, this should lead to a reduction in volatility.

Over the past few years, fixed-income investments have not been a source of real joy

The years since the 2008 global financial crisis have been shaped by quantitative easing by the major central banks. In the course of 2019, the ten-year Bund yield slipped well below the psychologically important 0% level, after having already seen

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a brief dip below this level in 2016. Negative yields dominated the picture in the Eurozone for the next two years. 2020 also saw the launch of Europe's Pandemic Emergency Purchase Programme (PEPP), which continued to impact the eurozone bond market in the following year. In the U.S., 10-year yields also reached a low of just under 0.3% in 2020 but rose quickly in the following months. The spread between U.S. Treasuries and Bunds in this maturity segment widened significantly during this period.

After the sharp rise in yields (especially for 2022), bond markets are likely to return to calmer waters



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Then, in 2022, it was the complete opposite. In one year, bond markets on both sides of the Atlantic suffered their biggest losses since World War II as major central banks dramatically tightened interest rates to fight inflation, causing bond yields to soar. The term "inflection point" was in vogue. During this period, which continued to cast a shadow over the years that followed, fixed income securities defied their reputation as calm investment products and displayed a high degree of volatility even on an intraday basis. However, it is precisely these developments in recent years that have brought markets to a point where we believe opportunities now exist.

1.2 In our view, the case for investing in bonds is strong again

In our opinion, looking ahead, the different segments of the bond market appear attractive again. The key word for the coming months and probably for the whole of 2025 is normalization. Another important, albeit very simple, aspect from an investor's point of view is the fact that fixed income securities are once again generating substantial income due to the higher yield levels.

Bunds and U.S. Treasuries - duration back in demand

Since the middle of this year we have been in a new interest rate regime. Growth and inflation trends give the European Central Bank (ECB) and the Federal Reserve (Fed) potential room to cut rates further. They have started to cut interest rates

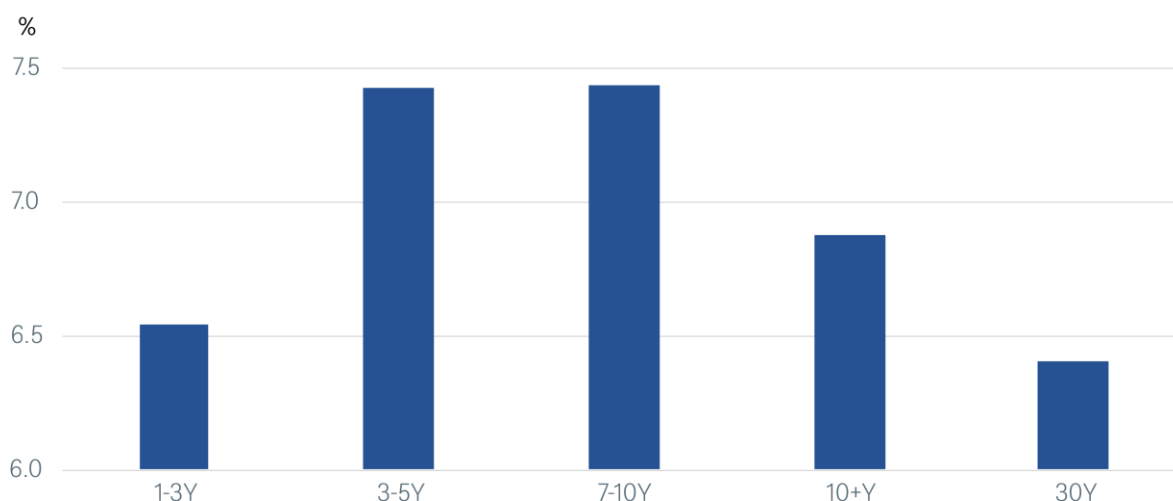
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and this trend is likely to continue this year, albeit to different degrees in the U.S. and the eurozone. We expect the Fed to cut rates twice more over the course of 2025, while we forecast Christine Lagarde and her colleagues at the ECB to do so four times this year. While growth on both sides of the Atlantic is unlikely to surprise to the upside to significantly challenge this rate outlook, inflation could prove more intractable and pose a challenge to central banks. In our main scenario, however, we do not expect yields on Bunds and U.S. Treasuries to rise sharply, although overshooting cannot be ruled out in the short- and medium-term. However, yield levels of above 4.50% for 10-year U.S. Treasuries could trigger increased buying interest.

In our view, the new interest rate regime is likely to lead to a further normalization, i.e. a steepening, of yield curves on both sides of the Atlantic. However, we do not expect the spread between 2- and 10-year yields to return to the levels implied by long-term averages in the short term. At the end of 2025, we forecast that the curve could steepen by 30 basis points (bps) for U.S. Treasuries and 45bps for German Bunds. By way of comparison, the average spread between 2- and 10-year maturities has been just under 100bps in the U.S. since the late 1990s and around 86bps in the euro area. In our view, the flatness of the yield curve indicates that investors are not concerned about excessively high long-term inflation rates and therefore real yields at the longer end remain relatively low.

The government bond segment should remain calm in the coming months and throughout 2025. This could allow bonds to show once again what makes them so attractive for investor, "boredom," expressed by their low volatility. In terms of duration, we think it is a good idea to lock in the current attractive yield levels, although we do not expect yields to fall significantly over a 12-month horizon, especially at the longer end. We see some value in building up duration, especially in the intermediate maturities.

Medium duration has offered best performance after rate cuts (average 12-month total return after rate cuts and yield curve normalization*)



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 12/31/24; * Based on data for yield cutting cycles between 1989 and 2019, yield of the respective ICE BofA US Treasury Index for the respective term to maturity, 12-month return refers to the period after the initial rate cut. Past performance is not indicative of future performance.

Despite recent interest rate cuts, a significant shift of funds from money market funds into longer-dated bonds has yet to materialize on both sides of the Atlantic. The relatively attractive yields on shorter-term debt, coupled with persistently flat yield curves, continue to incentivize investors to remain in money market funds. Furthermore, the lack of compelling competition from bank deposits, particularly in terms of yield, further reinforces this preference for short-term instruments. Nevertheless, we expect that further rate cuts by the Fed and the ECB could cause money market funds to move and capital

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to be shifted to longer maturities. We do not expect a massive outflow, but the shifts should help to provide sufficient support for the intermediate and perhaps longer end of the curve.

One aspect that remains uncertain is the expected higher supply of Treasuries and Bunds. Following the German general elections in February, a new government may, similar to the one in the U.S., recognize the need for a significant increase in investment and thus increase borrowing on the capital market. However, we currently believe that the market as a whole should be able to absorb any additional supply. At the same time, such a development could also lead to a somewhat steeper yield curve for Bunds and Treasuries than we expect, driven by a renewed slight rise in yields at the longer end.

Corporate bonds particularly attractive from a carry perspective

Corporate bonds have also performed well on both sides of the Atlantic in recent months. Compared to government bonds, the segment generally offers the advantage of additional carry and a generally shorter duration profile. These two aspects are likely to become much more important in the future.

Looking at global corporate bonds, spreads are currently at the lower end of the range that has largely prevailed over the past decade (with the exception of the coronavirus pandemic). There are regional differences in that U.S. spreads are at their lowest levels since 2005, while comparable eurozone spreads are "only" at their lowest levels since early 2022. We do not expect spreads to move much lower over the next twelve months, barring possible exaggerations.

Both, fundamentally and technically we do not expect spreads to widen significantly either, at least in the investment grade segment. Risk appetite is on the rise, especially as corporate earnings are expected to remain solid overall and we do not expect a recession in either the U.S. or the eurozone in our main forecast scenario.

In the case of corporate bonds, the narrow spreads mean that the focus is on the carry



*yield differential between corporate bonds and government bonds

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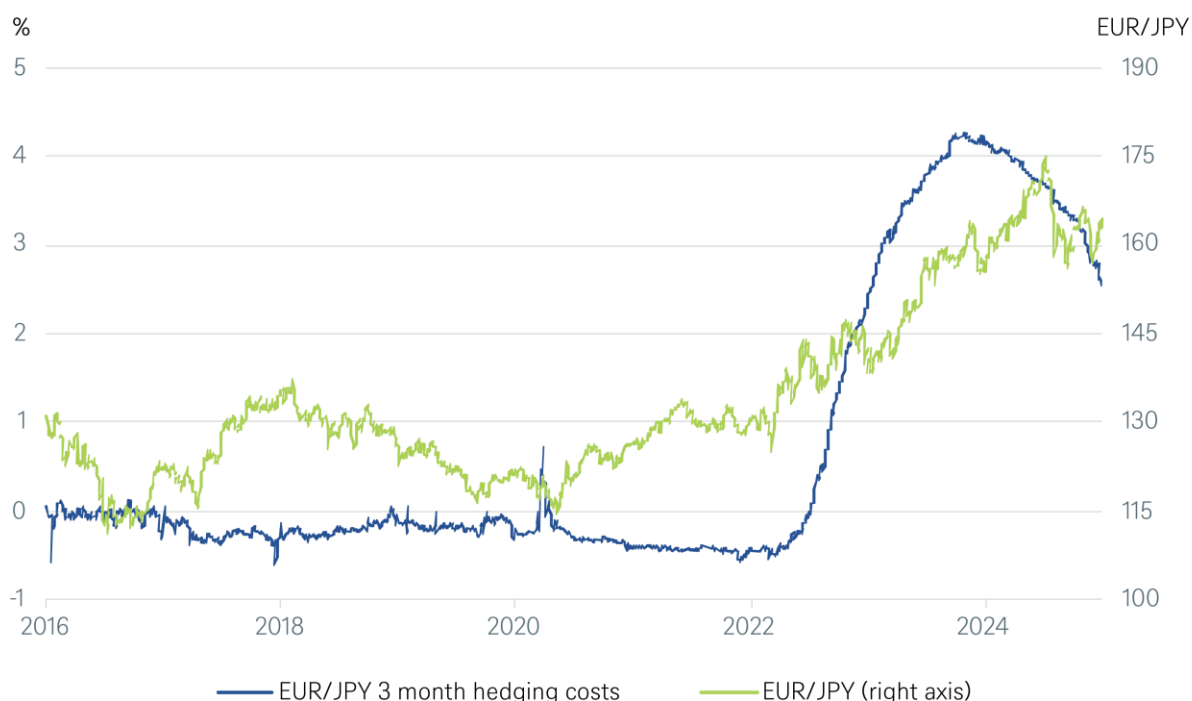
Demand for corporate bonds should also remain strong. In 2024 the market had to cope with a high level of new issuance, yet spreads in all segments remained stable or narrowed further. We do not expect this picture to change significantly in the coming months.

As long as the major Western economies do not lose significant momentum, the attractiveness of corporate bonds should largely come from carry, as we expect spreads to remain broadly stable. The shorter duration profile compared to government bonds should also prove advantageous in times of still elevated interest rate volatility.

1.3 Outside the Eurozone, euro-denominated bonds appear increasingly attractive too

Our generally very constructive view of the global bond market may well look different from the perspective of Japanese investors, for example, with euro-denominated bonds having a potential advantage in our view. This is because, from a risk perspective in particular, investments in U.S. Treasuries or the U.S. corporate bond market are more exposed than their counterparts on the other side of the Atlantic due to the unpredictable changes and challenges that a Trump administration could bring. Nervousness could remain high for some time, leading to a resurgence in volatility and the risk of higher yields if inflation re-emerges as a result of higher government spending. In the eurozone, by contrast, weak growth might force the ECB to make further interest rate cuts, but there is also no telling how the political situation in the single currency area will develop, with Germany and France the most prominent victims of high political uncertainty.

Euro/Japanese Yen hedging costs* have fallen over the past years



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 12/31/24 / Hedging-costs annualized per annum.

* Cost of a three-month currency hedge for yen-based investors on an annualized basis. This is based on the assumption that investors sell yen to buy Euros in the spot market, while simultaneously selling the Euros in the forward market to buy back the yen. Past performance is not indicative of future performance.

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Data from the Japanese Ministry of Finance has shown that Japanese purchases of U.S. Treasuries have declined in recent months, and also that demand for euro area government bonds has increased.¹ However, it should be noted that the data from the Japanese Ministry of Finance was collected before the US election. As recently as 2022, there was almost no demand for foreign government bonds, while in 2023 US Treasuries were heavily bought. Now there seems to be a new shift.

Hedging costs also play an important role. As the European Central Bank is expected to continue cutting interest rates this year while the Bank of Japan is expected to move in the opposite direction, EUR/JPY hedging costs for Japanese investors should fall, making eurozone bonds more attractive. As the Fed is expected to ease less, USD/JPY hedging costs should also fall, but to a lesser extent. This is another advantage for euro-denominated bonds.

All in all, the picture is one in which euro-denominated bonds could develop an advantage over USD-denominated bonds from the perspective of Japanese investors. We think there is a good chance that Japanese investors might become increasingly involved in the eurozone bond market in the coming months and over the course of 2025, and not just for diversification reasons.

2/ Summary

2.1 Fixed-income securities are generating income again

The 'income' in 'fixed income' is becoming more relevant again.

With starting yields at attractive levels and central banks in the midst of a rate-cutting cycle, bonds are well positioned to deliver healthy and attractive returns in the months ahead, in our opinion. Fixed income is also increasingly regaining its role as a diversifier and should therefore play a more dominant role in portfolio construction. And, of course, we believe there is a widespread belief that the Fed and the ECB are ready to act if the economy unexpectedly weakens and could intervene (again) to provide support if needed. This implicit support should give investors the confidence that bond markets, especially corporate bonds, could remain supported even if the economic situation deteriorates. However, bonds don't need a significant macroeconomic downturn to perform well. Initial yields on corporate bonds in a number of sectors are as of end 2024 at multi-year highs. This is just one example of the tailwind from falling interest rates.

Of course, there are also risks, especially if it becomes clear, particularly in Europe or the euro area (but also in the U.S.), that investment financed by rising deficits is urgently needed and that fiscal policy should be loosened accordingly. It is also far from certain that inflation will not rise on both sides of the Atlantic. Much in these scenarios depends on how expectations of central banks change. And while, on balance, we do not expect to see massive shifts in yields one way or the other over a 12-month horizon (especially at the longer end), we believe that the current yields on offer are attractive enough to lock in. If interest rates fall, longer maturities tend to outperform. But even if yields remained broadly unchanged, just a small increase in duration could provide an attractive return over the course of a year.

We believe that fixed income, including longer maturities, should play an increasingly important role in portfolios from a diversification perspective. In terms of duration, we see value in intermediate-term bonds, as the normalization of the yield curve is likely to be driven by shorter maturities. From a Japanese investor's perspective (also taking into account the expected evolution of hedging costs), euro-denominated bonds have a certain advantage over US dollar-denominated bonds.

¹ Japanese investors and European Government Bonds, Mizuho as of 11/22/24

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Glossary

One **basis point** equals 1/100 of a percentage point.

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

The **European Central Bank (ECB)** is the central bank for the Eurozone.

Federal Reserve Bank is a regional bank of the Federal Reserve System, the central banking system of the United States. There are twelve in total.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

The **ICE BofA Merrill Lynch 10 Year US Treasury Index** measures the performance of Treasuries with ten years remaining until maturity.

The ECB's **Pandemic Emergency Purchase Programme (PEPP)** is a non-standard monetary-policy measure initiated in March 2020 to counter the serious risks to the monetary-policy transmission mechanism and the outlook for the Eurozone posed by the coronavirus outbreak.

Quantitative easing (QE) is an unconventional monetary-policy tool, in which a central bank conducts broad-based asset purchases.

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

A **yield curve** shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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