The Major bond letter

#25. The Grizzly

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Fixed Income - Rates

Global

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The bond bear woke up feeling particularly grizzly. Sedated by another heavy dose of central bank anaesthetic, including a prolonged period of ultra-low rates and quantitative easing (QE), this was a very angry bear, one that snarled through just about every month in 2022, except July. You are not supposed to wave anything at an approaching bear, but looking at the move in UK gilts, someone must have poked a stick at this one (see figure 1).

What happened in the UK recently and why the previous dip in global yields through July?

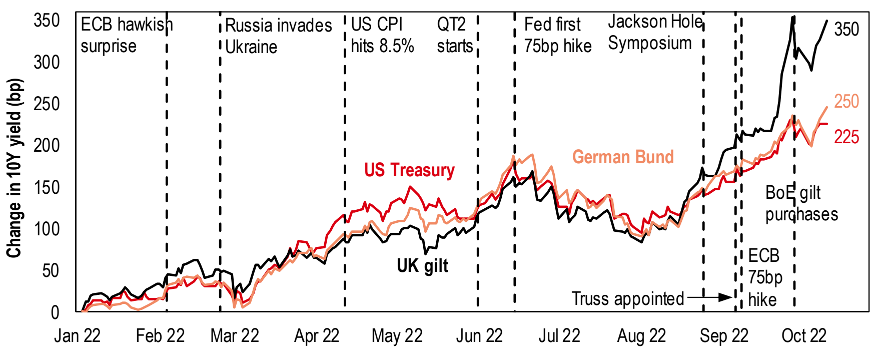
UK gilt yields surged through the last months on announcements of radical fiscal policy loosening and higher policy rates, a move that was accelerated recently by forced liquidations from pension funds. As we can see from the chart this had a read-across to global bonds. Markets are interconnected.

In answer to why global bond yields fell in July, markets were trying to pre-empt the central banks. They were looking beyond the guidance for higher rates to something more dovish, positioning for an inevitable slowdown in both inflation and growth. Central banks led by the Fed used Jackson Hole to put this right. Believe us, we mean it, they said, rates are going up and staying there.

Markets tend to lead the economy and policy makers. When inflation is at unacceptably high levels compared with targets, there is some urgency behind the rate hikes. Previously trapped by their own forward guidance and asset purchases the hawkish central bankers have spent the last few months racing to catch up.

The bear market for bonds is a reflection of both yields moving in advance of the central banks and the belated hawkish guidance. We think valuations for long-term bond yields should also reflect the equilibrium level of policy rates, which is where rates will naturally settle when overall investment matches saving. We cannot observe it easily because it's in the future, some five years hence, where there is assumed to be a return to price stability. This should not be confused with the peak rate, the level above the equilibrium that will have to be reached this cycle.

Figure 1. Yield increases of 10-year benchmarks this year



Source: Bloomberg, HSBC

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We think bond yields are relatively high for two related reasons. Markets are both testing the credibility of longer-run equilibria and exhibiting a recency bias which puts too much weight on the near-term peak rate. Let's look at these more closely.

First, the credibility of forecasts for a return to pre-pandemic equilibria has taken a bashing, not least because of the dominance of fiscal policy, and damage to the disinflationary trend of globalisation. The argument goes that there has been a regime shift which means the pre-pandemic trend of low interest rates is over. Indeed, the shock that started in the UK appears to have had an impact elsewhere, pushing yields still higher.

We look beyond the near-term exogenous shocks. There is simply too much debt in the global economy. And it has only increased to ease recovery from the pandemic and the current energy crisis. Refinancing of debt will weigh on future growth and continue to necessitate a low rate of interest. If there is anything recent events in the UK have shown us it is the role of excessive leverage, and what happens when it goes beyond a tipping point.

Debt overhangs and ageing populations are a large part of the explanation of why inflation did not take-off in the pre-pandemic years. Five years in the future will the backdrop for rates, largely the result of debt and demographics, be much different from 2019? Or, as we believe, will the last few years be regarded as an interruption to the longer-run trend?

Second, recency bias is at work when the focus is on the inflation prints, other near-term cyclical data and the need for central banks to catch-up. The Fed's projections for policy rates to reach 4.50-4.75% are reflected in valuations of short maturity bonds. Even projected five year forwards, yields are more than 100bp over the Fed's longer-term equilibrium.

Central bankers want us to believe that the causality runs from inflation. Their narrative is that until inflation moves sustainably lower, rates will stay high. But markets at some stage will note that global recession probabilities are on the increase, and US policy is even more restrictive given the strength of the dollar and the Fed's shrinking balance sheet.

If today's valuations were less influenced by recent developments, they would attach a decent probability to the scenario of a hard landing. This means that rather than policy rates arriving at the peak and staying there for a very long time, bond yields would also reflect that something might change. Market participants know that the mantra is that central banks hike until there is a recession or they break something.

This has been a bear market that gathered intensity in recent months. For context at the end of July, before Jackson Hole, US and German 10-year yields were more than 100bp lower than today. UK equivalents were some 260bp lower.

Say it quietly so as not to disturb the bear. The most recent surge in yields feels like a capitulation. Bond markets may have finally learnt the lesson. The consequence of this bear market is that nobody wants to fight anymore. By the way, when faced with a grizzly bear do not poke it with a stick. Just lay down, play dead and wait for it to pass.

Previous editions of 'The Major bond letter'

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