23 June 2023

The Major bond letter

#35. Great divergence, revisited

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Fixed Income - Rates

Global

An illustration of the divergence between the two biggest countries in the global economy, the US and China, is shown by a chart of two-year government bond yields. We look at how the yields moved so far apart, and wonder what will have to happen for there to be a great convergence?

We chose two-year yields because they are more directly sensitive to today's policy rate and expectations for their near-term moves. These yields move with the central bank's cyclical response to the economy. At the long end it is more about the structural drivers which result in the pull of the long-term equilibrium rate (see *The Major bond letter #31. See-saw*, 20 March).

A key explanation in the parting of ways between US and Chinese monetary policy is the response to inflation. When we last looked at the divergence in March 2022, US rates had only just started to go up. Inflation in the US has since surprised in its persistency – this is also true elsewhere, particularly Europe - undermining the argument that the shock would prove to be transitory.

Policymakers were caught on the back foot and the pace of monetary tightening has been the fastest for decades. Meanwhile, in China, the (financial) COVID-19-related policy responses were more measured, with neither a significant sustained easing of monetary policy, nor the fiscal largesse seen in the US and elsewhere.

Our chart shows a normalised series for China and US two-year government benchmarks. By adjusting the two time series to a common scale, in this case beginning five years ago at zero, we can see how much the yield for each country has moved in basis points. Focusing on the last five years, enough for a full interest rate cycle, we see that the China government two-year yield is down 114bp, whilst the US has gone the other way, up by 216bp.

The same directional, but less amplified, yield shifts have been seen in the last six months, with China down 20bp, and the US up 46bp to 22 June. These numbers understate something bigger, the weakening of China's currency versus the US dollar, another measure of the divergence.

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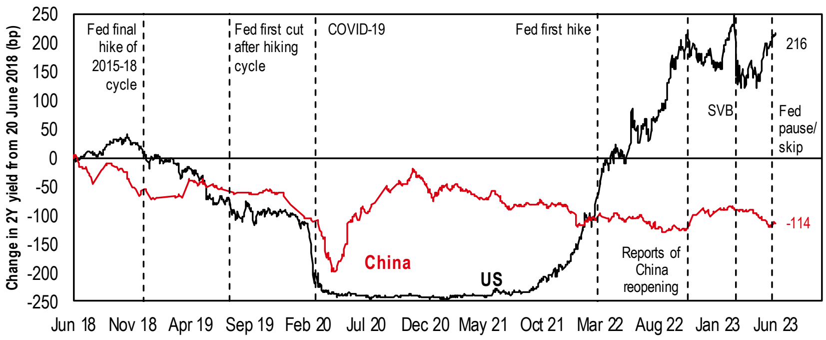
Divergence over the cycle: China and US two-year government bond yields



Source: Bloomberg, HSBC

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Bond yields, their differentials, and currency moves are outcomes from a discounting process that incorporates both today's policy rate and expectations for what comes next. When these two-year yields move persistently above or below the policy rate, the broad implication is that the next move by the respective central bank will be in the same direction.

So what would have to happen to allow us to discuss the "great convergence"? Three candidates come to mind: spillover effects via currencies, rate cycle resynchronisation, and the pull of common themes.

First, spillover effects. In a hypothetical two-country model, weak domestic demand in country A means it is likely to reduce imports from country B. If this weak demand requires a more accommodative policy rate from A's central bank, depending on what B's is doing, this would be expected to weaken the currency. In turn, country A's exports to B should feel a boost, whilst its more expensive imports are further reduced as its currency weakens.

It's the same in the global economy, where money flows from one region or product to others in search of additional yield for a given level of risk. In theory, this all results in a shift in the foreign exchange rate, with a relative tightening of financial conditions in one country versus another. In its simplest form, this means that the recent currency moves could be regarded as the equivalent of additional rate hikes in the US and rate cuts in China.

Through the first half of this year, the Chinese renminbi (CNY) has cheapened 7.1% versus the US dollar: from 6.70 (13 January) to 7.18 today. Given the yield differential was 189bp at the start point – this is how much the China yield was below the US equivalent – the currency forward should have been implying a ***strengthening*** of the CNY of about 2.0% over the entire year. This is an example of how wrong the rate and currency forwards can turn out to be. The currency weakening was clearly not expected so we wonder whether this shift will be calibrated in terms of future rate decisions by the two central banks.

Second, the rate cycles. Theoretically, rates should move up and down with the economic cycle, typically over about five years, but in reality the bond market is often leading, and right now we have a desynchronisation between China and the US.

Cycles can start when policy rates are reduced to stimulate demand in response to signs of a slowdown. Later, when rates have been reduced sufficiently the bond market leads policy by moving in response to, and in anticipation of, stronger growth and inflation. It transpires that the Federal Reserve's tightening move has been late and relatively aggressive. In comparison, there were just some small policy tweaks by the People's Bank of China (PBoC).

In the final stage of the cycle, there is an end to the rate hikes and preparation for easing. Again, this is led by the bond market with longer yields forming an inverted curve and anticipating the turn. Today the Fed guides that it is not done with tightening yet, but, given the surge in short yields, the market knows this, confirmed by US long yields consolidating after their 2022 jump. As the chart shows, in comparison, there has barely been a cycle in China.

Third, there is the pull of common themes. The divergence in rates is the result of a disruption to the cycle but this should not distract us from the structural drivers of global rates. Longer-run determinants include debt overhangs and the impact of ageing populations. We believe the longer-run equilibrium policy rate has likely remained low in the developed world and emerging economies are likely to converge on to this level over the next decade or so (see 'The Major bond letter #32. Emerging victorious', 17 April).

In summary, the difference between the divergence today and what we observed at the beginning of the Fed's tightening cycle is considerable. US yields are comfortably above their China equivalents and unlike in March 2022, when we last published on the divergence, there has already been a big move down in China's currency. As regards prospects for a great convergence, time will tell.

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