HSBC Global Research

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The Major bond letter

#13. Game of chicken

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Fixed Income - Rates

Global

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There is currently a tension in financial markets between what inflation-linked bond yields and long-dated yields are telling us. According to the former, inflation is going to persist for many years. Long-dated bond yields, by contrast, are still low, suggesting the current inflation pressures are temporary. For us, it is like a game of 'chicken', sometimes known as 'hawk-dove': one side is likely to have to give way eventually, whatever the shame involved.

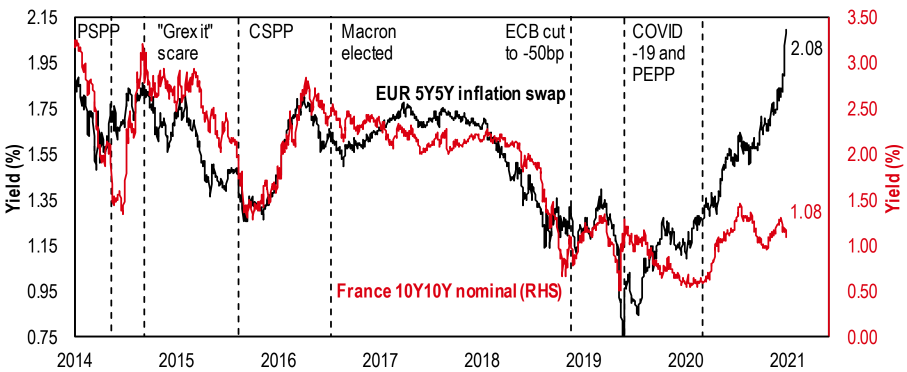
The issue is hugely important for central banks. Should they respond to what the inflation-linked markets are telling them – and raise policy rates now? Or should they bide their time, take solace in long bond yields, and ride out the bottlenecks and distortions caused by a 'once-in-a-century' global pandemic?

The Eurozone provides the ideal theatre in which to watch the game – as, unlike Japan, it is currently in play. Inflation in the region, which has long battled with disinflationary pressures, is now 3.4%, its highest level since 2008.

Opposing the dominant market narrative (see Figure 1), long-dated bond yields have resisted the surge in inflation expectations and remain comfortably below the heights reached earlier this year. Thirty-year yields are lower, too, and 10-year forward French bonds, used here as a reference for the Eurozone, are just 1.08%, representing a fall of 37bp from the peak.

All this gives the ECB and other central banks plenty to think about.

Figure 1. Eurozone inflation expectations and long French bond yields



Source: HSBC, Bloomberg

Longer-run inflation expectations matter to policymakers because they might impact behaviour today. If households and businesses think prices will go up in the future, they will buy goods and services today. This is the opposite of a deflationary mindset that can result in deferred consumption and investment. Why buy something today when it could be cheaper in the future?

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The intuition about the role of expectations makes sense to many economists, but there is another perspective, which is that the bond market might be right to see the inflation move as something that doesn't stick. Last month we *pushed back* on the inflation narrative, citing research that called into question the role of expectations.

If the ECB is worried about a wage price spiral – the cause-and-effect when employees push for higher wages because of increased prices – it need look no further than Germany. According to the Bundesbank, German inflation could be closing in on 5% at the end of this year, which would be concerning if it fed through into wages. The early signs are that it isn't. Employees may push for wage rises of 5.0% but then settle for less than half of that[1]. Indeed, German employees are likely to be rational, thinking about the longer-term viability of the business they work in, along with their employment prospects.

Living with lower-for-longer interest rates is an established theme that represents a base case for our forecasts. The central premise of 'lower for longer' is that, even if policy rates rise in the coming cycle, they will remain comfortably below the heights of the previous cycle. Our research identifies the role of key drivers behind lower-for-longer rates: debt overhangs, ageing populations, disruptive technology, and wealth inequality.

We think both the ECB and the Fed – two of the most important policymakers for global rates – will have learned lessons from previous periods of over-tightening. In the Eurozone, rates reached 4.25%, just prior to the Great Financial Crisis. Since then, the Fed had an additional cycle, with rates reaching 2.50% at the end of 2018. But then, as we have said many times before, the 'fundamental' headwinds mean rate increases are likely to fall well short of previous cycle peaks.

We could be wrong. The bond market may be misreading the current situation. Forecasting is a thankless task at the best of times, and markets have a way of making us all humble. How can we be so sure that low bond yields are more likely to be correct than the increase in inflation expectations? Maybe something has fundamentally changed. After all, this is bond letter 13, an unlucky number for some.

In a game of chicken, there is always the risk of a crash unless one of the two players yields. Looking at the chart, it is inflation expectations that seem most out of sync to us. As a compromise, the two lines could meet somewhere in the middle, as inflation expectations decline and the forwards rise through lower shorter yields.

Our view has not changed. Unless the balance of longer-run fundamentals – those that explain lower-for-longer rates – starts moving into reverse, then yields will stay at the lower end of the range.

[1] Bloomberg, 24 October 2021: "Eurozone inflation shock fizzles in German post-crisis pay"

Previous editions of 'The Major bond letter'

#1. *Eurozone common issuance*

#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*

#12. *Push back*

Disclosure appendix

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