

# The Major bond letter

## #38. The 'lower for longer' club

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Fixed Income - Rates

Global

We are paying a lot of attention to bond yields in the US, Japan, and China. A glance at our chart shows two highly indebted countries where the bond markets are trying to pull away from 'lower for longer' rates, and another that appears to be succumbing. Markets can be wrong, but they imply that the US and Japan are attempting to move away from 'lower for longer' whilst China is heading in this direction.

The chart plots the change in the one-year yield, five years from now, anchored a decade ago, at the start of 2013. This forward yield is the market's estimate of a longer-run equilibrium for policy rates, an interpretation of neutrality, where inflation is on target and there is full employment. An economy that is neither too hot, nor too cold.

So, given this picture, does 'lower for longer' still apply? First, what is it?

We use 'lower for longer' as a catch-all to describe the falling trend for the longer-run equilibrium real rate. Rates can go up and down through the cycle, but 'lower for longer' is about where they are likely to settle five to ten years hence. Like gravity, the longer-run equilibrium is unobservable, but we need to try to understand it. In our case, it is for the purpose of valuing bonds.

'Lower for longer' is both descriptive about what went before and a view of where the market might be heading. Because the determinants are structural and secular in nature, the longer-run equilibrium is unlikely to turn on a sixpence. Rather, it requires a fundamental shift in regime for the trend to change.

We think 'lower for longer' has become a global theme, with excessive borrowing, ageing populations, inequality, and the excess of saving over investment, amongst explanations. If we had to choose the main driver behind the theme, we would choose debt. There's little disagreement in markets and policy circles that there is too much debt, but where we find the biggest dissonance is in what it means for bonds.

A persistent view we hear from some investors is that bigger deficits mean more bond supply and feed through to higher yields. Whilst intuitively appealing, we find no support in the data.

### Pulling away from and succumbing to 'lower for longer'



Note: 5Y1Y OIS used for US and Japan, 5Y1Y NDIRS used for China. 5-day moving average used throughout; data as of 22 August 2023  
Source: Bloomberg, HSBC

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In fact, we find the opposite: more debt is often associated with lower yields.

The explanation for this is that the massive build-up of debt – equivalent to multiples of GDP for non-financial debt in Japan, China, and the US – has often been unproductive. There may be an occasional short-term boost to consumption or infrastructure investment, but nothing that succeeds in pushing the trend GDP meaningfully higher. Debt has to be serviced, and history shows that diverting cash flow away from investment and consumption tends to weigh on growth.

Not so long ago, 'Japanification' was a term used to describe how a debt overhang, combined with an ageing population, resulted in permanently low yields, with a flat curve extending from the short maturities. Since the Global Financial Crisis (GFC, 2008), 'lower for longer' has been used as a form of forward guidance by central banks when rates have approached zero – and as part of a commitment to keep them there. Today, the Fed's published guidance for rates is in the 'dot plot', which still has a longer-run equilibrium policy rate of 2.50%. This is 300bp below the current policy rate and about 150bp through market estimates for five years ahead.

Does 'lower for longer' still apply?

The fact that US bond yields are at the top of the range, implying higher policy rates than in the last cycle, could easily be the reflection of a risk premium. Put differently, the market's estimate may imply that the equilibrium for US policy rates will be revised higher, not that it already has been. As examples of how the debt narrative can be wrong, there were notable increases in US yields at the time of the 2013 'taper tantrum', the 2016 US presidential election, and the recent recovery from the economic impact of the COVID-19 pandemic (see chart) might be another.

Markets can be wrong. Just because US and Japanese forward yields have moved towards the top right of the chart, they won't necessarily keep heading higher. Similarly, China forwards may be at the bottom of the range, but that does not tell us where they will go next. If the US example is any indication, a massive fiscal boost might have lifted growth expectations and pulled the forwards upwards, but there is no guarantee that this is sustainable (see [The year is still young](#), 16 August 2023).

Things might be different if the new debt is put to productive use. Investment in new technology, for example, could help lift potential GDP. Indeed, the stock market boom related to artificial intelligence in the US tells us just that. In time, we'll see.

There is still a great deal of uncertainty. Since the beginning of 2013, expectations for the market's measure of the equilibrium have, on several occasions, visited the bottom of the range for all three countries. The high-low range for the US and China has been about 300bp, whilst for Japan it's about half of that.

The large ranges described here are not desirable given central bank financial stability objectives. Excessive accommodation from previous cycles can come back to haunt policymakers when rapid rate hikes expose the debt, as we saw with US regional banks in March. 'Lower for longer' may be the least bad option in such a scenario.

Rising debt levels have been a key driver of the 'lower for longer' theme across the three countries over the last decade, but the defining difference today is the contribution from inflation. Fiscal largesse added to demand-side inflation pressures in the US, keeping the Fed hawkish – for now, at least. Japan has been waiting for decades to experience some inflation pressure whilst China has experienced strong structural headwinds, partly explaining the divergence in the chart. This means 'lower for longer' is still relevant. The club is even broadening its membership.

**Previous editions of 'The Major bond letter'**

- |  |  |  |
|--|--|--|
| #1. <a href="#"><u>Eurozone common issuance</u></a>            | #14. <a href="#"><u>Across the pond</u></a>              | #27. <a href="#"><u>Funny old game</u></a>                 |
| #2. <a href="#"><u>How to spice it up in a dull market</u></a> | #15. <a href="#"><u>The most insightful question</u></a> | #28. <a href="#"><u>Japan's curveball</u></a>              |
| #3. <a href="#"><u>New year, old narrative</u></a>             | #16. <a href="#"><u>QT teaser</u></a>                    | #29. <a href="#"><u>The penultimate hike</u></a>           |
| #4. <a href="#"><u>Beneath the surface</u></a>                 | #17. <a href="#"><u>Hikes that won't stick</u></a>       | #30. <a href="#"><u>Score draw</u></a>                     |
| #5. <a href="#"><u>The bond market sell-off</u></a>            | #18. <a href="#"><u>China-US divergence</u></a>          | #31. <a href="#"><u>See-saw</u></a>                        |
| #6. <a href="#"><u>Treasuries and trees</u></a>                | #19. <a href="#"><u>Warp speed</u></a>                   | #32. <a href="#"><u>Emerging Victorious</u></a>            |
| #7. <a href="#"><u>Inflation rationality</u></a>               | #20. <a href="#"><u>Usefully wrong</u></a>               | #33. <a href="#"><u>Mind the gap</u></a>                   |
| #8. <a href="#"><u>Lucky number</u></a>                        | #21. <a href="#"><u>Second half narrative</u></a>        | #34. <a href="#"><u>Addressing 'higher for longer'</u></a> |
| #9. <a href="#"><u>Stuck in the middle</u></a>                 | #22. <a href="#"><u>Curve cacophonia</u></a>             | #35. <a href="#"><u>Great divergence, revisited</u></a>    |
| #10. <a href="#"><u>Taper and the Hole</u></a>                 | #23. <a href="#"><u>Breathe (in the air)</u></a>         | #36. <a href="#"><u>Fly on the wall</u></a>                |
| #11. <a href="#"><u>Every basis point counts</u></a>           | #24. <a href="#"><u>EM reaps rewards</u></a>             | #37. <a href="#"><u>The year is still young</u></a>        |
| #12. <a href="#"><u>Push back</u></a>                          | #25. <a href="#"><u>The Grizzly</u></a>                  |  |
| #13. <a href="#"><u>Game of chicken</u></a>                    | #26. <a href="#"><u>Bring it on</u></a>                  |  |

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