

This document is intended for professional investors
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2024 outlook

Duration and the climate transition: risk or opportunity for sovereign bonds?



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With major central banks crossing the finish line on aggressive tightening cycles, Ostrum Asset Management (Ostrum AM) expects 2024 to be rich in investment opportunities but signals there are still multiple risks to be managed. Amongst the usual suspects are credit, duration and volatility, but there are also others to consider such as the configuration of yield curves and the growing risks related to the climate transition.

How are sovereign bonds likely to shape up in this context?

For many investors, sovereign bonds tend to be a significant weight in portfolios, representing defensive positioning, and providing a buffer against other risks that may be associated with asset classes like credit or equities. That said, sovereigns still have their own risks and one that stands out is duration. Duration is a critical element as it is an amplifier in terms of both risk and performance. Investors are well aware of this risk. When central banks raise rates, investors shy away from longer maturity bonds to avoid duration risk. Considering that 2022 was marked by impressive ECB rate increases, it is a good year for illustrating how duration can affect performance on eurozone sovereign bonds with 1–3-year maturities finishing the year down around -2.50% and 3–5-year maturities down around -7%. Longer dated bonds were down even more significantly, posting losses of more than -15% for 7–10-year maturities.

In 2023, the aggressive move on rates continued but also was finalized. For the sovereign bond asset class this is good news as performance has turned back to positive with longer duration bonds outperforming year-to-date. However, the cross over the finish line on rates has left its mark on the yield curve which is now inverted. This inversion has been driven by the front end of the curve and is a result of the speed and amplitude of the rate hikes.

Participants are now focused on anticipating market drivers and forward-looking scenarios: **What is the impact of higher rates?** considering there are delays between rates hikes and their impact on the economy, there is still a risk of recession. **Public**

deficits? government financing will be more costly with refinancing rates across maturities now at higher levels. **Where do we stand on the ECB's PEPP exit?** The end of reinvestments, initially forecasted for the end of 2024, should finally take place in July. **Yield curves?** The mood is for normalization, thus bull or bear steepening to reintroduce the risk premium. **Duration?** Adding duration is directional. In 2023, investors added duration as we neared 3% on German 10 years. And finally, **where do we stand on climate change?** We are still behind the curve. Significant investments are needed to meet the 2030-2050 deadlines.

Ostrum AM is monitoring all of these elements as sources of risk and opportunity in the coming year. In addition, while the market sees inflation contained, Ostrum AM still sees tail risks, coming in part from a more heterogenous environment where countries and regions now prioritize energy independence and also in part from the ongoing uncertainties regarding the cost of the energy transition. This tail risks, for Ostrum AM, imply that ECB rates will stay higher for longer than anticipated and when official rates do move lower, we can no longer anticipate negative rate scenarios like we had in the past. Instead, we may be entering a new era with short term rates floored at higher levels. A 3% level, for example, may represent the new normal going forward.

Growing risks related to the energy transition?

In November 2022, Fabio Panetta (1), Member of the Executive Board of the ECB stated that the price effects associated with the energy transition will be largely determined by technological developments and policies implemented by governments globally. In a May 2023 ECB report (2) on climate change and sovereign risk, it was

raised that a late-push transition will imply higher credit risk. According to the report, transition risk factors, such as carbon emissions and energy consumption are not yet reflected in country ratings. The report calls for financial stability, saying it is important for rating agencies to incorporate all relevant climate-related variables into credit assessments to reduce the risk of abrupt repricing and allow investors to reflect sovereign climate-related risk adequately.

Ostrum AM's risk assessments on sovereigns include ESG materiality. Research teams apply proprietary methodology to rate both conventional and GSSS bonds (ie green bonds). The objective is to identify sovereign countries who are leading in terms of all ESG pillars. Ostrum AM proposes SFDR Article 8 sovereign portfolios with ambitious targets related to the climate with an objective to reduce the carbon intensity of portfolios. Country selection takes into consideration climate risk factors.

The duration risk/opportunity set is an integral part of Ostrum AM's sovereign bond investment process with position taking varying from strategic to tactical day to day management of investment portfolios. Considering that interest rate and yield curve movements fluctuate over time, Ostrum AM's sovereign investment team will adapt

portfolios to the changing environment. To reduce the sensitivity of the portfolio, the team can shift into shorter maturities or use hedging instruments. As yields rise, the investment team may decide to overweight longer maturity bonds. Investment decisions will also depend on investment team's view of the yield curve. Invest decisions systematically take into consideration each country's carbon intensity and how each implemented change will impact the overall carbon intensity score of the portfolio relative to its reference index.

(1)
<https://www.ecb.europa.eu/press/key/date/2022/html/ecb.sp221116~c1d5160785.en.html>

(2)
https://www.ecb.europa.eu/pub/financial-stability/fsr/special/html/ecb.fsrart202305_03~f51dd11fd7.en.html



Sovereign bonds markets: which opportunities for 2024 in a context where US & European governments debts have more than doubled in a decade?

Dieudonné Djimi, Global Interest Rates & Currency Portfolio Manager at Ostrum Asset Management, discusses Outlook for sovereign bond markets in 2024.

➔ <https://www.ostrum.com/fr/news-insights/insights/marches-des-obligations-souveraines-quelles-opportunites-pour-2024-dans-un>

Additional notes

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