

The Major bond letter

#9. Stuck in the middle

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Fixed Income - Rates

Global

The narrative most investors have been presented with is one of a strong economic recovery and reflation. So, why, then, would bond yields be just stuck in the middle of the range for the year?

Recall that through Q1 2021 yields were, according to most, only going up. The US 10-year Treasury touched 1.74% at the end of March, about 120bp higher than around this time last year, with most forecasters projecting a move much higher. In fact, yields today are bang in the middle of the range for the year, at 1.37%.

When analysts and forecasters are saying the same thing – that yields will rise to 2.0% and above – it is easy for this group to dismiss lower yields as a mere technical correction, the result of excessively short positions in bonds that had to be unwound.

Such ex-post rationalisation of position squaring does not suffice, in our view, and a more fundamental explanation for lower yields is necessary. There are at least four good reasons why yields have fallen.

First, optimism has likely peaked. We are not being killjoys here. Sentiment indicators have long been suggesting that much of the data was as good as it gets. On top of this the fiscal impulse will inevitably turn negative next year.

Meanwhile, there's not much help from the rest of the world. Mainland China appears to be slowing, hence the more accommodative monetary policy, the Eurozone is still far from withdrawing its accommodative stance, and Japan is, well, still Japan.

Second, the debt. There was already too much of it before the pandemic struck. Both developed market (DM) and emerging market (EM) total debt levels have risen, the majority from an increase in government borrowing. At the end of 2019 government debt in DM and EM stood at 98% and 54% of GDP. It has since risen to 121% and 63%, respectively¹.

Money borrowed has to be paid back. Tempting as it is to think of government debt as free money when rates are low, this really misses the point. Effectively this is a loan from future generations to support today's, with the hope that stronger growth will make the servicing of the increased debt stock more sustainable. But hope is not a plan. And it is not popular to talk about higher taxation.

Meanwhile the surge in debt levels, which were already problematic pre-pandemic, means it would only take a small rise in rates to result in a big increase in debt servicing costs. We can see strong negative associations between rising debt and falling yields in the major developed markets; as the debt goes up, yields fall. In the corporate sector we can identify falling marginal productivity of debt; as each new dollar of debt raised contributes less to total output than the previous dollar².

According to Fitch, EM debt servicing payments have recently risen to DM levels³. This is because, whilst government debt has increased in both EM and DM, falling DM yields have made the financing more sustainable. Yields have been rising in many EM countries, where the central banks are already ahead of the Federal Reserve in tightening rates. These effects could be even more pronounced if the Fed was increasing rates too.

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¹ BIS and IIF data for Q4 2019 and Q1 2021, using averages for 12 DM and 18 EM economies

² Lee, S.J., Huang, H. and Major, S. *Running out of steam*, 27 June 2021

³ McCormack, J. *Global Perspectives: The Growing Inequality in Global Government Debt Burdens*, 5 January 2021

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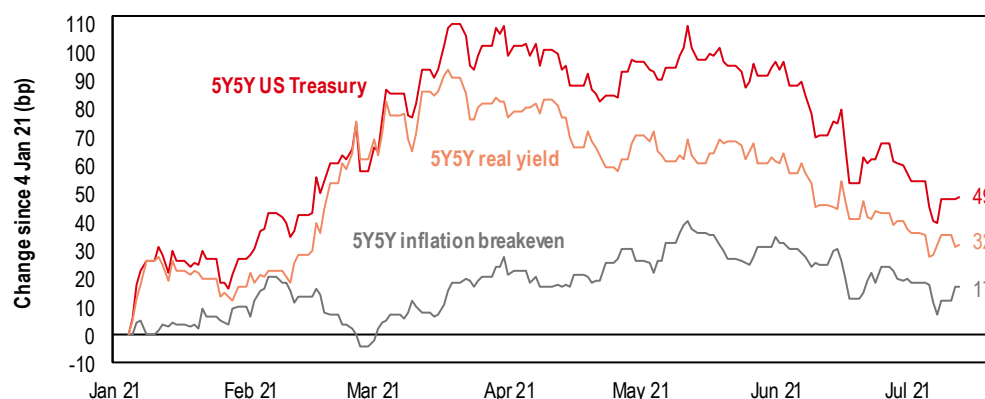
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Third, markets had already been building higher inflation into valuations since last year. We can see this by splitting the nominal yield to show the inflation expectation from what's left over, the real yield (see figure 1). The chart plots the forward measures – the five-year yields starting in five years – and shows how the dominant mover in 2021 has been the real yield.

Figure 1. Real yield dominated 5Y5Y in 2021



Source: HSBC, Bloomberg.

see *Fixed Income Asset Allocation: Calling Captain America*, 10 March 2021,

In the absence of growth, higher inflation is supposed to reduce the effective cost of the debt in real terms. To a large extent this is going to plan: nominal yields have been contained whilst rising inflation expectations and risk premium resulted in a more deeply negative real rate⁴.

The Fed's flexible average inflation targeting (FAIT) could be seen as a commitment to being more reactive than proactive. But it has become clearer that this is not open-ended. As the June FOMC showed, there are those in the Fed that favour rate hikes as soon as 2023.

Fourth, this brings us to the equilibrium level for rates. With some Fed policymakers already thinking about rate hikes, there are questions around whether there has been much of a regime shift after all. Remember that earlier hikes are associated with a pre-emptive policy to nip inflation in the bud.

And, given everything we have said above about debt, the level to which rates might be increased is unlikely to be as high as previous rate cycles. Indeed, long-term forward yields, as shown in the chart, were already above the Fed's long-run dot projection in March, a level that represented value for investors.

In summary, there is a fundamental explanation for bond yields falling back to the middle of the range. We have touched on a few of them here. But please, it's more than position squaring.

Previous editions of 'The Major bond letter'

- #1. [Eurozone common issuance – a long time coming](#)
- #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. [Treasures and trees](#)
- #7. [Inflation rationality](#)
- #8. [Lucky number](#)

⁴ Major, S. *Real yields are a residual*, 26 August 2020

Disclosure appendix

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Source: HSBC

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