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Rates: Why investors may turn to EGBs amid equity jitters

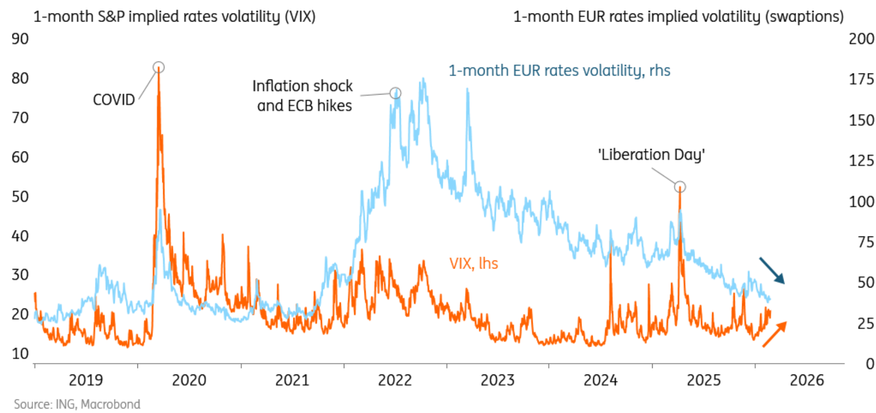
AI-related equity jitters are unlikely to be resolved overnight and eurozone government bonds (EGBs) could actually come out as a winner. Relative to euro rates, US equity volatility is reaching highs similar to previous crisis periods. A global rebalancing of portfolios could see significant demand for euro rates, mitigating the upward rate pressure

With AI jitters in US equity markets, investors may see eurozone government bonds as a safe haven

Equity volatility and rates volatility telling opposing stories

Implied volatility measures paint a clear picture of what is going on; equity volatility is on the rise whilst the outlook for bonds is still turning increasingly stable – a rare mix by historical standards. Rates and equities are usually driven by some form of macro volatility, as we've seen during the spike in volatility around Covid-19 and US President Donald Trump's 'Liberation Day' tariffs. Since the inflation shocks in 2022, the uncertainty in monetary policy has come down significantly, helping to stabilise both short and longer-dated rates.

Volatility in US equities is moving higher, but EUR rates volatility remains low

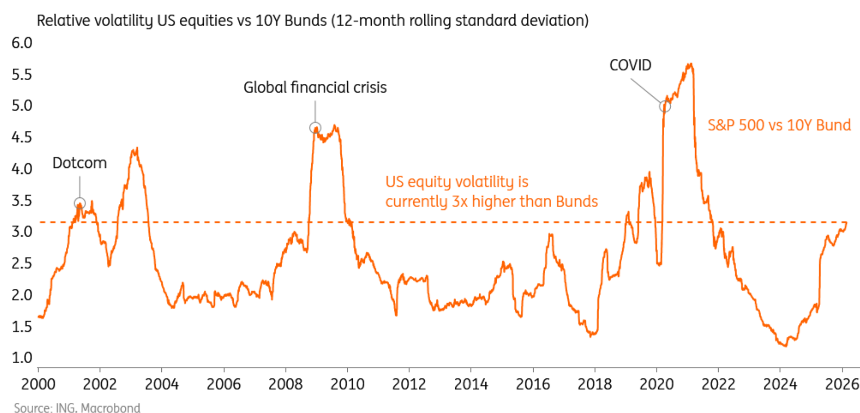


Source: ING, Macrobond

The relative volatility of US equities versus eurozone government bonds makes bonds look increasingly attractive. The standard deviation of daily returns was three times higher for US equities compared to Bunds over the past year. Higher numbers were almost exclusively found around periods of major market stress, like the dot-com bubble, the global financial crisis and Covid-19.

From a portfolio optimisation perspective, an asset with three times higher volatility would need significantly higher returns to justify investment. For a 10Y Bund with a yield of 2.7%, the total expected return over a one-year horizon when including roll is 3.5%. Not bad for a risk-free investment. Do the same for a 10Y BTP and you get an attractive 4.3% return. Per unit of volatility, that would demand US equity returns of at least 12% to break even. With valuations already stretched, such numbers look challenging.

US equities volatility is reaching new highs relative to eurozone government bonds



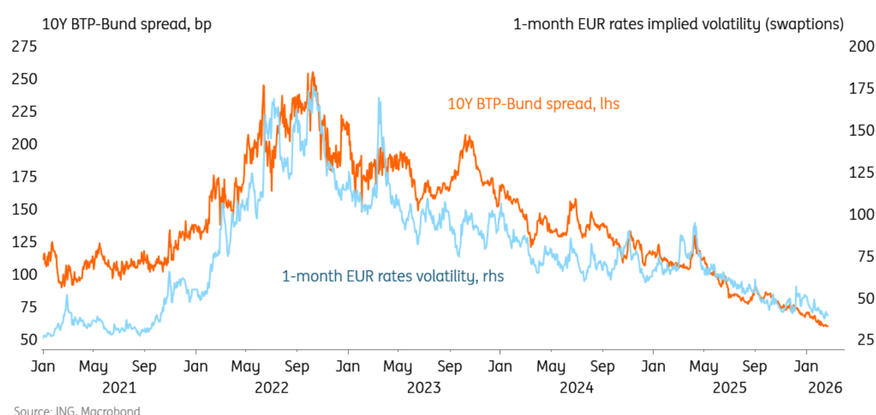
Source: ING, Macrobond

The macro risk profile of eurozone government bonds also makes for a good diversifier against AI-related market stress. In contrast to the US, the eurozone economy does not rely on the tech

sector for its growth outlook. This also means that the deficit concerns that we see in the US do not have the same linkage with AI as the fiscal situation in Europe. Already in the past few weeks, we see that the spreads of European government bonds versus Bunds don't reflect a worsening of risk sentiment. In fact, the 10Y BTP-Bund spread is still at its tightest since 2010.

Investors looking for some yield pickup but at lower risk than equities may find themselves lured to the riskier eurozone government bonds. A soft landing by the European Central Bank provides a very attractive carry environment, helping spreads stay tight. Meanwhile, a challenge to the US as a safe haven should help support global demand for European fixed income.

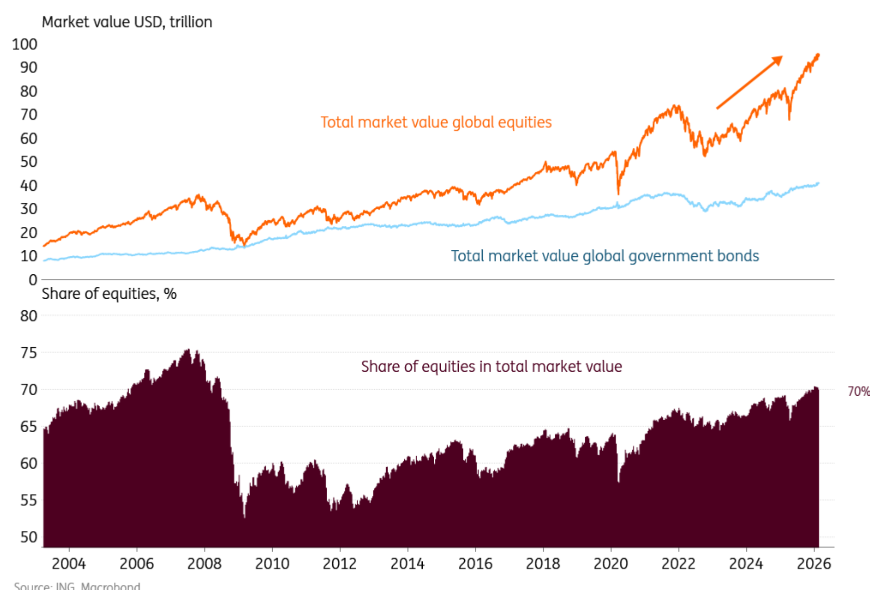
Riskier EGBs benefit from favourable carry environment



Then the last question we answer is how far can such a rotation from equities to bonds go? If we compare the total market value of global equities and government bonds, we come to the conclusion that investors are very overweight equities. With 70% in equities, the positioning is clearly stretched versus a more conservative 60-40 portfolio. A rebalancing might not have to take the shape of a sharp sell-off, but as AI-related volatility lingers, we could foresee a scenario whereby equities drift lower in favour of bonds.

An orderly rotation away from equities to bonds should help absorb the record supply of eurozone government bonds. We see a demand gap this year which means more price-sensitive investors will have to be pulled in. Our baseline is still that this happens through higher rates, but if a broader rotation away from equities starts materialising more broadly, then rates might not have to rise as much.

At a global level, investors are relatively overweight equities



Source: ING, Macrobond

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