Deutsche Bank
Chief Investment Office

CIO Viewpoint
Fixed Income

July 23, 2024

Authors:
Dr. Konrad Aigner
Senior Investment Officer Europe

Ahmed Khalid
Investment Strategist Europe

Andreas Umsonst
Investment Officer Europe

Bond markets in turbulent political times

Key takeaways

- Recent economic data from the U.S. and the Eurozone have created the necessary conditions for interest rate cuts. However, interest rates are likely to remain at a high level.
- The elections in Europe, particularly in France, but also the U.S. election campaign, which is gaining momentum, have led to significant price movements on the bond markets.
- Despite recent price fluctuations, bonds offer interesting yield opportunities. Good entry opportunities could arise in the coming months.

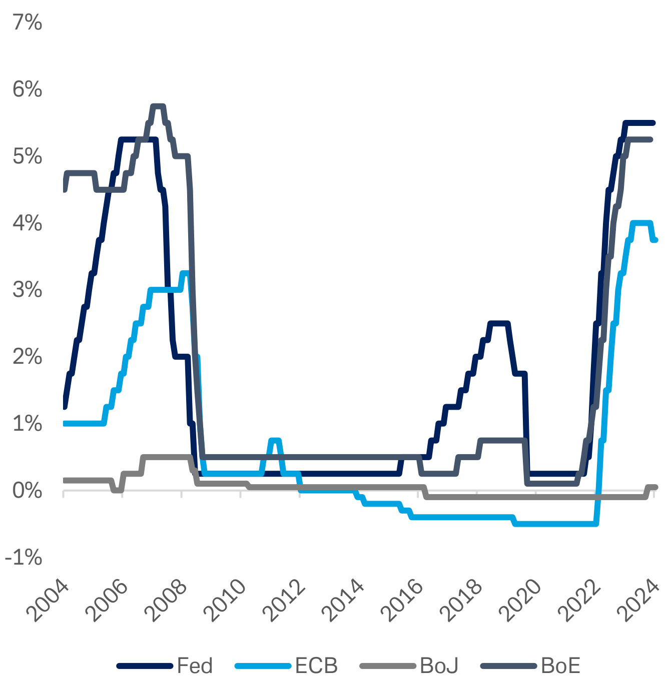
Introduction

U.S. economic data is increasingly showing signs of a slowdown in the economy. Market participants have become more confident that the Fed will make the first interest rate cut of this cycle in September. However, the bond market is likely to become more susceptible to volatility as the election campaign for the U.S. presidential election is becoming more intense and represents a significant uncertainty factor.

Politically-related nervousness also affected bond markets in Europe due to the elections in France.

Meanwhile, the prospect of falling interest rates and decreasing inflation in the eurozone is creating burgeoning optimism for the second half of the year, and it is worth taking a look at the various asset classes.

Chart 1: Key interest rates of selected central banks (in %)



Source: Deutsche Bank AG, LSEG Datastream; Date as of July 17, 2024.

Monetary policy – interest rate shift towards "higher for longer"

The fight against inflation in the U.S. and Europe remains the focus of their respective monetary authorities, the Fed and the ECB. Significant progress has been made on both sides of the Atlantic in recent quarters. Inflation rates have fallen significantly from their highs. The hiking of key interest rates within a very short space of time had the desired monetary policy effect in this context. However, the inflation rates are still above the two central banks' target of around 2%.

Following robust U.S. quarterly growth of 1.3% (annualised) in Q1 in the wake of the interest rate hike, it was only in recent months that signs emerged of the economic slowdown hoped for by the Fed, particularly in the previously strong private consumption and in corporate investment. This slowdown now also appears to be reflected in the price data and the labour market. Price developments and the labour market situation are the Fed's two key targets, which it uses to guide U.S. monetary policy. The labour market remained robust, with around 206,000 jobs added in June, but it also gave clear indications of a slowdown. Most market participants consider that this development towards equilibrium between demand and supply in the labour market is likely to have improved the Fed's scope to begin cutting interest rates this year.

In June, annual inflation in the U.S. was 3%, down from the 3.3% in May. The rate was also below expectations, and the prices fell month-on-month for the first time since 2020, by -0.1%, while the core rate (excluding food and energy prices) rose by just 0.1%. We expect the inflation rate to fall below the 3% mark in the second half of the year and see the Fed on track to combat inflation. As a result, the Fed is likely to make its first interest rate cut of 25 basis points this year. Looking ahead to the next 12 months, we also expect two further interest rate cuts in the U.S. of 25 basis points each. Market participants are fully pricing in first rate cut in September by the Fed.

In the Eurozone, the ECB has a mandate to ensure price stability, on which it must base its monetary policy – price developments are therefore the sole determinant. Inflation in the Eurozone fell by 0.1 percentage points to 2.5% on an annual basis in June, while the core rate remained at 2.9%. The high core rate is due, among other things, to the persistently high price increases in the services sector, as high wage increases in this sector continue to have an impact on prices. Wage developments are considered one of the major obstacles and opportunities for the Eurozone. Since collective bargaining is the norm in most European countries, it takes several quarters for higher nominal wages to become apparent due to increased inflation. In addition to the resulting potential risk of a wage price spiral that counteracts the fight against high inflation rates, wage increases are also seen as an important basis for the recovery of real household incomes and the Eurozone economy as a whole, which have suffered greatly from the high inflation of recent years.

Q1 GDP growth of 0.3% compared to the previous quarter indicated increasing momentum in economic activity. Given the continued robust labour market situation, wage increases could possibly delay the decline in core inflation somewhat – but not stop it. In our view, the ECB is therefore likely to cut the key interest rate by 25 basis points each in Q3 and Q4 after the first cut in June. The central bank is likely to continue this expansionary course in 2025 and cut the key interest rate once again in the first three months of 2025 before taking a break in Q2 2025. Market participants are currently pricing in a rate cut in September with a probability of around 80%.

We therefore assume that inflation in the U.S. and the Eurozone will continue to decline. We forecast a headline inflation rate of 3.0% for the U.S. in 2024, before it falls to 2.3% next year. In the Eurozone, inflation could reach 2.5% this year and fall to 2.3% in 2025. It seems unlikely that inflation will reach levels as low as in the 2010s. Inflation is much more likely to be kept at elevated levels by a number of factors.

On the one hand, ageing and the associated shortage of labour are playing a role in most regions. This effect is already noticeable today, with companies in many places already finding it difficult to hire the necessary staff. These difficulties are likely to intensify in the coming years and will partly impact product prices via rising company wage costs, thus raising the price level.

Inflationary pressures in the U.S. and the Eurozone, at least in the short term, could be eased somewhat by the current price development in China. In June, the consumer price index fell by 0.1 percentage points to 0.2% on an annual basis. Producer prices rose by 0.6 percentage points to -0.8%. The Middle Kingdom is currently experiencing one of the longest and deepest declines in producer prices since the 1990s. According to some analysts, Beijing's current policies are reinforcing this trend even further by focusing on higher investments in the manufacturing sector instead of supporting domestic consumption. Since China is also the world's largest exporter of goods, this has an impact on the entire global economy – falling Chinese producer prices are also exported. Some analysts estimate this effect on core inflation in the U.S. and the Eurozone at around 0.1 percentage points.

However, in the medium term, this effect could be reversed, as rising protectionism worldwide could cause a higher level of inflation. In the U.S. and recently also in the EU, political willingness to impose higher tariffs, especially on imports from China, has grown. The motives are varied, but ultimately a higher tariff leads to higher consumer prices, as cheap imported goods become more expensive and may be replaced by more expensive domestic products. Political developments, especially after the elections, are crucial for future developments in the U.S. and Europe. Investors should take this into account in their investment strategy, as the example of France recently illustrated.

Since the returns on longer-term bonds are generally above the inflation rate, the inflation forecast therefore indicates an interest rate environment that is described on the market as "higher for longer". This creates interesting investment opportunities for investors on the bond market, which will now be discussed below.

EUR government bonds weighed down by uncertainties

The benign economic picture and the decline in inflation rates enabled the ECB to make its first key interest rate cut in June. The uncertainties surrounding the elections in France have so far only had a short-term effect on EUR government bonds. Money market interest rates and yields on short-term bonds have followed the key interest rate move and fallen slightly. However, they remain at higher levels than the yields on longer-term bonds, so that the yield structure remains negative. This shows that the ECB's monetary policy continues to have a dampening effect on the economy and that further interest rate cuts appear appropriate.

Yield levels are likely to remain at the elevated levels for longer as the ECB is in the process of reducing the holdings of securities acquired under the Pandemic Emergency Purchase Programme (PEPP) that was launched to support the economy. In the second half of 2024, the PEPP bond portfolio will be reduced by 7.5 billion euros per month and the reinvestment of funds from this program will be stopped at the end of 2024. On balance, the reduction in this securities portfolio will eliminate demand from the ECB on the bond markets and therefore tend to increase yields. After the increased uncertainty in the Eurozone triggered by the elections in France, it seems quite possible that these plans for monetary policy fine-tuning may still be adjusted.

Political developments and geopolitical risks this year have contributed to increased uncertainty for the economic outlook. One trigger for uncertainty was, for example, the early elections in France. The bond markets react sensitively to political uncertainties that arise in individual countries in the Eurozone. For example, the yield gap between 10-year French government bonds and corresponding German government bonds widened significantly to around 80 basis points near the election dates. Only when it became clear that none of the extreme political positions could achieve a clear majority due to the election results and that compromises were necessary, which made moderate policies more likely, did the yield gap narrow. It is currently back below 70 basis points.

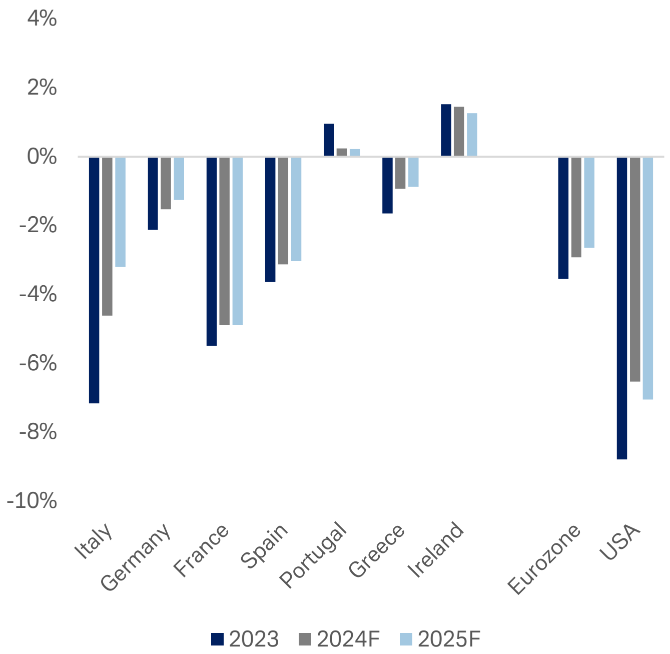
At the European level, the EU Commission is about to return to monitoring and complying with budgetary rules. The debt ratio of individual countries continues to be a central element of the Stability and Growth Pact in the EU. During the pandemic, these stability criteria were suspended and individual countries launched fiscal policy programs that have burdened public finances and increased budget deficits. These increased deficits must now be reduced again to enable a return to solid public finances.

In June 2024, the EU Commission determined that an excessive deficit procedure was justified for France, along with 6 other countries. The planned excessive deficit procedure is intended to send a signal that action is being taken at the European level to combat a large increase in new debt. If an excessive deficit is identified, proposals for recommendations on how to reduce the excessive deficit must then be drawn up.

In contrast to this, some parties in France are planning to increase government spending in accordance with their election manifestos. Following the rating agency S&P, Moody's has now also warned that it may downgrade France's credit rating. The party that won the most seats, the Nouveau Front populaire (NFP), not only wants to put forward a joint candidate for the office of prime minister, but is also planning additional spending of EUR25bn this year and EUR100bn next year.

It is not yet clear whether such programmes will be implemented, but the news has contributed to investor uncertainty. The development of public finances is therefore likely to come back into focus. The French budget deficit could be around 5% this year and barely decrease in 2025 or possibly even increase. Accordingly, yields on French government bonds are likely to remain at an elevated level until there is a sustained consolidation of public finances.

Chart 2: Government budget balances of selected countries and regions (in % of GDP)



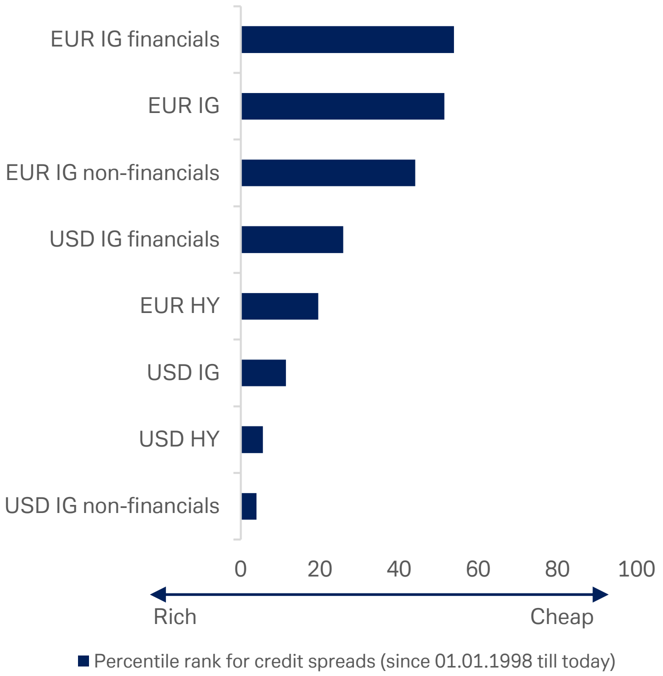
Source: Deutsche Bank AG, LSEG Datastream; Date as of July 17, 2024.

EUR credit: Carry still the king!

Until the close of trading on the Friday before the European elections on June 9, European credit markets were doing well. Yield spreads over German Bunds for both EUR IG (ICE BofA Euro Corporate Index) and EUR HY (ICE BofA Euro High YIeld Index) were at their lowest levels in more than two years at around 106 bps and 313 bps respectively. However, the subsequent price fluctuations due to the surprise announcement of early parliamentary elections in France temporarily pushed the yields of the above-mentioned indices up by 16 basis points and 42 bps respectively. The important aspect for credit markets is that French OAT (French government bond, Obligations assimilables du Trésor, OAT) yield differentials over Bunds had increased by around 30 bps to around 80 basis points, the highest level since 2017, which has also spilled over into credit markets.

In terms of the initial market reaction, the decision to hold a new election for the French parliament far overshadowed the impact of the ECB's first rate cut. It is easy to see why this was important for EUR credit markets: French issuers account for more than one-fifth of the EUR IG market, with some sectors even having a French share of over 40%. Nevertheless, with the results of the second-round of the election now in the background, EUR IG has now reversed its earlier jump in spreads and investor sentiment has shifted towards increasing optimism about the European economy and the region's prospects of economic recovery in the longer term. Such a Goldilocks-like scenario is a boon for credit markets as it is attractive for investors to lock in these elevated yields available in EUR credit markets.

Chart 3: EUR IG still not expensive relative to history (in percentile)



Source: Deutsche Bank AG, LSEG Datastream; Date as of July 17, 2024.

This is not to suggest that the period of uncertainty is over given the work that lies ahead for the political parties to form a coalition government due to the hung parliament. This will bring its own set of problem with regards to policy formulation and reducing the budget deficit which stands well above the EU's 3% threshold. So, until we get clarity on the composition of potential coalitions in the French parliament and the resulting political implications, we will continue to see bouts of pressure on credit markets.

However, as a testament to the resilience of credit markets, during the midst of this turmoil that pushed the spreads to similar maturity Bunds higher, the yield differential of the French IG index to the French government bond index narrowed and a major French energy company was able to complete a bond issue that was more than three times oversubscribed between the two rounds of elections, in other words at a time of high uncertainty. We therefore continue to see the EUR IG market as attractive to medium to long-term investors given its high quality and favourable carry-driven return potential.

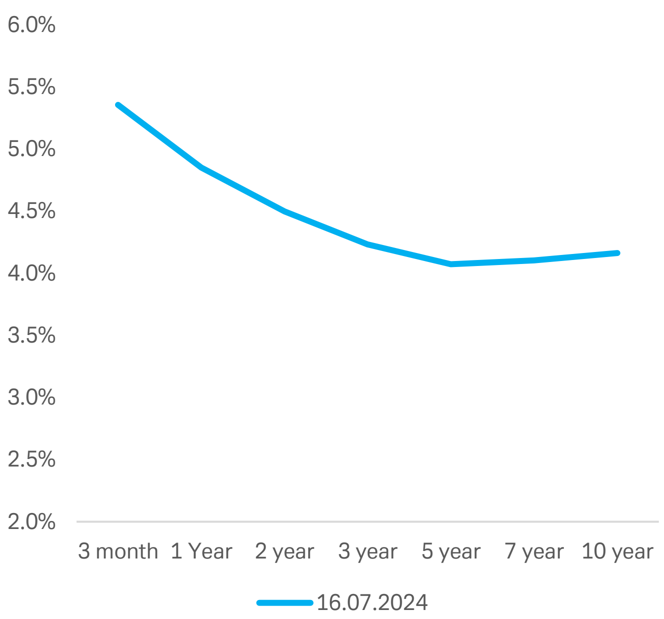
While the risk premium in the broad EUR IG market trade has tightened materially over the past two years, it still does not screen too expensive by long-term historical standards. Financial bonds look even slightly cheaper over the same period and trade at a spread 17 bps higher than the non-financials while also providing a higher carry opportunity. Although the ECB has already made its first rate cut, banks are still likely to benefit from higher net interest income. This is caused by the rising valuation of assets on the balance sheet, cheap deposit costs, higher deposit volumes and improved loan growth. With a large portion of banks making a concentrated effort to contain cost increases at the same time, the cost-income ratio in the sector has also fallen according to the data in the Q1 2024 reporting season. Commission income growth also showed encouraging signs of acceleration in the first quarter of 2024. Insurers derive a large portion of their income from their investment portfolios, which perform better in an environment of persistently higher interest rates. In addition, solvency ratios (a solvency ratio measures how well a company's cash flow can cover its long-term debt) are well above minimum requirements. We therefore expect the financial sector to do well going forward, which should be reflected in their corporate bonds as well.

U.S. Treasuries: Debating the yields

The U.S. has also already seen some initial election-related volatility. The first presidential debate happened the on same day that we obtained new PCE data which showed the continued gradual progress towards bringing inflation under control. Nevertheless, the aftermath of the debate overshadowed the discussion of inflation pressures and the monetary policy stance, as the U.S. yield curve steepened during this period and 2-/10-/30-year yields rose by 4 bps/11 bps/13 bps respectively. However, with the initial nerves having calmed down, the focus has returned back to the inflation figures, where the latest CPI data also ticked lower, strengthening the case for rate cuts in the next few months.

Looking ahead to the second half of the year, U.S. growth is expected to moderate, but to a limited extent, justifying a high bond yield environment. The labour market continues to approach its pre-pandemic equilibrium. On the monetary policy front, a flatter tightening cycle is largely priced in, given the rebalancing since the beginning of the year. While we see the

Chart 4: U.S. yield curve (in %)



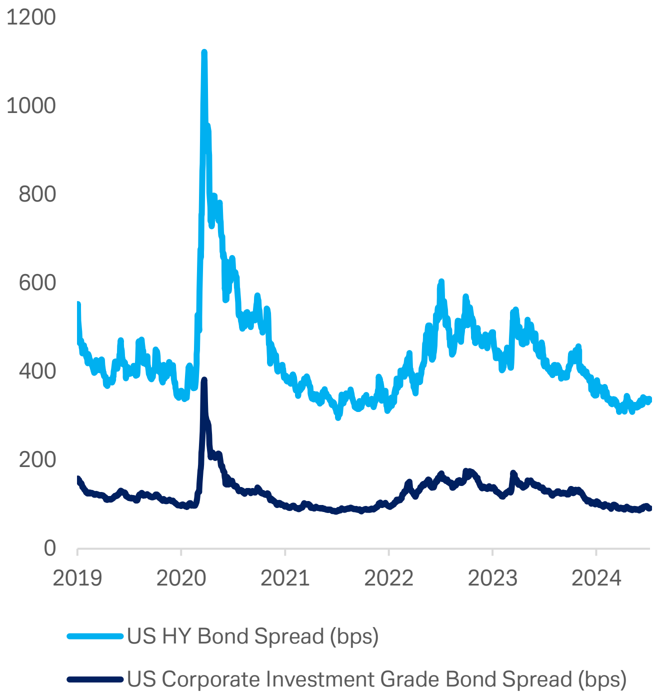
Source: Deutsche Bank AG, LSEG Datastream; Date as of July 17, 2024.

curve steepening as we get closer to rate cuts, it is difficult to be directly optimistic about short term rates as the inflation risks are still prevalent – especially given recent oil price volatility against the backdrop of potential further escalation in the current Middle East conflict.

In the wake of (upcoming) elections in the U.S. and Europe, market analysts have drawn investors' focus to the long-term sustainability of budget deficits and rising public debt. This focus was reinforced by the recent update of the Congressional Budget Office's fiscal outlook for the U.S., in which it raised its forecast for the 2024 deficit by USD400bn, a 27% increase from its February calculation. In addition, the agency now expects a USD2.1tn higher cumulative deficit over the next 10 years. According to this, the national debt would rise from 97% of GDP to around 122% over this period, even under the implicit assumption that income tax rates return to pre-Tax Cuts and Jobs Act levels in 2025.

Consequently, we expect that questions around fiscal sustainability will remain the focus of attention going forward – regardless of who wins the election. The economic impact of further tariffs is also likely to put upward pressure on the term premium on U.S. Treasuries. Therefore, we think that positioning on a steepening of the U.S. yield curve (via a steepener trade) is a more interesting option at the moment than positioning in long-maturity bonds. However, as we are likely to see bouts of volatility going forward, investors should consider adding long-duration exposure at 10-year yield levels of above 4.5%, if the opportunity arises.

Chart 5: Yield development (spread) of USD corporate bonds (in basis points)



Source: Deutsche Bank AG, LSEG Datastream; Date as of July 17, 2024.

USD Credit: Light turbulence

The recent U.S. elections related uncertainty gave us a glimpse of what to expect in the next couple of months. Spreads zigzagged on both USD IG (Bloomberg U.S. Corporate Bond Index) and USD HY (Bloomberg U.S. High Yield Index).

With weakening economic data coupled with uncertainty fuelled by the U.S. election and the run-up to the first rate cut by the Fed, such price movements are becoming more likely. Issues such as future tax policy, trade policy and budget deficits in the U.S. are likely to be at the centre of this and create corresponding uncertainty among market participants. While the ups and downs of interest rate spreads can be challenging during this period, investors should look beyond this short-term period and focus on the return potential and seek entry opportunities for exposure to this sector during periods of widening spreads. One could have obtained an additional 20 basis points of carry interest during the recent yield increase in late June compared to current levels in the USD IG market. We continue to recommend that investors focus on the return potential of total returns (currently: around 5.3%) rather than risk premium compression. However, we do not expect risk premiums to widen permanently in the coming quarters. We are therefore not concerned that such a scenario will reduce carry-driven returns.

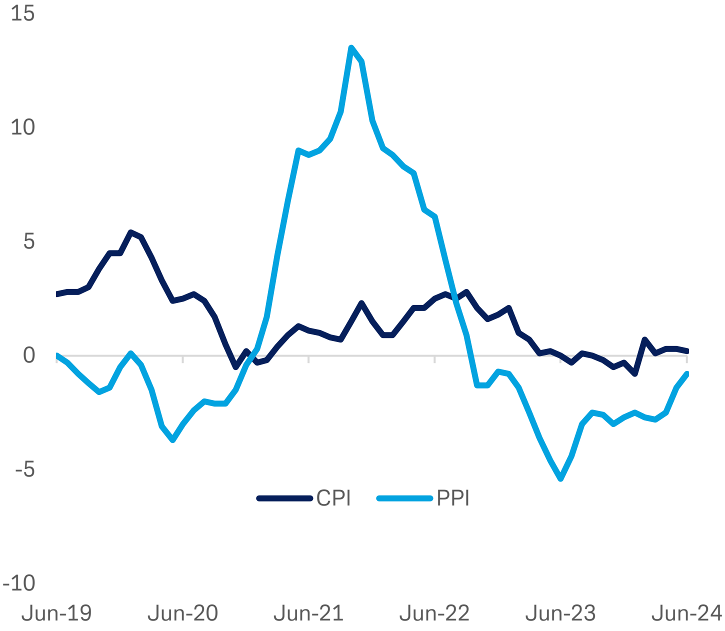
Strong demand for the sector seems to support this view. High quality funds (including mixed fixed income funds) saw inflows of around USD175bn in the first half of the year, representing around 4.8% of initial assets under management. A large portion of these inflows occurred during the period when the market was pricing in significant Fed rate cuts earlier in the year, as these institutional investors sought longer-term exposure. This scenario could repeat itself as we approach the first U.S. rate cut priced around end-Q3. Although life insurance companies have not increased their broad portfolio allocation to IG bonds, they have nonetheless been active buyers, maintaining a consistent share of bonds in the portfolio. Similarly, U.S. pension funds with funding ratios above 100 have gradually bought into the IG market. On the supply side, we expect issuance to moderate from the record levels of H1 2024, when gross issuance totalled USD874bn, the second highest after 2020. Market analysts expect about half of this volume (net) to be issued in H2 2024, which should likely be well absorbed given the estimated coupon income of about USD170-180bn generated by the credit portfolios.

The high-yield (HY) market has so far managed to absorb the weakness in fundamentals well, with leverage only 0.2x higher than the lowest levels in the last 10 years. Although interest coverage (ratio that measures how big the company's profit is relative to its interest expense) declined for the sixth quarter in a row, it is still 0.4x above the historical average. Similarly, the HY market's 12-month issuer-weighted default rate fell to 3.6% last month and is expected to end the year at a slightly lower level of 3.4%, suggesting that the peaks in default rates may be behind us. Although fundamentally the HY market seems to be in a decent shape and provides a strong yield of around 7.8%, valuations remain unattractive with risk premiums of almost 300 basis points, trading at extremely low levels by historical standards. In our view, the risks of this market, especially in the lower rating segments such as BB and CCC, are not sufficiently offset by the risk premium. In addition, given the difficult period that will be brought about in the coming months by political developments and uncertainties regarding future economic developments, there could well be even greater price volatility.

Conclusion

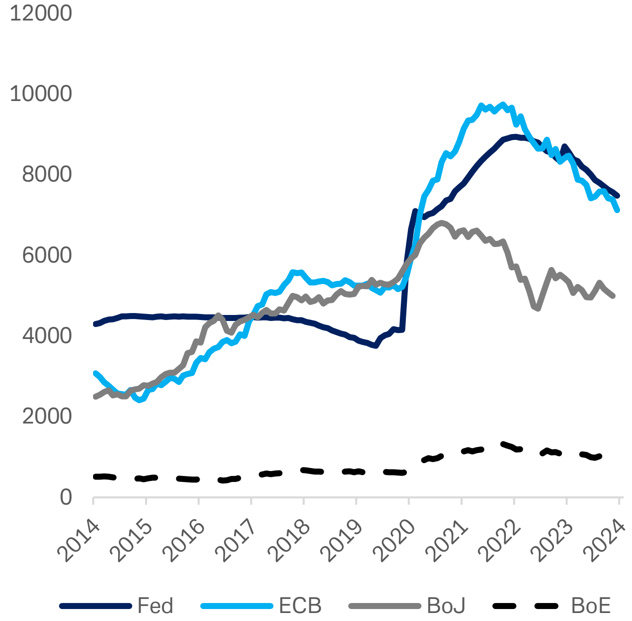
The interest rate cycle in Europe has already shifted to a less restrictive direction and a similar development is likely to be seen in the USA in the coming months. During this time, market participants are closely monitoring the upcoming economic data in order to price in possible deviations from the expected monetary policy course in Europe and the USA. In addition to monetary policy, further political developments in Europe and the USA could also lead to stronger price movements in the coming months. However, we see these as merely temporary movements that may even offer good entry opportunities for interested investors. Overall, we assume that the bond markets could therefore experience volatile phases in the short term. In the medium term, bond investors are likely to concentrate on the current interest rate and place a focus on corporate bonds.

Chart 6: Price development in China (in %, compared to previous year)



Source: Deutsche Bank AG, LSEG Datastream; Date as of July 17, 2024.

Chart 7: Central bank balance sheets (billion USD)

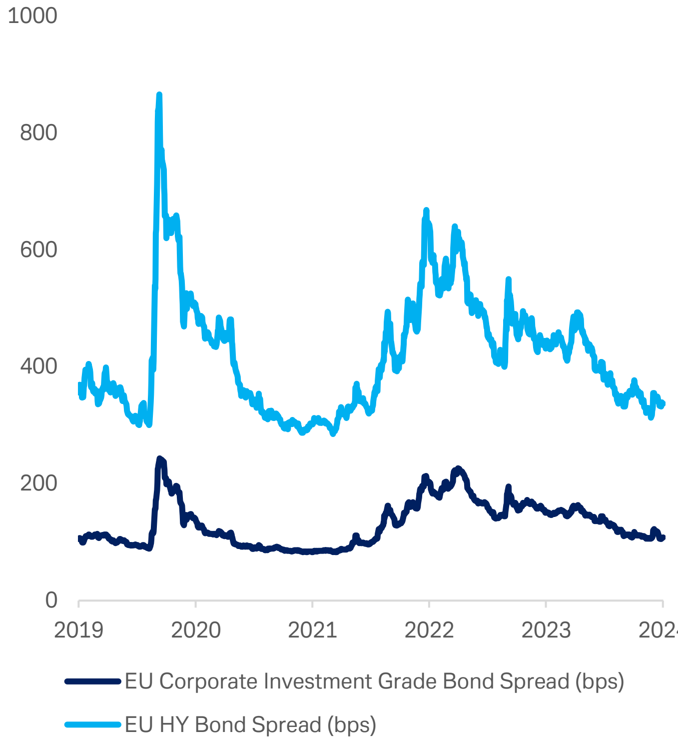


Source: Deutsche Bank AG, LSEG Datastream; Date as of July 17, 2024.

Chart 8: Yield on 10-year government bonds (%) over the past 25 years

Source: Deutsche Bank AG, LSEG Datastream; Date as of July 17, 2024.

Chart 9: Yield development (spread) of EUR corporate bonds (in basis points)

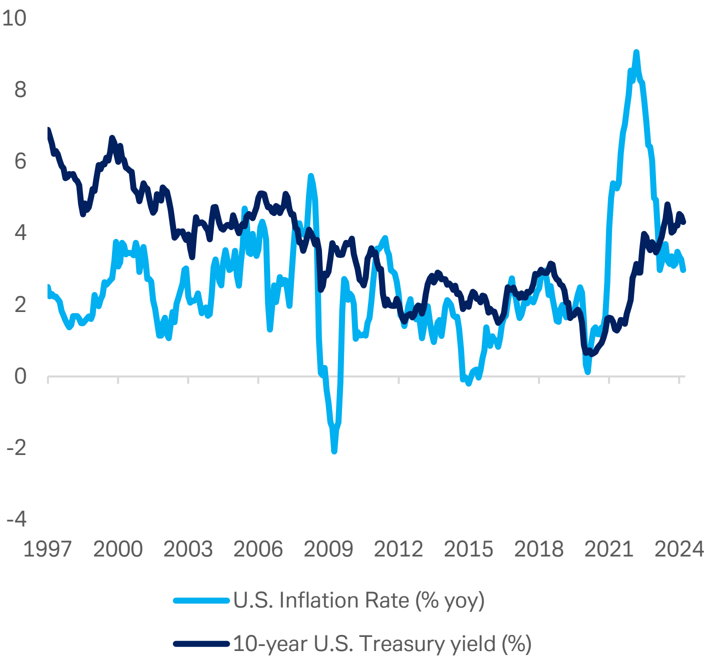


Source: Deutsche Bank AG, LSEG Datastream; Date as of July 17, 2024.

Chart 10: Yield on 2-year government bonds (%) over the past 25 years

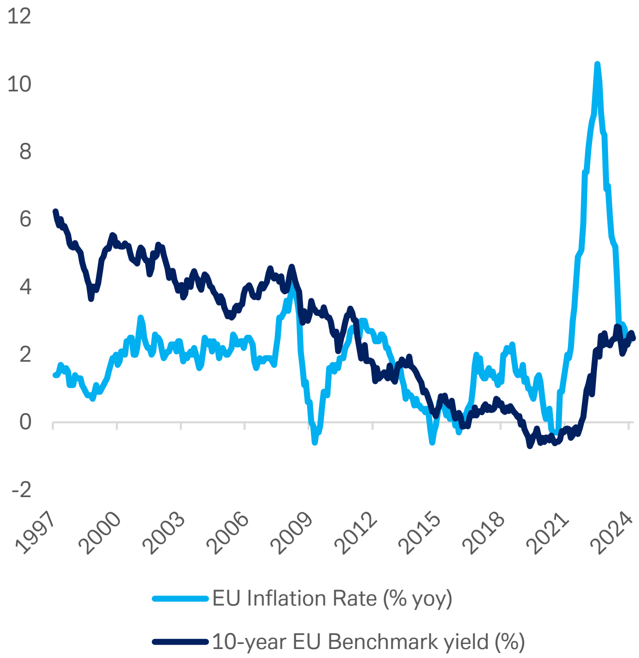
Source: Deutsche Bank AG, LSEG Datastream; Date as of July 17, 2024.

Chart 11: Yield on 10-year US Treasury bonds and inflation rate



Source: Deutsche Bank AG, LSEG Datastream; Date as of July 17, 2024.

Chart 12: Yield on 10-year EU government bonds and inflation rate



Source: Deutsche Bank AG, LSEG Datastream; Date as of July 17, 2024.

Performance over the past 5 years

Performance	22.7.2019 – 22.7.2020	22.7.2020 – 22.7.2021	22.7.2021 – 22.7.2022	22.7.2022 – 22.7.2023	22.7.2023 – 22.7.2024
10-year U.S. Government Bonds	17.8%	-3.9%	-11.3%	-5.1%	0.5%
2-year U.S. Government Bonds	4.0%	0.1%	-2.7%	-0.2%	4.9%
10-year EMU Benchmark Bonds	1.6%	-0.2%	-11.9%	-9.6%	2.5%
2-year EMU Benchmark Bonds	-0.9%	-0.8%	-1.6%	-2.2%	2.6%
10-year U.K. Government Bonds	7.0%	-3.8%	-10.2%	-15.2%	6.0%
2-year U.K. Government Bonds	1.0%	-0.2%	-2.3%	-3.5%	5.6%
10-year Japanese Government Bonds	-1.2%	0.5%	-1.2%	1.0%	-3.7%
2-year Japanese Government Bonds	-0.3%	-0.1%	-0.2%	-0.1%	-0.3%
10-year German Government Bonds	1.6%	-0.2%	-11.9%	-9.6%	2.5%
2-year German Government Bonds	-0.9%	-0.8%	-1.6%	-2.2%	2.6%
ICE BofA Euro Corporate Index	0.1%	3.1%	-10.6%	-2.5%	6.5%
ICE BofA Euro High Yield Index	-0.4%	9.7%	-11.8%	5.5%	11.0%
ICE BofA Euro Financial Index	0.3%	2.6%	-8.7%	-1.9%	7.0%
ICE BofA Euro Non-Financial Index	0.0%	3.3%	-11.6%	-2.9%	6.2%
Bloomberg U.S. Corporate IG Index	12.5%	1.5%	-12.9%	-0.8%	5.6%
Bloomberg U.S. Corporate HY Index	3.5%	11.6%	-9.3%	5.7%	10.9%

Source: Deutsche Bank AG, LSEG Datastream; Date as of July 22, 2024.

Glossary

A basispoint (bp) corresponds to 1/100 percent.

Bunds are federal bonds, i.e. German government bonds.

The U.S. Congressional Budget Office is a federal agency that provides budget expertise and forecasts to Congress.

The consumer price index (CPI) measures the price of a basket of products and services that is based on the typical consumption of a private household.

Core or underlying inflation refers to a measure of inflation which excludes some volatile components (e.g. energy). These excluded components can vary country by country.

Duration measures show the sensitivity of the price of a bond to a change in interest rates, expressed in the number of years that a bond takes to be repaid through its internal cash flows.

The European Central Bank (ECB) is the central bank for the Eurozone.

The European Commission (EC) is the executive body of the European Union (EU) representing the interests of the European Union as a whole.

The Eurozone is formed of 20 European Union member states that have adopted the euro as their common currency and sole legal tender.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

In a Goldilocks scenario, there is steady economic growth that prevents a recession, but not growth so strong that inflation rises sharply. A Goldilocks condition is ideal for investing because stocks perform well while companies grow and achieve positive earnings growth.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

High yield (HY) bonds are higher-yielding bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds.

ICE BofA Euro Corporate Index and ICE BofA Euro High Yield Index are comprehensive and representative bond indices that track the development of investment grade and high-yield bonds denominated in EUR. To be included in the indices, a bond must have a fixed coupon, a remaining term of at least one year and a minimum volume of EUR 100 million.

An investment grade (IG) rating by a rating agency such as Standard & Poor's indicates that a bond is seen as having a relatively low risk of default.

OATs – in full, Obligation assimilable du Trésor – are French government bonds.

The ECB's Pandemic Emergency Purchase Programme (PEPP) is a temporary asset purchase programme introduced in March 2020 of private and public sector securities in order to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by COVID-19 outbreak

Personal Consumption Expenditure (PCE) is a price index for goods and services, particularly relevant in the context of U.S. GDP.

Risk premium refers to the return in excess of the risk-free rate of return that an investment is expected to yield. It is a form of compensation for investors who tolerate the extra risk.

Quantitative tightening (QT) is the progressive removal of monetary support through the reduction of a central bank's balance sheet.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The S&P U.S. Aggregate Bond Index measures the performance of publicly issued U.S. dollar denominated investment-grade debt.

Spread on bond markets is in general the difference of the yield of two bonds with similar maturity. It can be interpreted as a risk premium.

Treasuries are bonds issued by the U.S. government.

U.S. is the United States.

USD is the currency code for the U.S. Dollar.

The VIX Index is a measure of equity market volatility implied by S&P 500 Index options.

Volatility measures the degree of variation of a trading-price series over time.

The yield curve shows the different rates for bonds of differing maturities but the same credit quality.

Yield curve inversion is a situation where longer-term bonds have a lower yield than short-term bonds.

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