

The Major bond letter

#30. Score draw

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In what was setting up to be a winning year for bonds, there has in fact been a 1:1 score draw over the last two months because yields went up in February, reversing the declines of January. For those who don't follow football (we prefer not to call it soccer), this is when both teams score at least one goal and, when the match ends, they have an equal number of goals.

We have admittedly been selective. Viewed over the last year, the bond market has been delivering for the bears on average in two out of three months. Taking the yield on the US 10-year Treasury, through the previous six months, the bears won 4:2 because there were more months when yields rose. Over the last 12 months, yields rose in eight months, so the score was 8:4 to the bears.

Three questions need answering. What has been driving the latest rise in yields? Is increased volatility symptomatic of a bumpy turning point? Or does the recent rise in yields mean yields will be higher-for-longer?

In answer to the first question, the bullish run for bonds that started last October was anticipating softer data that did not materialise. February data releases confirmed an economy running hot with full employment and stubbornly high inflation. This trumped the view that signs of disinflation would continue, buoyed by easier energy prices and evidence of weakness in the housing market.

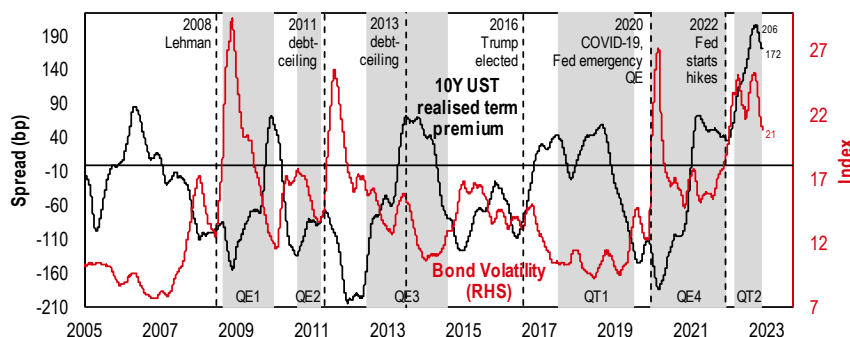
Initial conditions made the February sell-off appear quite fierce. At the beginning of the month, when two-year Treasury Note yields were at 4.10%, they were maybe over-interpreting the reduced pace of rate hikes and, flying in the face of Fed guidance, even looking for cuts.

It is likely true that we are nearer to the end of the tightening cycle than the beginning, but central banks don't want the markets to get ahead of themselves. Today it is 4.8%, so the two-year Treasury Note is more consistently priced to the Fed's guidance for the policy rate, as per the December dot plot.



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Figure 1. Realised term premium and bond volatility



Source: Bloomberg, HSBC
Note: 3M moving averages. CBOE 20Y+ UST Bond Volatility Index used. Realised term premium is spot 10Y UST minus 1Y lagged 1Y10Y forward UST.

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To answer the second question, we can see from the chart that higher yields are also associated with increased risk premium. More surprises mean higher bond volatility. This is what happens when economic data beats or misses expectations. But when markets adjust sufficiently, the risk premium may start to dissolve, consistent with yields falling back down.

We take the forward yields as a proxy for consensus expectations, and can measure the extent to which bond markets have been “surprised” by central banks, and their response to the data, with a measure we call the realised term premium. This is what the forwards expected a year ago subtracted from what actually transpired.

Our chart shows a move towards 200bp for the 10-year segment, reflecting how policy has been tightened far more than expected by the market. Recall that at the end of 2021, the Fed’s dot plot was guiding policy rates close to 1.0% in a year’s time. Just over a year later, they are guiding the Fed funds to at least 5.0%. So bond yields rose by about half as much as the policy rate.

Higher bond volatility is associated with the hawkish outcome from central bank policy but it can also be related to geopolitical uncertainty or developments from within the financial markets themselves. Whatever the cause, markets don’t like volatility and tend to respond by requiring compensation in the form of higher yields.

This takes us to the third question, as to whether there is a regime shift afoot, where the peak in rates becomes a plateau. If this is the case, yields will not be returning to the low levels of previous years anytime soon. We would argue that given the 10-year yield is close to 4.0%, it is arguably pricing in a regime shift of sorts. Without getting into the specifics of lower versus higher longer-run rates, our chart at least shows elevated risk premium around the equilibrium.

A simple example will help. Imagine that policy rates averaged approximately 5% for the next five years and then 3.0% for the following five. This is a “hawkish” scenario implying both higher-for-longer rates, and a longer-run equilibrium 50bp above that guided by the 2.50% in the dot plot. In this case, the average for 10-year expected rate would be 4.0%, not far off from where the market is today, calculated by adding together the rate for the two periods and dividing by two.

In essence, the debate in bond markets today is whether to buy and hold short-dated bonds at close to 5%, or go for the longer ones which are almost 4.0%.

Those that think the bear market of 2022 has resumed will nonetheless play it safe and stay in the shorter maturities. Confident in the view that rates will remain at 5%, or even higher, they will not be worried about having to reinvest at lower yields in the future.

What if the peak for rates is close and the rise in bond market volatility is an indication of a bumpy turning point? Bond investors will consider this to be opportunity cost and know it is not a simple case of taking the highest yield. The bond bulls believe rates will be [falling before long](#), and prefer the longer maturity, locking in yields at 4%.

Ultimately, bond investors have to be comfortable that the majority of the tightening is in the past, and that market expectations of higher equilibrium policy rates are due to a higher risk premium that will dissolve over time. Chastened after the beating of last year, the bond bulls will anyway take a score draw.

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