HSBC Global Research

5 October 2021

The Major bond letter

#12. Push back

Free to View
Fixed Income - Rates

Global

Steven Major, CFA
Global Head of Fixed Income Research
The Hongkong and Shanghai Banking Corporation Limited

We get plenty of push-back to our lower-for-longer view on bond yields because it goes against the intuition that the recent surge in inflation means yields should be higher. But we're not looking at short-term trends like the price of natural gas. We're looking at longer-term drivers – things like debt overhangs, demographics, distribution of wealth, and disruptive technology. We doubt they will reverse anytime soon. Our framework is more akin to trying to understand climate change than forecasting the next typhoon.

The basic premise is that, if and when the big central banks do lift interest rates, they will fall well short of the peak in the last cycle. Taking this type of approach means putting a low weight on the near-term news flow, particularly regarding inflation. So we continue to believe longer-run fair value for 10-year US Treasury yields is nearer to 1.0% than 2.0%.

Our view is consistent with what we see in the inflation-linked bond market. At 2.2%, the US five-year forward inflation rate aligns with the Fed's average inflation target and is only modestly higher than at the start of the year. For all of the "inflationista" narrative in 2021, longer-term inflation expectations have not become unanchored and the bond market agrees.

Judging from the questions we get, there are two main strands to the push-back over lower-for-longer: 1) self-fulfilling expectations of higher inflation, and 2) the not-unrelated reluctance to accept the drivers of lower-for-longer rates.

Let's take higher inflation first. Household and business survey measures of inflation expectations have been trending upwards, consistent with the sharp increase in the actual inflation data. US Consumer Prices Index (CPI) is currently at 5.25%, and the New York Fed's Survey of Consumer Expectations recently reported inflation expectations of 5.2% and 4.0%, for the one-year and three-year horizons. These are dizzy heights given that the average for the pre-COVID-19 decade was 1.8%.

Expectations matter because some market participants believe they feed into actual inflation. We say "some" because not everyone agrees and we think this may be a bit of a 1970s argument. The decade from 1971 saw average inflation of 7.9% and a high of 14.8%, and a lot has changed since then.

The idea that expectations matter is that when people see prices increase – as with energy right now – they respond by demanding higher wages. Intuitively this makes sense, but the reality is not quite so simple[1]. We need to think about the global economy and demand for labour, along with the fact that, in the US, formal wage bargaining does not exist on a significant scale. The labour market has changed beyond all recognition from 50 years ago, with unionised industries now representing only 6% of employment in the US.

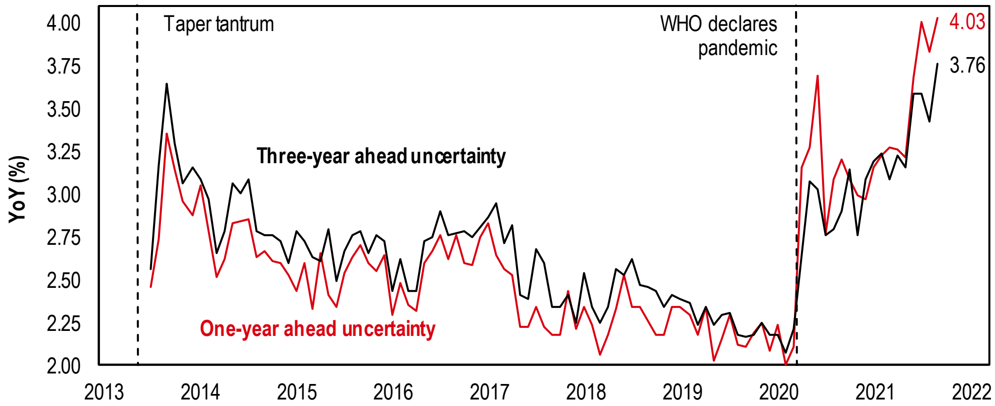
This is a Free-to-View version of a report by the same title published on 05-Oct-21. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

[1] Rudd, Jeremy, B. (2021): Why do we think inflation expectations matter for inflation? (and should we?)

Furthermore, the 5.2% survey expectation for one year hence comes with a strong health warning. The chart below shows the level of uncertainty around the forecasts. Not only does the expectation appear to be closely associated with the most recent inflation observation, it also comes with little conviction.

Uncertainty is highest amongst those below 40, those with fewer qualifications and those that gave "low numeracy" in their response. These are also likely to be the people most hurt by higher inflation if their wages don't keep up. Closer inspection shows that the highest inflation expectation comes from the older respondents (above 59), perhaps because they have memories of the 1970s.

Figure 1. Heightened uncertainty on the inflation outlook



Source: HSBC, NY Fed SCE. Latest data as of September 2021 SCE.

Second, there is a strong reluctance to accept lower-for-longer interest rates as the base case.

If many market participants are positioning their portfolios for higher yields then there can be a strong "technical" resistance to it actually happening. The focus on higher inflation is a case in point. If as we suspect the recent inflation surge is just the aftermath of the "once-in-a-century" global pandemic shock, then we will soon return to the challenge of disinflation that led to the Fed easing policy in 2019.

Maybe we have failed to fully appreciate how everything has changed. For us this would mean that the weighted average of all the drivers of lower-for-longer rates starts moving into reverse. This is a big ask, and if, as we expect, today's inflation proves to be temporary, then it will not significantly influence where we think fair value for bonds sits right now.

What has to happen to change our view? We are often asked this question. One piece of economic data, a central bank announcement, or big rise in yields, just won't do it. The answer to the question returns to what we think really matters, and this is the longer-run equilibrium policy rate. This is the rate at which the economy is running just right, not too hot or cold, where there is full employment and inflation is on target.

Dizzy heights for inflation expectations should not distract us. If policy rates do go up they are unlikely to get very far. And if higher yields result from expectations of early rate hikes, they will likely give rise to opportunities to enter the market at the top of the yield range. We are pushing back on the push back.

Previous editions of 'The Major bond letter'

#1. *Eurozone common issuance – a long time coming*

#2. *How to spice it up in a dull market*

#3. *New year, old narrative*

#4. *Beneath the surface*

#5. *The bond market sell-off*

#6. *Treasuries and trees*

#7. *Inflation rationality*

#8. *Lucky number*

#9. *Stuck in the middle*

#10. *Taper and the Hole*

#11. *Every basis point counts*

Disclosure appendix

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Source: HSBC

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Source: HSBC

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Issuer of report
The Hongkong and Shanghai Banking Corporation Limited
Level 19, 1 Queen's Road Central
Hong Kong SAR
Telephone: +852 2843 9111
Fax: +852 2801 4138
Website: www.research.hsbc.com

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