Deutsche Asset
& Wealth Management

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.

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While increasing growth fears played a role, other issues also triggered volatility in Q3

While we believe that some degree of revaluation of both equity and bond markets is justified by a slightly deteriorating macroeconomic outlook, we believe the recent correction was overdone as it was also the result of many – but we believe short-term – issues as mentioned above. Short-term issues include contagion to asset classes which would otherwise be unaffected by events, as due to liquidity issues investors may have to sell what they can. The fact that many asset classes year-to-date (YTD) are in negative territory may also make unusual portfolio realignments more likely. We expect the Q3 reporting season to validate our assumptions of a slight, but not major decline in growth levels; if not, we will have to revisit our targets and recommendations. We still count on DM consumers to support growth. As this is mainly a domestic recovery story, EM issues could slow down, but are not likely to stop DM growth. Remember also that low commodity prices not only have victims, but also beneficiaries within EM.

— Fixed Income: While pending Fed tightening over the medium term remains a headwind and ECB QE, with its potential expansion, a tailwind, markets are currently focusing on fundamental issues while also being affected by technical issues such as offer/demand, liquidity and portfolio adjustments. With consensus global growth forecasts further declining, markets are pricing risks higher as they fear default risk may increase. We believe the recent sell-off has however led to valuations that will encourage investors to reassess the asset class. We feel most comfortable with U.S. and Euro IG and believe that certain sectors have been overly punished for single-borrower events. Nonetheless, company selection remains highly important and in the short term high supply will likely reduce the extent of spread tightening. The same applies to Euro HY, where we are nearing entry points, as supply and possible fund outflows could first lead to further price pressure. The asset class has already seen the biggest spread widening recently, mainly driven by companies related to EMs and the metals/mining and telecom/cable sectors. Valuations for better-quality names now seem attractive, while the ECB‘s QE remains supportive. For EM hard-currency debt, we stay cautious on both sovereign and corporate debt as a Fed hike would increase investors' concern about such debtors' ability to service their debt, especially in light of the EM currency depreciations seen this year. Political risks in countries such as Russia, Turkey, Malaysia and Brazil also encourage investors to avoid this asset class, as do weak commodity prices and the slowdown in China. We believe some of these fears are overdone and also do not take full account of structural improvements in some EMs, leading to favorable risk-return profiles for example for IG sovereign bonds. Overall we stay cautious on the sector, which will likely suffer disproportionally high from any market return to a "risk-off" mode.

— Equities: Equities have been under pressure for two months. As they may be more liquid than bonds, portfolio readjustments often happen via equities and respective index futures which helps explain why firms which are included in the major indices on average often suffer more than those which are not. We have already adjusted both our earnings forecasts and multiples to the current environment, but we believe that the equity sell-off is overdone. On a 12-month horizon we see potentially double-digit returns for our preferred regions. Developed markets are preferred over emerging markets.

— Currencies: Currencies from commodity-exporting countries have probably seen the worst of their decline. Increasing "risk-off" sentiment in the markets could be beneficial to the funding currencies euro and Japanese yen.

Glossary

Explanation of terms

The **Bank of Japan (BOJ)** is the central bank of Japan.

Credit-risk metrics are measures used to assess the credit risk of individual assets, sectors or markets.

Default is the failure to meet the legal obligations of a loan, for example when a corporation or government fails to pay a bond which has reached maturity. A national or sovereign default is the failure or refusal of a government to repay its national debt.

A **developed market (DM)** is a country fully developed in terms of its economy and capital markets.

An **emerging market (EM)** is a country that has some characteristics of a developed market in terms of market efficiency, liquidity and other factors, but does not meet standards to be a developed market.

The Dow Jones **EURO STOXX 50 Index** is a market capitalization-weighted stock index of 50 large, blue-chip companies operating within Eurozone nations.

The **European Central Bank (ECB)** is the central bank for the Eurozone's single currency, the euro.

Fundamentals are the qualitative and quantitative information about a company, economy, security or currency.

A **hard currency**, usually from a highly industrialized country, is widely accepted around the world as a form of payment for goods and services, e.g. U.S. dollar, the euro and the British pound.

High-yield is often used as a shorthand for high-yield bonds.

High-yield (HY) bonds are high-paying bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds.

An **investment grade (IG)** rating by a rating agency such as Standard & Poor's indicates that a bond has a relatively low risk of default.

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

Mergers and acquisitions (M&A) are two key methods of corporate consolidation: A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed.

A **multiple** is a ratio that is used to measure aspects of a company’s well-being by setting various of the company’s metrics against each other and thereby building indicative ratios.

Quantitative easing (QE) is an unconventional monetary policy in which a central bank purchases securities in order to lower interest rates and increase the money supply to promote increased lending and liquidity.

Reallocation refers to the movement of an investor’s funds between or within asset classes.

Glossary

Explanation of terms

Risk aversion considers the degree to which investors are willing to take on risk to meet investment objectives.

The **risk premium** is the expected return on an investment minus the return that would be earned on a risk-free investment.

Risk-on/risk-off investing describes a process where investors move to riskier potentially higher-yielding investments and then back again to investments which are perceived to have lower risk.

Risk-return profile attempt to evaluate the historical and likely future returns on assets or markets, and the degree of risk associated with them.

The **S&P 500 Index** includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Sell-off refers to the rapid disposal of assets by investors.

A **share buyback** or repurchase is a program by which a company buys back its own shares from the marketplace, reducing the number of outstanding shares.

Specific risk is risk that affects only a small number of assets, not the overall market.

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

Systemic risk is risk that could threaten a whole market or financial system.

The **U.S. Federal Reserve Board (Fed)** is the board of governors of the Federal Reserve; it implements U.S. monetary policy.

Valuation attempts to quantify the attractiveness of an asset, for example through looking a firm's stock price in relation to its earnings.

Volatility is the degree of variation of a trading-price series over time.

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