

Strategy

Taking profit on tactical long duration and curve flattening

On 20 August we moved our tactical and strategic recommendation on duration to overweight from neutral – see *Strategy Update: Bond yields to fall further and curve to flatten*. This was based on a) very weak key figures out of the US culminating in the Philadelphia Fed survey for August and b) anticipation of further ALM hedging in the long end of Europe.

Since then German 10-year yields have declined 16bp to 2.14%. However, the recent price action suggests that flows may be slowing and that bonds could correct lower from current overbought levels. We got a early sign of this on Wednesday with the release of more very weak US data (durable goods orders and new home sales), which failed to push bond yields down further. Friday was the first day with significant losses on the back of the Jackson Hole speech by Ben Bernanke.

We therefore recommend to switch to neutral duration on a tactical horizon as we see a rising risk of a correction higher in yields.

On a strategic horizon we still recommend to be overweight duration though, due to carry considerations and because we still expect the longer-term impulses to bond yields to support low yields as growth and core inflation fall further and double-dip fears stay with us for some time. We therefore also favour trading the market from the long side on a tactical basis. We would look to re-enter long positions around 2.50-2.60% in bund yields.

On the 2-10 German government curve we also switch the tactical position from flattening to neutral. It has flattened 12bp since we recommended it on August 20 and as it is very directional it makes sense to switch to neutral here as well. We keep the strategic flattening view.

On the German 10-30 government curve we also switch to neutral from flattening – on both the tactical and the strategic horizon. The 10-30 curve has flattened due to extensive ALM flows. While it could continue in the short term the signals have become more diverging. Due to negative carry we also switch to neutral on a strategic horizon.

We will follow up on our market views in Reading the Markets – Euroland on Thursday.

See charts on the next page.

Today's key points

- We switch tactical position on duration in Euroland from overweight to neutral
- We also switch the tactical German 2-10 curve position from flattening to neutral
- On a strategic horizon we keep overweight duration and 2-10 flattening
- On German 10-30 curve we switch to neutral on both tactical and strategic horizon

Note: Tactical position has a horizon of 0-1m while strategic position has a 3-6m horizon

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Bond yields have come a long way - we go sidelined for now on a tactical basis but would re-enter long on correction higher in yield to around 2.5-2.6%



Source: Reuters Ecowin

Curve flattening has been substantial



Source: Reuters Ecowin

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