The Major bond letter

#3. New year, old narrative

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After yet another good year for bonds, with yields and spreads lower than most of the market expected a year ago, there is inevitably the fear that the good times cannot last. The Bloomberg global fixed income aggregate generated 9.4% last year, which followed on from 6.9% in 2019 (see chart below for the evolution of each year's bond return). US Treasuries returned 7.3%, following 9.1% the year before, measured in the US currency. Because the dollar weakened, those holding European and Chinese bonds (unhedged) made double digit returns in USD terms.

We start 2021 pushing back on the bond bears and their narrative on fiscal policy and inflation. It may be a new year but the arguments for higher yields appear old. This year the bond supply and inflation expectations narratives will likely be combined, with historical analogies to post-war spending booms, which supposedly is going to drive prices higher.

In brief we are not going to lose sleep over bigger government deficits and the resulting increase in bond supply. And whilst there is so much economic slack we think it is difficult for the aggregate level of wages to rise, which is surely the source of inflation that would worry central banks. Making comparisons with past cycles is all very well but we are in the midst of a pandemic, which has been a game-changer through explosive implementation of technology, new working practices and changes in consumer preferences.

So let's explain why we think the supply of bonds and inflation are not going to be the drivers of higher yields in 2021.

First, the increased bond supply argument is a particular bugbear of ours. Not only is the view one-sided, focusing on supply and ignoring demand, it is also not supported by empirical analysis, certainly for the major developed markets and big emerging markets that we tested. We did this work a year ago, only to find that our hypothesis – supply does not matter – was going to be rigorously tested in March.

Yields went down when bond supply increased by amounts beyond anyone's expectation.

We think the "supply matters" view is based on nothing more than intuition. People feel more comfortable when they can frame their views around something that they think they know. It's an approach that regularly fails.

But the reality in markets is that the fiscal stimulus in one particular year becomes part of the base case for the next. There will be countries where bond supply will likely fall this year and next. Does this mean bond yields should fall? The answer is "no", because the empirical evidence says it doesn't matter.

This is a redacted version of the report published on 06-Jan-21. Please contact your HSBC representative or email AskResearch@hsbc.com for information.

When we say supply does not matter we are referring to our forecasts for yields. Some participants in the bond markets are hyper-sensitive to small changes in valuations that may come as a result of the next supply event. So supply may matter to intra-day market moves, in the same way that any surprise information will move the market, but it does not matter to our forecasts or to the longer-term bond yield trend. Ultimately, policies like QE and fiscal stimulus are responses to lack of aggregate demand. Yields will rise if these policies are a solution to this problem, rather than a short-term anaesthetic.

Second, the other old narrative on inflation expectations. Maybe this time is different but we believe a rise in inflation has been well-priced by the bond market already. The reflation trade of Q4 2020 was essentially the positioning for what will largely be base-effects in Q1 2021. For us, there will need to be fresh impetus from upside surprises to drive the inflation expectations part of nominal bond yields higher from here.

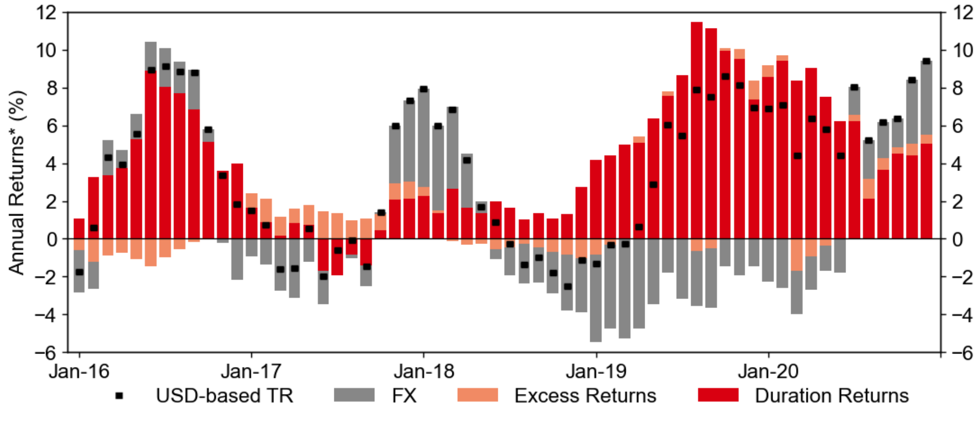
Forward guidance by central banks means that nominal policy rates are essentially pegged, and in the case of the US Federal Reserve they are pegged through 2023 or beyond. It will take some major shock for the Fed to backtrack on this commitment, especially given how sincerely it has been made, but this is what the markets have been predicting for some point in 2021.

The focus on the monthly inflation data ignores what really matters, which is the rate of unemployment. If US inflation were to go above 2.0% for a while this would be consistent with the average inflation targeting (AIT) but it does not mean the Fed is going to hike rates. In 2012, when the Fed started the previous regime of targeting 2.0% for the PCE rate, there was a period of overshoot which didn't matter because unemployment was so high.

This was before AIT. So our view is that the bond market and rate of inflation could decouple. Nominal yields are referenced on the expected path of the nominal short rate, which is itself now capped. Inflation could even rise a little and with nominal yields contained the adjustment would be made through the real yields; i.e. real yields would fall with higher inflation.

If the 50-100bp range for the 10-year Treasury that has been observed over the last six months holds and absent a clearly defined trend in yields, there are times when it pays to be agile and save some dry powder.

Figure 1. Global bond total returns, split by their drivers



Source: HSBC, Bloomberg. Note: *Annual returns take the 12-month return at the end of the month. So the last bar shows the return from end-Dec 19 to end-Dec 20. Total Return in fixed income measures price appreciation, accrual, coupon payments, and FX translation

Disclosure appendix

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Source: HSBC

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Source: HSBC

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