

# Bond Market Outlook

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**Katharine Neiss, PhD, Deputy Head of Global Economics  
and Chief European Economist**

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## Calm Before the Storm or Persistent Resilience...

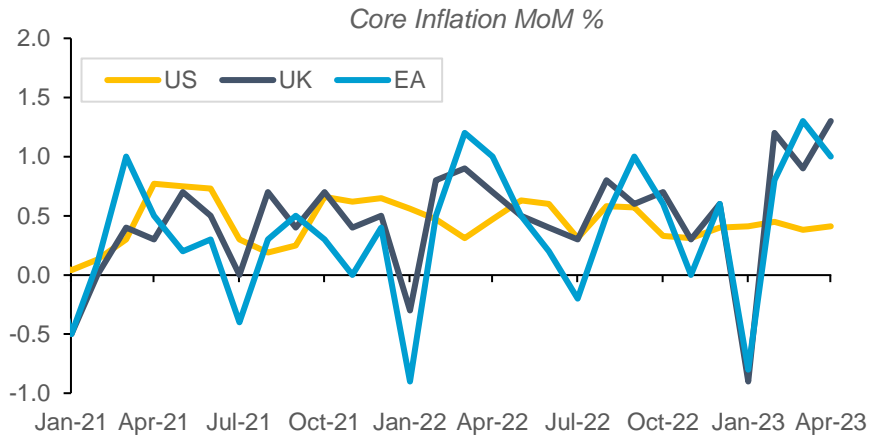
- Near-term policy uncertainty remains high given the conflicting signals from lags in the transmission mechanism and uncomfortably high core inflation...
- ...and we could see a repricing as views regarding the long-term neutral rate shift
- European bond markets are currently benefitting from technicals...
- ..but fragilities, especially around liquidity, remain
- Fundamentals in Europe have proven to be more resilient than expected, but contagion and spillover risks from the US remain
- The prospect that the issuer of the world's dominant reserve currency chooses to default may be long lasting

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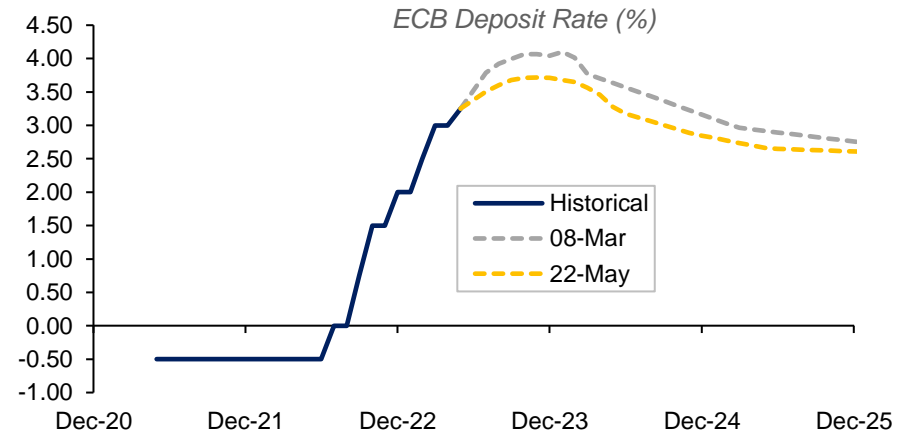


## Policy Uncertainty Remains High, Pointing To Continued Volatility

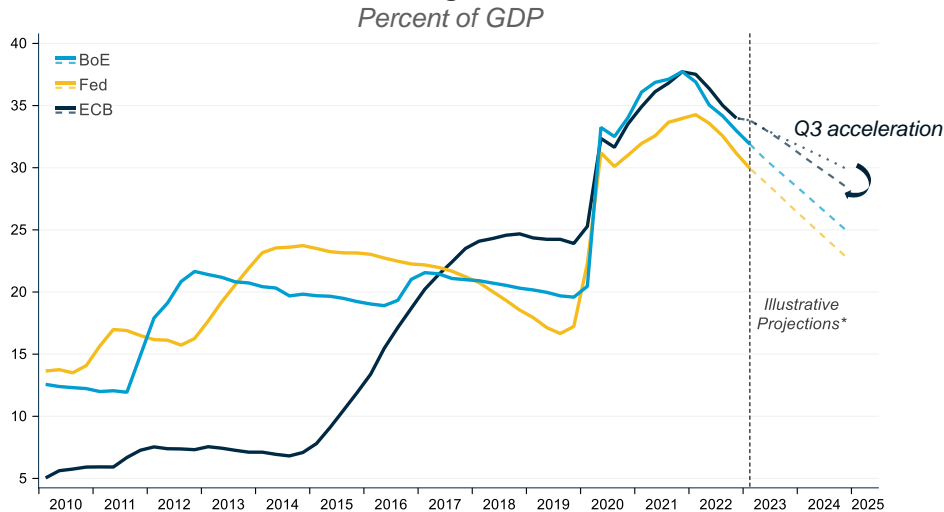
**Core inflation in Europe Has Accelerated...**



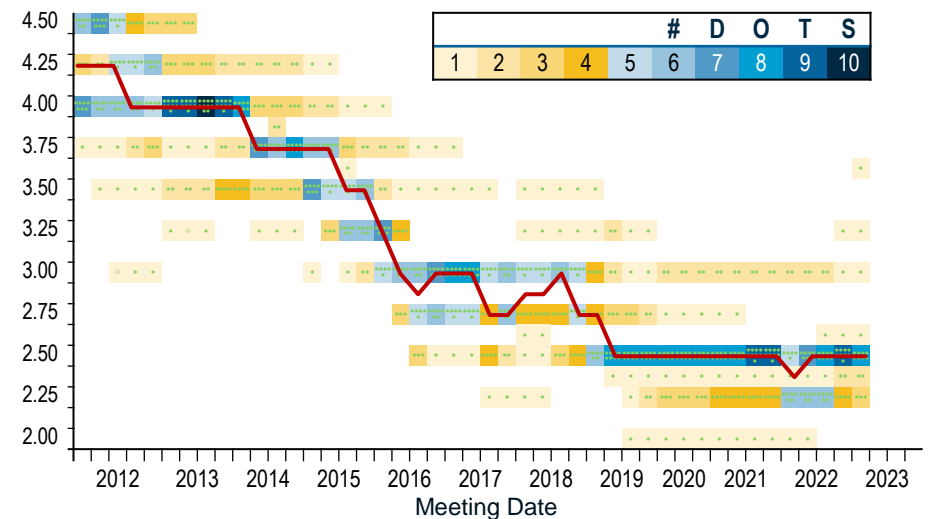
**...but Transmission Lags and FS Risks Point to a Shallower Path**



**The Impact of Accelerated QT Remains Unknown**  
**Central Bank Holdings of Debt Securities**



**...and Estimates of the Long-term Rate are Rising**  
**Federal Reserve longer Run Dot (%)**



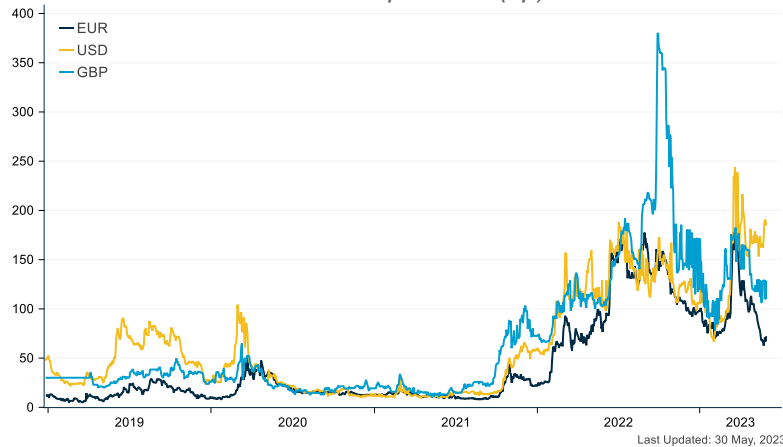
Sources: Top left Macrobond as of April 30, 2023. Top right Bloomberg as of May 22, 2023. Bottom left Macrobond as of May 18, 2023. Bottom right Bloomberg as of March 22, 2023. The forecasts presented herein are for informational purposes. There can be no assurance that these forecasts will be achieved.



## European Sovereign and Corporate Bond Markets are Currently Benefiting From Technicals, but Fragilities Around Liquidity Remain

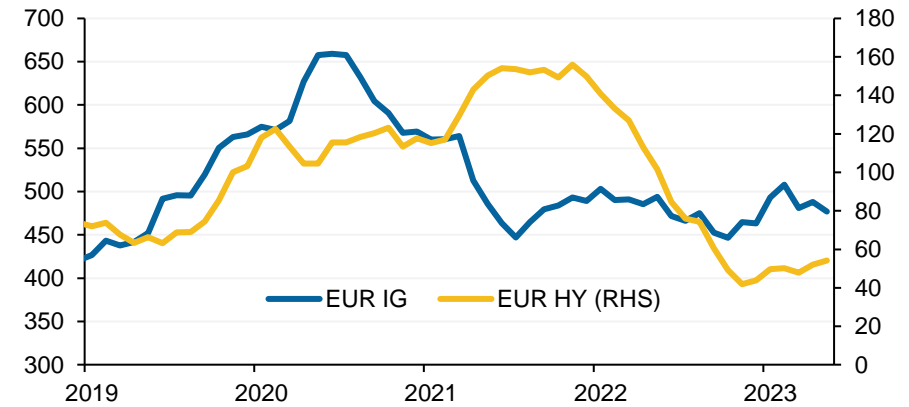
### Short-term Rates Volatility Remains Elevated

1M1Y Swaption Vol (bp)

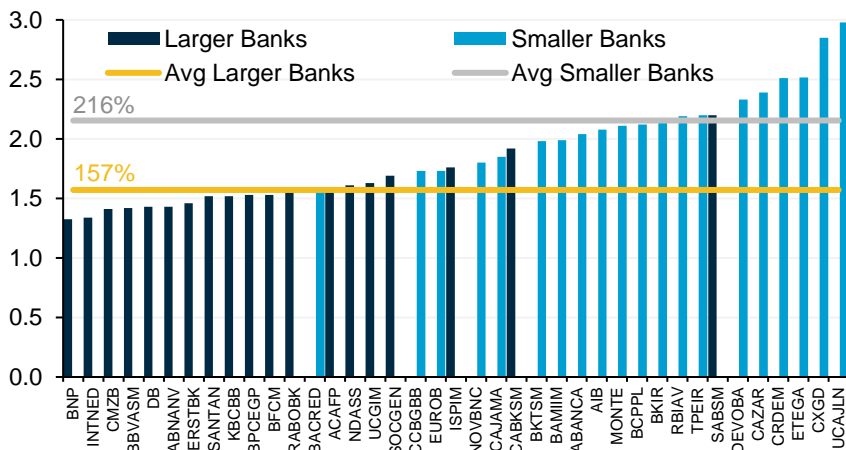


### HY Issuance has Been Compressed

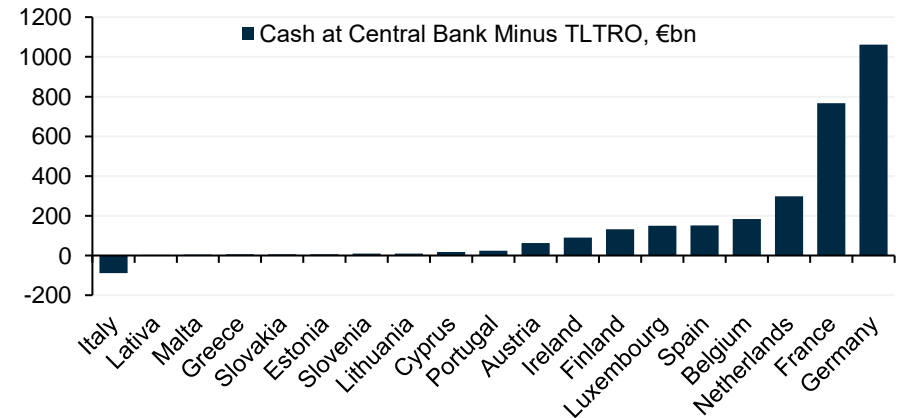
Trailing 12-Month Issuance (EUR Bn)



### LCRs are Comfortable, but Set to Decline



### (Smaller) Banks in Italy Have Less Cash at Central Bank Than TLTRO Borrowing



Sources: Top left Bloomberg as of May 30, 2023. Top right Bond Radar and Morgan Stanley Research as of May 1, 2023. Bottom left Banks, BofA Global Research as of May 17, 2023. Bottom right ECB, BofA Global Research as of March 2023.



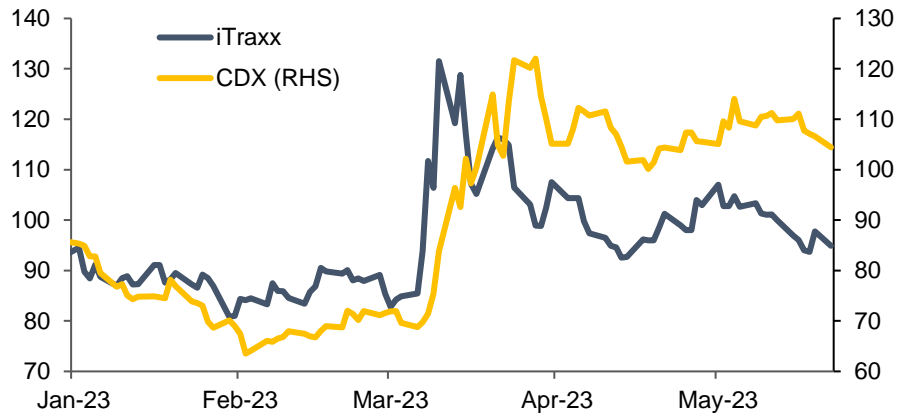


# Contagion and Spillovers

## Contagion Risk and Spillovers From the U.S. Cloud the Outlook

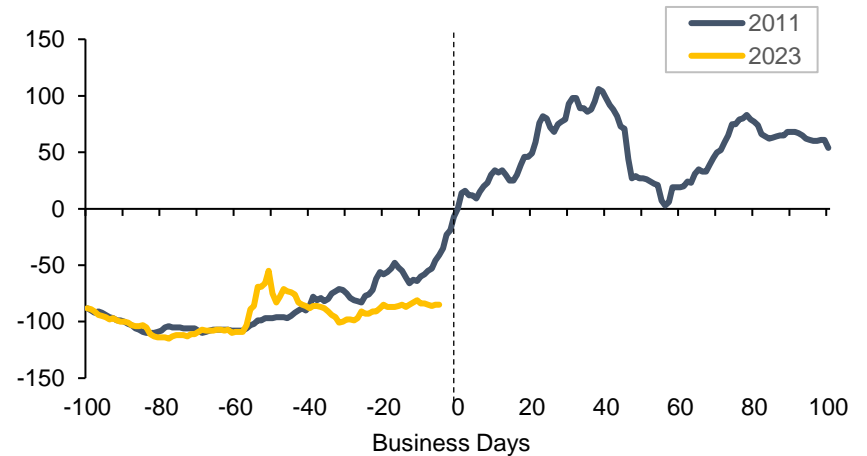
### US Banking Stress Spillovers Have Subsided...

Financials (bp)

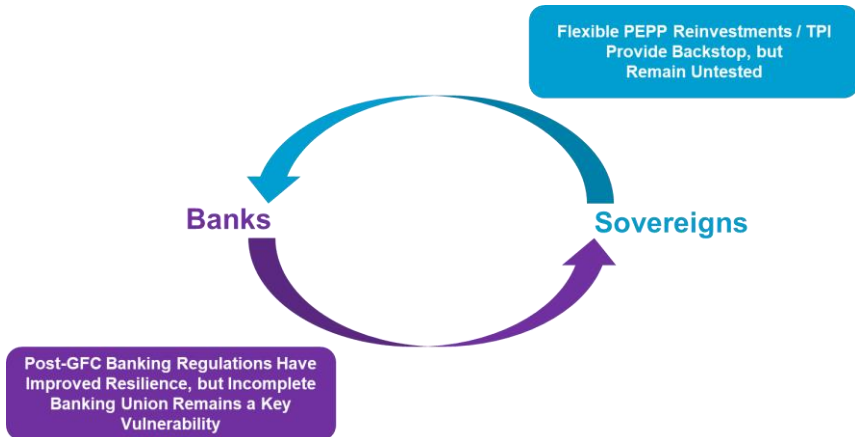


### ... but Concerns Around the Debt Ceiling Remain

Euro IG Spread (bp, 0 = Aug 10, 2011)

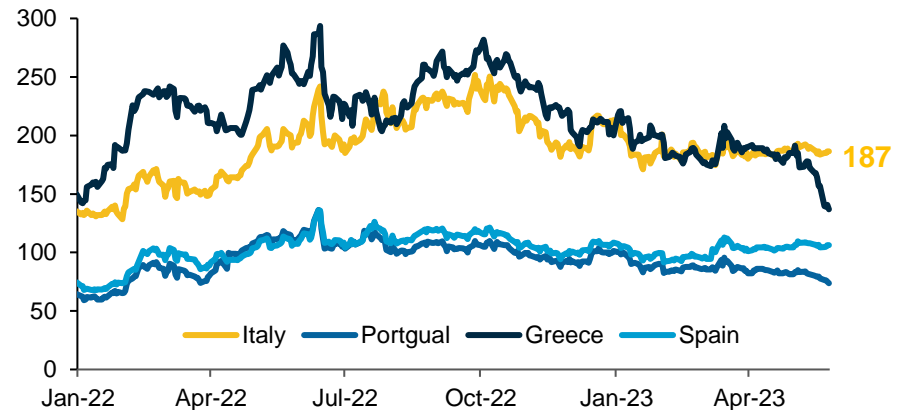


### Market Focus on Banks Could Shift to Sovereigns— With Italy a Weak Link



### Italian Fundamentals Have Improved, but Markets Remain Nervous...

Spread to 10Y Bund (bp)



Sources: Top left Bloomberg as of May 22, 2023. Top right Bloomberg as of May 30, 2023. Bottom left PGIM Fixed Income as of April 25, 2023. Bottom right Bloomberg as of May 25, 2023.





# Market Stress Will be a Positive Indicator for a Deal, but Reputational Damage may be Longer Lasting

- Scenario #1:  
Orderly resolution before X-date (5%)
- Scenario #2:  
Nail-biter, with associated market pain and US sovereign downgrades (40%)
- Scenario #3:  
Prioritisation of payments, with associated impact due to abrupt fiscal squeeze (50%)
- Scenario #4:  
Outright default (5%)

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- Will demand for European sovereign bonds hold up in the face of uncertainty and stresses?
- How might spillovers from U.S. Debt Ceiling impact the European IG and HY bond market?
- Can the European Banking Sector adjust to the end of TLTROs? Or is a new tool needed?
- How confident can we be that QT will remain broadly neutral in the face of an accelerated and lumpy redemption schedule?
- How can we judge that tightened credit conditions will return inflation to target?

# Reference





**Katharine Neiss, PhD**, is Deputy Head of Global Economics and Chief European Economist for PGIM Fixed Income, based in London. Ms. Neiss covers the macro-economic outlook in the UK and euro area, including Bank of England and ECB policy. Her own research focuses on thematic issues, such as monetary strategy and trade, with a particular emphasis on their relevance to Europe. Ms. Neiss has appeared as an expert witness on monetary policy for Parliament's Treasury Select Committee. Prior to joining the Firm in 2020, Ms. Neiss held a variety of roles at the Bank of England. Most recently, as Head of the International Surveillance Division, she was responsible for advising Committee members on the global macro-economic and financial stability outlook and was part of a small group of economists directly supporting the Monetary Policy Committee. Other roles Ms. Neiss held at the Bank of England include Head of the Policy, Strategy and Implementation Division, covering regulation of major systemic U.K. banks, and senior manager roles in the Structural Economic Analysis and Monetary Assessment and Strategy Divisions, covering the U.K. economy. Ms. Neiss has been published in the Journal of Money, Credit, and Banking, the Review of Economic Dynamics, Macroeconomic Dynamics and the Oxford Bulletin of Economics and Statistics. She received a BA Honours in Economics from Queen's University and a Masters and PhD in Economics from the University of British Columbia.

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