



Regime Change in Bond Markets?

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With a steady repricing of global bond markets having contributed to a sharp plunge in global stock markets, there could be a whiff of a new era in the air. Given the failure of both markets and central banks to forecast inflation accurately, we should all be humble about the level of precision attached to the timing or nature of the bond market's next chapter. What we can say is that any such shift will likely be cyclical rather than secular.

After a material repricing of 10-year U.S. Treasuries since September 2017, four factors argue against an imminent regime change in major global bond markets.

First, market pricing of policy rate expectations appears reasonable in the context of a mature U.S. growth cycle and a gradually normalizing inflation environment. The U.S. futures market is now pricing roughly four additional rate hikes through January 2020. This is the first time since the Federal Reserve began publishing its "dot plot" (a projection of where it expects the policy rate will be in the long run) that market pricing has caught up with the Fed.

Second, global bond markets have become increasingly integrated – a spillover effect from post-crisis unconventional monetary policy across major central banks. The Bank of Japan (BOJ) and the European Central Bank (ECB), for example, have reiterated their commitment to loose monetary policies for the time being. Japanese and European overseas bond purchases could well constrain the cyclical repricing of other advanced economy bond yields.

Third, the effects of past quantitative easing matter. Central banks have removed large amounts of duration and convexity from the hands of private market participants. The stockpile of bonds held by these central banks is like a wet blanket thrown over past and potential sources of volatility.

Finally, the equity market correction seems to be a reaction to the lofty exuberance that followed U.S. tax reform and the remarkable strength of global growth. The reining in of extreme equity valuations likely will not stop bond yields from repricing gradually higher in line with the cyclical recovery, and in fact reduces the likelihood that the repricing becomes disorderly (thereby undermining an already mature recovery).

Risks that could usher in a new era for bonds

At the same time, there are three main sources of uncertainty around how, or indeed if, regime change occurs in bond markets.

Most modern U.S. business cycles have been killed by some form of monetary policy shock, or so the saying goes. In the present cycle, the intersection of monetary policy shocks and inflation risk is, atypically, fiscal policy. It is arguable that the substantial uncertainty around the U.S. tax package's impact on the fiscal deficit, growth and inflation is so high that there should be more risk premium in long-term bond yields than is presently the case.

Further, the integration of major bond markets may eventually become a problem as the ECB and the BOJ attempt to normalize policy. Japan's exit from yield curve control could be particularly challenging, if Switzerland's messy exit from price targeting is any indication.

Last but not least is the U.S. dollar, which has depreciated by 10% over the past year versus a basket of global currencies. Dollar weakness has served to export loose U.S. financial conditions to the rest of the world. Interest rate differentials have been persistently in favor of the dollar, reflecting the U.S. economy's earlier recovery. Instead, markets have repriced the dollar progressively weaker as the rest of the world has begun to close the growth gap with the U.S.

If America's late cycle fiscal stimulus were to reestablish U.S. growth leadership, the dollar could yet recover. All else equal, dollar appreciation would export tighter financial conditions to the rest of the world. Given strong cyclical recoveries, depreciating currencies against the dollar could hasten Europe's and Japan's exits from quantitative easing, reignite capital outflows from China (thus forcing China's central bank to tighten policy further) and weigh on commodity prices (a negative terms of trade shock for many emerging markets).

The common thread running through these three risks is that higher bond yields in the short run reinforce the secular case for low bond yields over time. Because of ageing populations and persistently high debt levels across most of the developed world, the sensitivity of global GDP growth to interest rates remains high, even after the healing of the past decade.

Cyclical repricing is not a page-turner

None of the above aims to suggest that bond yields won't continue to rise as the global cyclical recovery matures. Cyclical repricing is not a new chapter for bond markets. The central question is around the persistence of a low-volatility interest rate environment, which worsens the trade-off between higher yields cyclically and lower yields on the secular horizon.

The lesson of the equity correction for the bond market relates to the dangers of an extended period of artificially suppressed volatility. The internal contradiction between central bank efforts to unwind excessive stimulus without generating volatility is prone to be tested as the synchronized global recovery extends.

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