HSBC Asset Management

Goldilocks interrupted?

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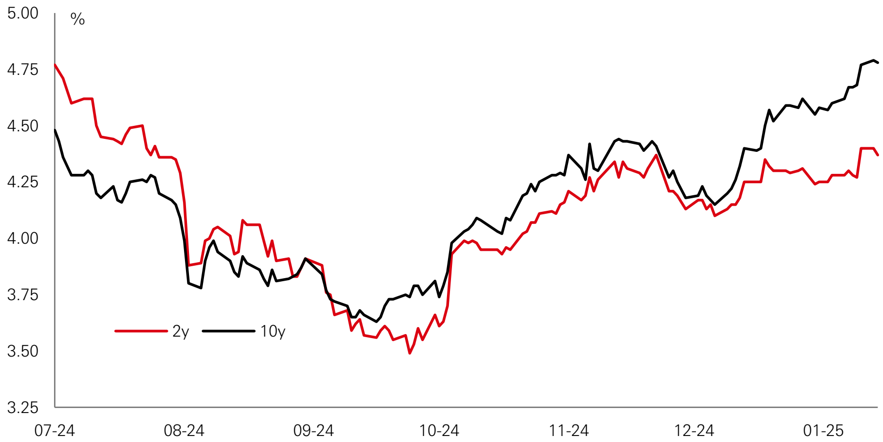
An upward grind in bond yields

Developed market government bond markets have lost significant ground in recent months. On 13 January, the benchmark US 10-year treasury yield surpassed 4.8% for the first time since October 2023, while the 10-year UK gilt yield has flirted with 4.9%, its highest since 2008.

The rise in US yields has come in two phases:

1. From September to December 2024 both two-year and 10-year yields moved higher (figure 1), reflecting upward surprising to growth and inflation data, which led markets to reduce expectations Federal Reserve rate cuts (Figure 2).

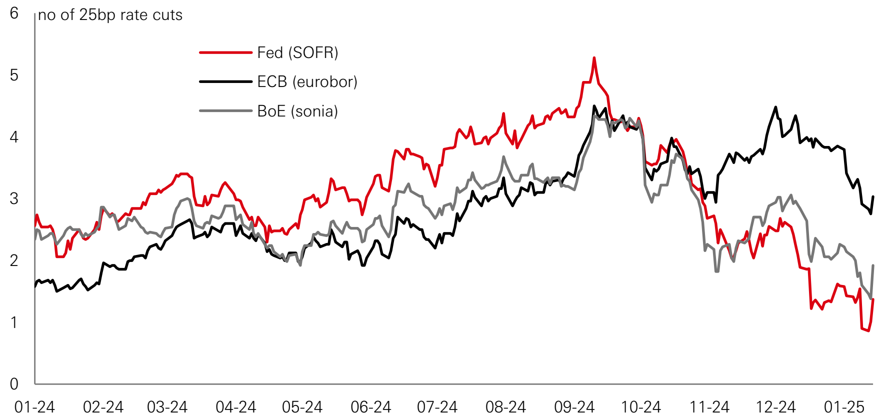
Figure 1: US two- and 10-year Treasury yields



Source: Bloomberg, HSBC AM as of 15 January 2025. Past performance does not predict future returns.

2. Since mid-December, two-year yields have traded in a narrow range (albeit hitting the top if that range following the unexpectedly strong December payrolls print) but the 10-year yield has continued to rise, indicating that factors other than monetary policy expectations are now in the driving seat.

Figure 2: Market pricing of 2025 rate cuts



Source: Bloomberg, HSBC AM as of 15 January 2025

Thus far, the price action can be characterised as orderly, but the sell-off has led to concern that yields could climb further and potentially result in a (much) worse market environment relative to market participant's prior expectations.

For the UK, much of the move has been driven by higher US Treasury yields. However, more recently, the sell-off in gilts has started to reflect more idiosyncratic or specific UK developments.

The selloff in government bonds since September comes amid robust economic data and elevated economic uncertainty

A move of the 10-year US Treasury yield above 5% cannot be ruled out on a temporary basis, although we see a predominantly a range-bound market as more likely in Q1

Investment markets performed strongly in 2024 and risk premia in asset classes like stocks and credits have fallen. This implies potential for greater sensitivity to higher risk-free rates

However, our base case of no recession, further rate cuts, and profits resilience means periods of risk aversion and market volatility can offer attractive entry points

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What has driven yields higher?

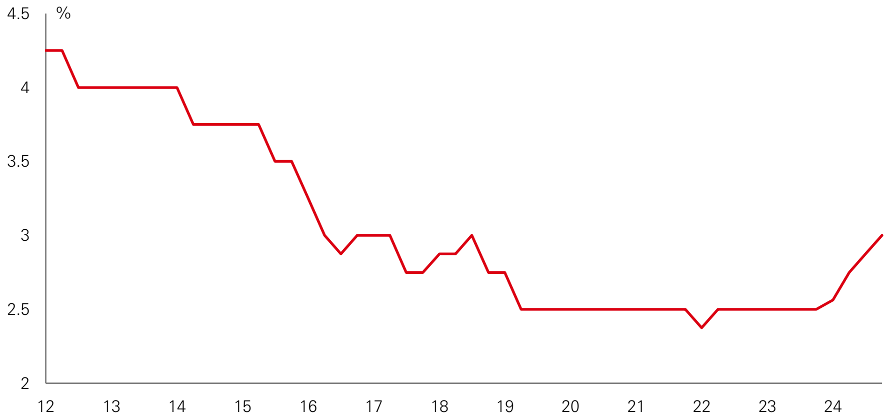
As noted, the move higher in yields from September to December 2024 was consistent with fundamental developments in growth, inflation, and monetary policy expectations. **The economy is entering 2025 on a solid footing** – reflected in December blowout nonfarm payrolls print – with few analysts expecting a meaningful near-term growth slowdown. Inflation has been sticky but is gradually moderating. And the Federal Reserve still expects to cut rates this year, but by only 50bp in its December forecasts versus 100bp in its September projections. Overall, this could be characterised as a "goldilocks" economy.

However, the outlook is highly unpredictable given the imminent change of administration on 20 January. Uncertainty regarding Trump's policies on immigration, tariffs, fiscal measures and deregulation remains elevated. In our view, since December, this uncertainty is one factor that has pushed 10-year treasury yields higher.

However, two further factors are potentially more important:

1. **Market participants revising up their estimates of the neutral interest rate** for the US economy (the rate at which monetary policy is neither contractionary nor expansionary) reflecting the ongoing resilience of the economy to higher interest rates. The Fed's median projection of the long-run fed funds rate—essentially, an estimate of the neutral rate—has risen over the past year (figure 3).

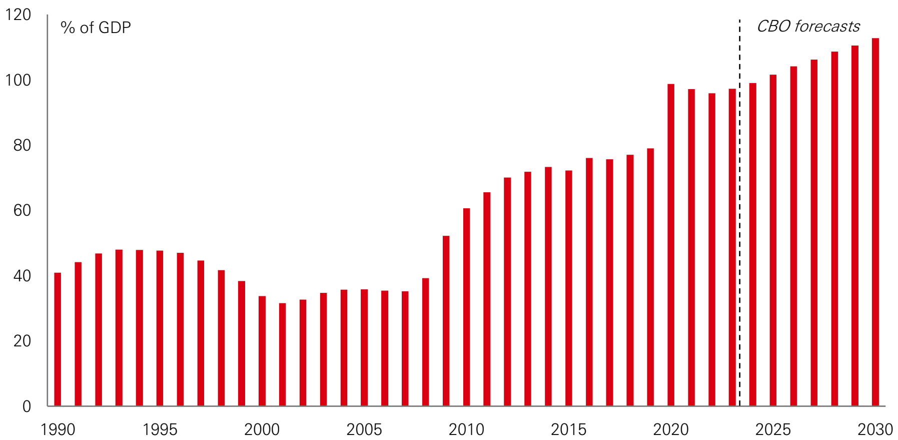
Figure 3: FOMC DOTS Median of the Longer Run Projections



Source: Bloomberg as of 15 January 2025

2. **The current unsustainable path of the US public finances** (figure 4). The Congressional Budget Office's forecasts, which do not include the impact of looser fiscal policies proposed by Donald Trump, show debt on a rising trajectory for the rest of the decade. In a world of "deficits forever", investors look to be demanding greater compensation for holding US debt.

Figure 4: US Federal debt held by the public



Source: Congressional Budget Office, HSBC AM as of 15 January 2025

The path forward

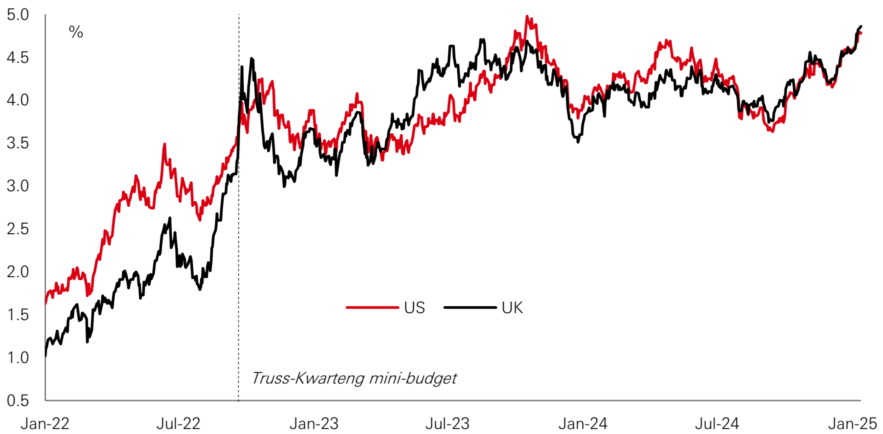
In the near-term, with the US economy on a robust footing, and policy uncertainty unlikely to dissipate, we think it is difficult to find a positive narrative for the US rates market. Although lower-than-expected UK and US CPI inflation prints for December has contributed to a slight pullback in yields, **a move of the 10-year US Treasury yield above 5% cannot be ruled out on a temporary basis**, although we see a predominantly a range-bound market as more likely in Q1. Further ahead, as uncertainty regarding Trumps policies is reduced, **our central scenario of moderating growth and inflation stabilising around 2% implies some decline in yields. Even in a scenario of sticky inflation, restrictive rates may end up undermining growth, meaning yields could eventually fall more significantly.**

UK caught in the cross hairs

UK gilt yields followed US rates in late 2024, which is quite normal given the strong correlation between both markets. But in recent days, the UK sell-off has been more pronounced than that of the US. This reflects yields reaching a level where market participants are now questioning the fiscal plans of the new UK government. **This creates a negative feedback loop**, whereby higher yields worsen the perception of fiscal sustainability, which in turn pushes yields higher.

Importantly, however, the speed of **the move is not on a par with the "Liz Truss event" seen in the autumn of 2022**, although yields have surpassed the levels seen then (figure 5).

Figure 5: UK and US 10-year yields



Source: Bloomberg, HSBC AM as of 15 January 2025. The level of yield is not guaranteed and may rise or fall in the future.

If the government remains committed to its fiscal rules (and it seems it is), this should be more of a temporary episode of increased market weakness, rather than a sustained move higher in UK gilts or a market crisis brewing. That said, general strong momentum in UK rates can nonetheless make this a painful experience and there are no easy fixes for the UK government.

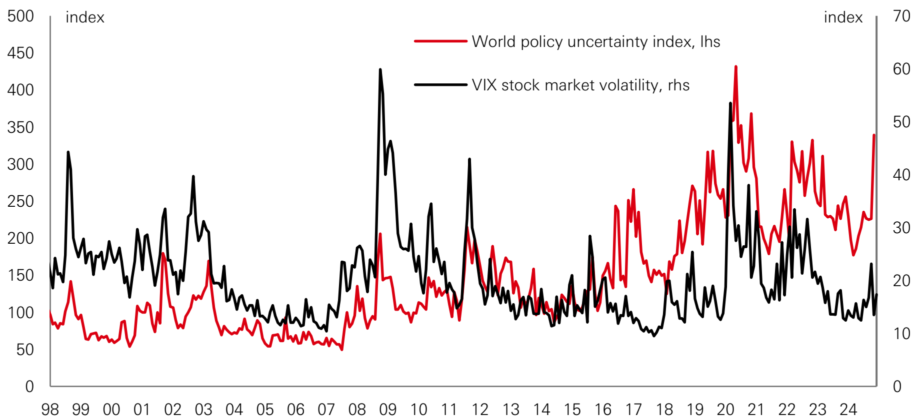
Pressure will build for either further tax hikes or reversing spending commitments. Having already hiked taxes by GBP40bn, additional increases could undermine business and investor confidence while spending cuts would be politically unpopular. Either course of action would weigh on growth.

Broader market implications

2024 was unusual because although short term interest rates markets were volatile, the credit and stock markets were calm. But the recent rise in long bond yields – if not offset by better news on growth – is likely to matter for all asset classes in 2025.

Investment markets performed strongly in 2024 and risk premia in asset classes like stocks and credits have fallen. This implies greater sensitivity to higher risk-free rates - **10-year yields pushing above 5% could be a tipping point in investors' minds**. The most expensive parts of the market such as US tech – which look priced for perfection – could be the most vulnerable. **Amid elevated policy uncertainty, we think equity market volatility has room to increase in 2025** (figure 6).

Figure 6: VIX and world policy uncertainty indices

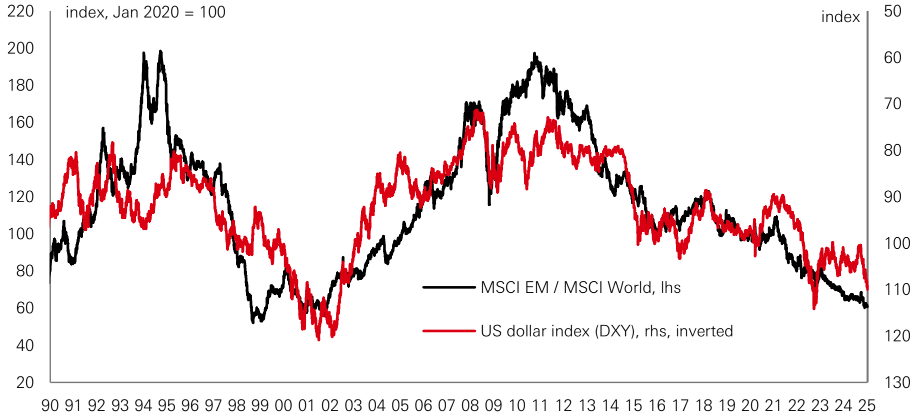


Source: Bloomberg, HSBC AM as of 15 January 2025.

In a higher rate environment, **small cap and real estate stocks may remain under investor scrutiny**. But these parts of the market can still perform well amid robust growth. Financials and industrials make up a big chunk of small cap indices and are likely to benefit from deregulation, increased M&A activity and a protectionist trade agenda. Meanwhile, although **bond proxy sectors** such as healthcare, staples, utilities, would also feel the hit from higher rates, they are somewhat insulated by their defensive attributes and significantly favourable relative valuations.

Higher US yields are also likely to put upward pressure on the US dollar, which would have spillover effects on global financial conditions and, based on traditional correlations, may cause some **pain in the EM asset universe** (figure 7). But the broader backdrop for EM remains positive as China delivers policy stimulus and economic growth outperforms developed markets. With many markets remaining under-loved and under-owned by international investors, PE ratios are low and real yields high.

Figure 7: US dollar index and EM equity performance relative to DM equities



Source: Bloomberg, HSBC AM as of 15January 2025. Past performance does not predict future returns. Index returns assume reinvestment of all distributions and do not reflect fees or expenses. You cannot invest directly in an index.

Riskier credits may sell off as higher interest rates start to weigh on the ability of firms to cover their interest expenses, with highly indebted firms being particularly affected. With credit spreads at or approaching all-time tights in many parts of the global credit universe, **there is a material risk of spread widening**. The good news, however, is that **high "all-in yields" and solid fundamentals remain an attractive proposition for investors across the credit universe, including private credits**. And in a higher-for-longer scenario, shorter duration credits, like ABS look particularly interesting given their floating rate nature.

The case for an active and opportunistic approach to investing in 2025 looks strong. Although higher rates weigh on growth prospects and raise financial stability risks, **our base case remains one of no recession, further rate cuts, and profits resilience. This means periods of risk aversion and market volatility can offer attractive entry points for stocks and riskier credits**. And higher yields amid risks of economic weakening and potential for further disinflation support the case for adding duration exposure.

Recent market action highlights that the 2010s era of monetary policy on steroids, ultra-low interest rates and depressed bond yields is over. The medium-term economic regime is one of more volatile inflation and a new fiscal/monetary policy mix. In this environment, **the prospect of higher stock/bond correlations could require a greater use of alternative diversifiers**, including options, hedge funds or commodities. Securitised credits also exhibit low correlations to regular fixed income, making it a potential diversifier for multi-asset portfolios.

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