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MACRO MORNING BRIEFING

December 4, 2024

Unwelcome Convergence

Chinese and German 10-year government bonds yield 2%

- Monetary policy and growth concerns both contributing to weakness
- Long-term (dis)inflation expectations also converging
- Curves still positive but may also align without stimulus

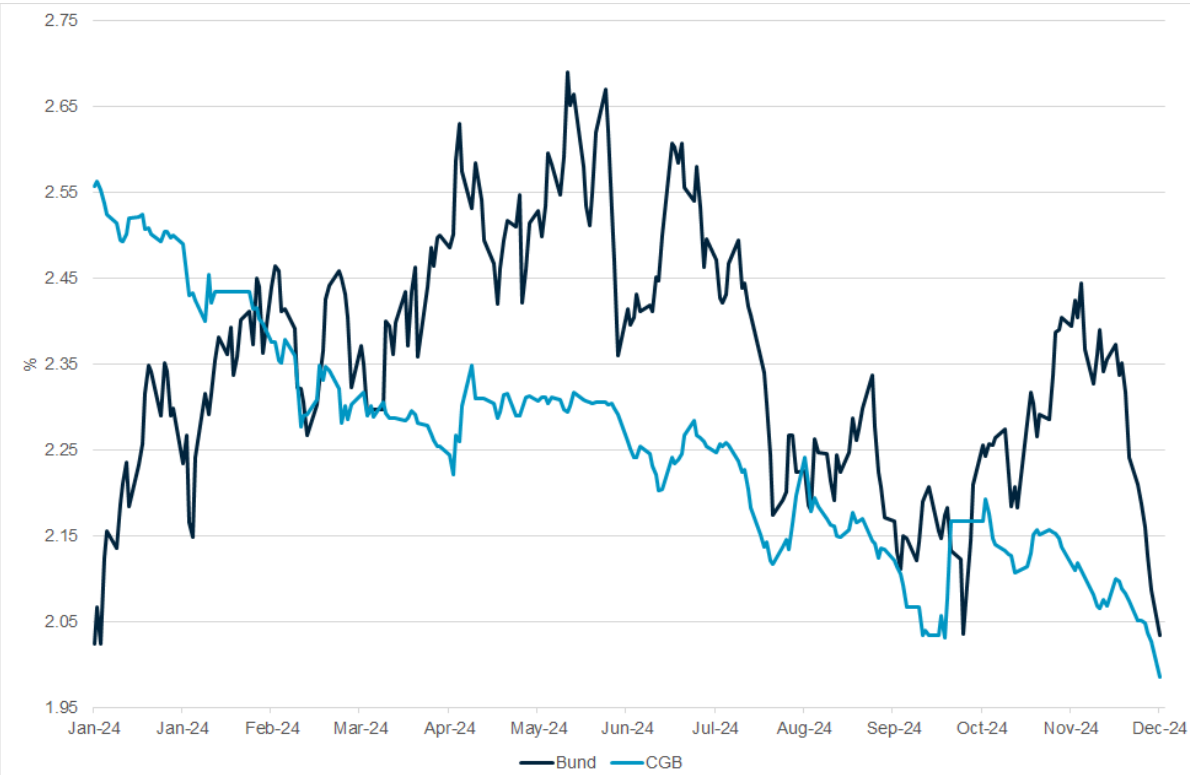
Low nominal and real yields make strong stimulus cost-effective

Sino-US trade relations remain at the forefront of market risks, but it would be remiss of asset allocators to dismiss the importance of current Sino-EU trade talks as well. On December 2, the German and Chinese foreign ministers met in Beijing, but there was very little common ground between the two. However, some asset trends suggest that the two economies, as well as economies based on exports to China and Europe, may have far more in common than both sides would currently like to admit. Perhaps this is because the signals do not point to a favourable narrative for growth. Consequently, there is even more reason for the two economies to work toward some form of accommodation, and even exchange views on how to channel the large level of savings accumulated over decades of surpluses – which the incoming US administration will try to reverse – into domestic economies in search of an entirely new growth model.

When readouts from the Sino-German foreign ministers' meeting were hitting the wires, the yield on the 10-year Chinese government bond fell below the 2% for the first time ever. There were several explanations for the move and monetary policy execution and expectations would have played a role. However, the conventional view on long-dated bond yields and the signalling effect for long-term growth expectations should also be considered. The People's Bank of China (PBoC) has attempted at various points this year to provide some guidance to the contrary, but sometimes allowing the market to do its job so policymakers can calibrate an appropriate reaction is equally important.

At the same time, the European Union's political issues have yet again pushed investors into the safety of German bunds, which also look set to move decisively through 2% this year, where we will likely see yield convergence between German and Chinese 10-year yields (Exhibit #1). A shift away from OATs and the prospect of more forceful ECB easing is even offsetting the anticipated increase in supply as Germany adjusts its debt brake.

Exhibit #1: 10y Government Bond Yields

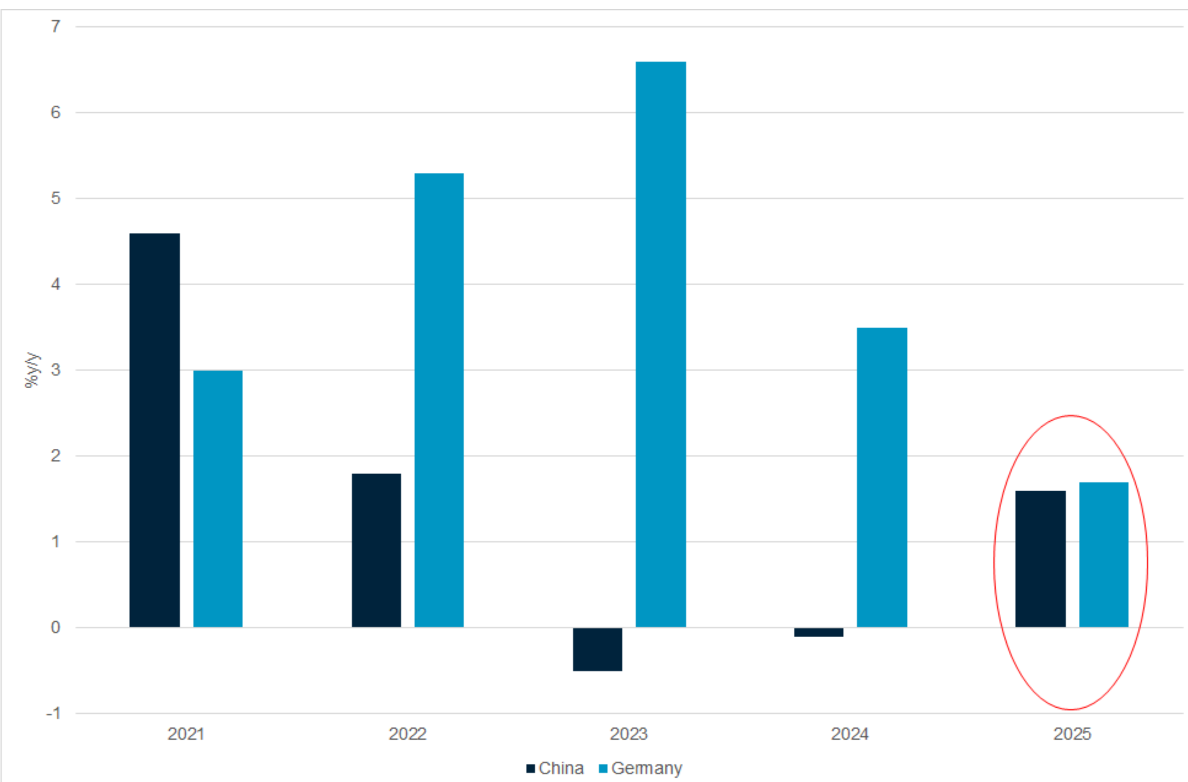


Source: Bloomberg, BNY

For now, central bank decisions in both the Eurozone and China are managing the front end and there is some distance to go before large-scale asset purchases (LSAP) are even considered, though we believe that China should be further along that path given the growth and disinflation risk. However, in the past low Eurozone yields at the very long end have been indicative of expectations for weak potential growth. This often leads to abnormal demand for government bonds due to expectations of prolonged weakness in cash rates, and, since the advent of quantitative easing, expectations of a large marginal buyer coming through have also played a role. For example, during the more extreme phases of the pandemic, the yield on the Austrian 100-year bond was effectively zero.

It remains to be seen whether convergence in ECB and PBoC policy is possible, but the direction of travel is clear in the front end and LSAPs are a part of both central banks' toolkits. However, if both central banks' monetary policies are now in reaction to the inflation outlook across their forecast horizon and beyond, then convergence is also taking place. Based on the OECD's latest forecasts and using the GDP deflator as a proxy for their respective long-term inflation outlooks, we can see that both the German and Chinese economy will head to 2% price growth in 2025 (Exhibit #2). The Eurozone deflator is unlikely to deviate much from the figure for Germany. Although the paths to "price stability" are different and involve material differences in the contribution of growth, the bottom line is that inflation persistence synonymous with tight supply relative to demand is not expected to become prolonged. In the Eurozone, wages will adjust lower in services while manufacturing struggles, while China will likely see some improvement in domestic demand. Crucially, both countries are struggling with poor demographics and ongoing revisions lower to potential growth. As we have highlighted previously, savings-heavy economies will have to push more aggressively on productivity to turn expectations around. It is quite telling that even with Germany set to ease off the debt brake and more stimulus due out of China – both of which will involve additional debt issuance – market demand is more than strong enough to absorb impending supply.

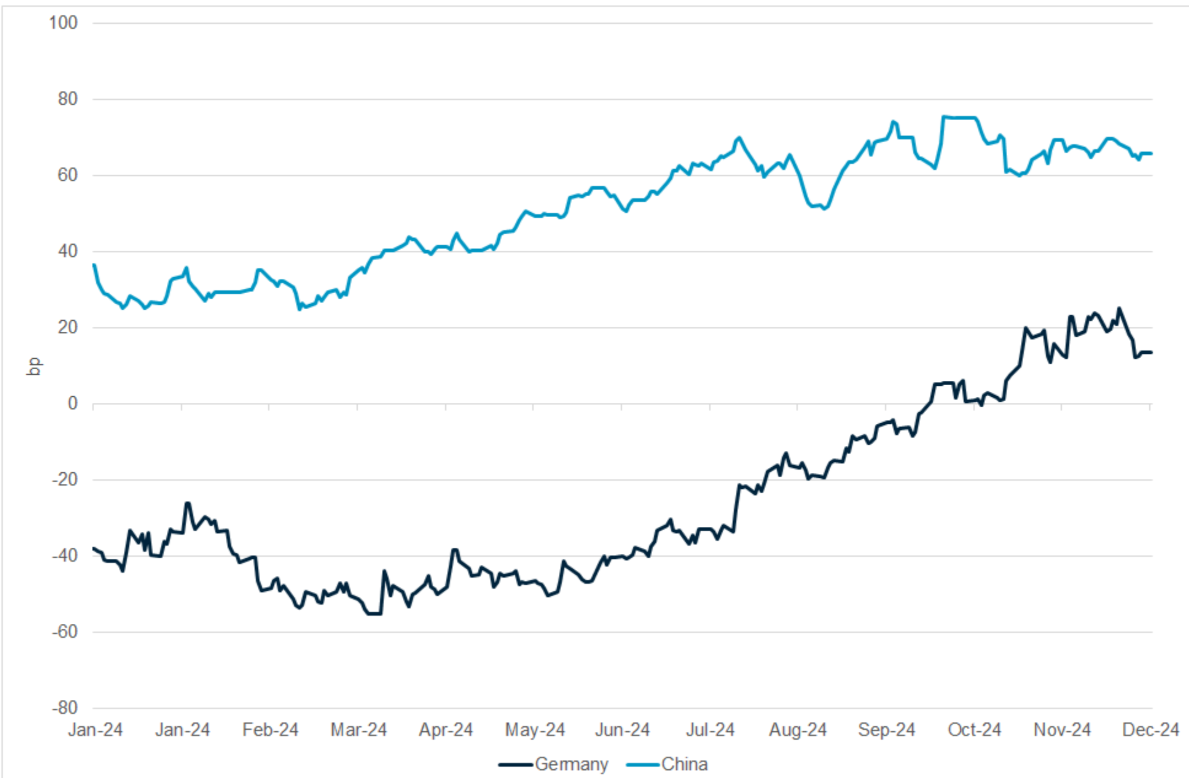
Exhibit #2: GDP Deflator Estimates



Source: OECD, BNY

There is also the matter of how the curve will behave as any inversion could also be seen as recession risk coming through. For now, both CGB and bund curves (measured by the spread between the 2-year and the 10-year yield; see Exhibit #3) are positive, but the latter has been struggling to maintain positivity. There are idiosyncratic reasons behind excessive demand for bunds which sometimes are not directly attributable to German fundamentals, but even if the market is concerned about sovereign risk elsewhere in the Eurozone, the growth drag will undoubtedly have an impact on the German economy. The lack of front-end movement due to stubborn post-pandemic inflation has adversely affected the shape of the curve. Given the potential for more assertive ECB easing, we believe that CGB and bund curves also stand a strong chance of converging, but it would be yet another indication of cyclical weakness.

Exhibit #3: 2y-10y Curves



Source: Bloomberg, BNY

Until very recently, iFlow trends in both bunds and CGBs (cross-border basis) have also been converging, but not in a favourable manner in an asset allocation context. The two securities matched each other one-for-one between August and October as growth expectations in both economies declined aggressively. For international investors, there was very limited interest in adding to such exposures with US yields staying robust and the dollar remaining on the ascent. There was a particularly large outflow from CGBs in the aftermath of the US election. The recent rebound in bunds may have originated in anticipation of greater supply and higher yields as fresh elections were called in Germany, but the demand through month-end was more likely to be related to the situation in France. Even so, for savings- and export-based economies, domestic financing is more than ample. On a demand and cost basis, there is no better time to increase supply in long-dated bonds to fund increased investment in productivity. For Germany, the Eurozone and China, taking full advantage of the current predicament in the bund and CGB markets is the best way to get out of it.

Exhibit #4: Cumulative Flows, Year-to-date

Source: BNY, iFlow

Please direct questions or comments to: iflow@bny.com

Disclaimer & Disclosures

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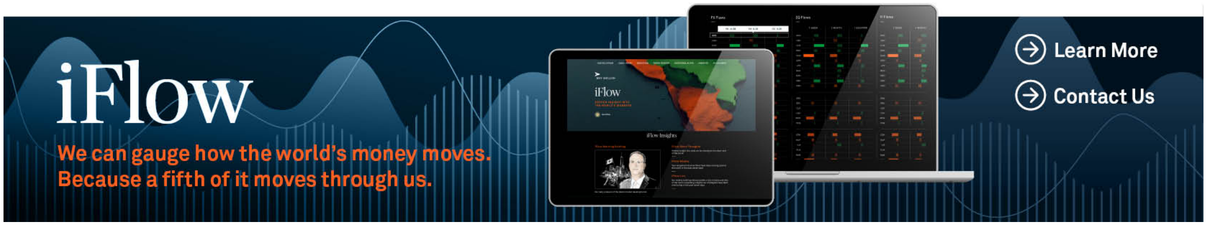

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