Our bond market, your problem?

Comments from the US Federal Reserve aimed at signalling that monetary policy cannot stay at historically low levels indefinitely have caused bond yields and credit spreads to rise both in the US and abroad. Higher borrowing rates are particularly inappropriate for the Eurozone which, unlike the US, is still struggling to emerge from recession. This tightening of financial conditions will place pressure on the ECB to act.

Although surveys show that investors' bearishness on US government bonds is at an extreme level, suggesting that in the coming weeks bond yields are more likely to fall than rise, the longer-term trend in bond yields is now upwards. But we do not expect the rise in yields over the next two or three years to kill off the US recovery. Consequently, we believe that the US equity market is still on an upward uptrend, albeit one that will experience regular spikes in volatility as the Fed gradually moves away from its ultra-loose policy.

Shortly after becoming US Treasury secretary in 1971, John Connally famously told a group of European finance ministers worried about the export of US inflation that the dollar "is our currency, but your problem." Now it is the US bond market rather than the US dollar that risks becoming a problem for policy makers outside the US. Since Ben Bernanke, chairman of the US Federal Reserve, made it clear in testimony to Congress on 22 May that, if US economic data continue to improve, the Fed could start to slow the pace of bond purchases, the yield on 10-year US government bonds has risen by 60bp to 2.6%.

Fed's words have reverberated around the world…

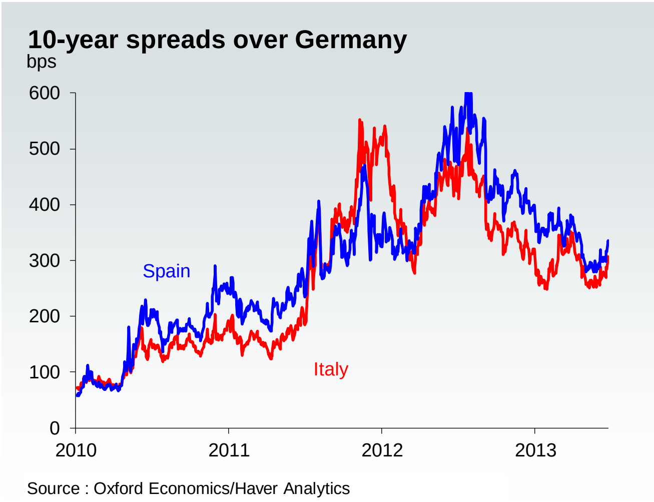
This sharp rise in bond yields has reverberated around the world, causing interest rates to rise in many other key economies, credit and emerging market spreads to widen, equity markets to sell off and volatility to rise, and the price of gold to fall. These asset price moves may well be welcomed by the Fed and are unlikely to have come as a surprise. For some months, the Fed has been warning that, if maintained for too long, low interest rates could undermine financial stability. The Fed is concerned that if it keeps rates low for too long, more investors will grow dissatisfied with low returns and will "reach for yield" by taking on more credit risk, duration risk, or leverage. The Fed wants to stop a bubble developing in these asset classes and remind investors that financial markets are not a one-way bet.

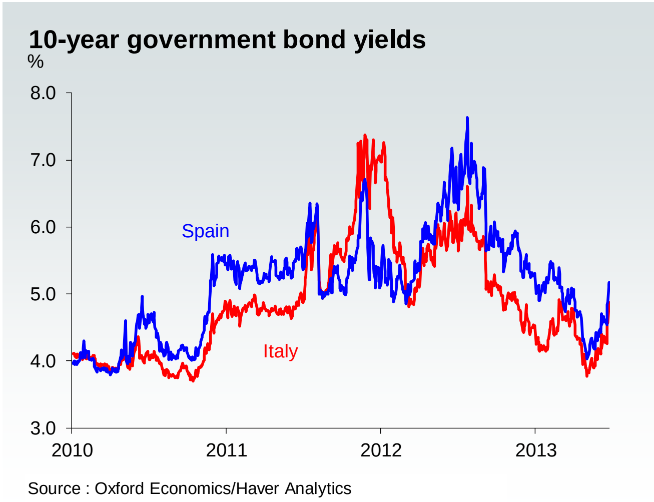
…pushing up the cost of capital

The first steps by the Fed towards a turn in the monetary policy cycle have pushed up the cost of capital not just in the US but also elsewhere. In some countries, particularly those in the Eurozone periphery, this tightening of financial conditions will be far from welcome. Since Bernanke's comments, 10-year bond yields have risen by 40bp in Germany and by around 90bp in Spain and Italy as sovereign credit spreads have widened. As a result, Spanish bond yields now stand at 5.1% and Italian bond yields at 4.9%. They were last around this level in February and March this year, when markets were first concerned about Italy's ability to form a government, following a failed election, and then by the need for a bailout of Cyprus' banking system.

Eurozone not as well positioned as the US to cope with higher rates

Although Italian and Spanish bond yields have not risen to the levels they hit last summer prior to the ECB promise to do whatever it takes to save the euro, they have risen enough to feed through into noticeable increases in borrowing rates for households and companies at a time when the Eurozone is struggling to emerge from an 18-month recession. As such, the Eurozone does not look anywhere near as able to cope with higher borrowing rates as the US. Thanks to falling unemployment, rising consumer confidence, an improving housing market, positive lending growth and a manufacturing sector that is now highly competitive internationally, the US economy looks to be on a much sounder footing than the Eurozone.





Tighter financial conditions place pressure on ECB to act

To make matters worse, the tightening in Eurozone financial conditions due to higher borrowing rates has not been offset by a weaker euro despite bond yields in the Eurozone having risen by more than in the US, but it does open the door to further ECB policy easing. In a speech this week, ECB president Mario Draghi said that the ECB “has an open mind about taking further steps” to ease policy and that an exit from a highly stimulative policy stance remains “very distant”. However, in the past Draghi has said options for further action are under discussion but he has hesitated to enact them.

The policy possibilities open to the ECB include fresh offers of three-year liquidity, perhaps on even more favourable terms than in 2011-12, negative interest rates on deposits held by banks at the ECB, and a variety of asset-purchase schemes, some tailored for specific markets such as credit-starved companies and households in peripheral economies. Given the Eurozone’s complex political and financial systems, each of these options has pros and cons that need to be carefully weighed before they are implemented. However, the tightening of Eurozone financial conditions following the Fed’s first steps towards a turn in the US monetary policy cycle may soon force the ECB to make a decision.

Fed officials have now started to try to reassure markets

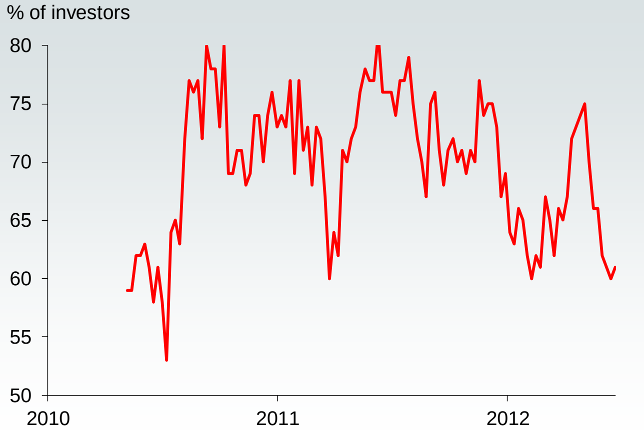
The Fed will do all it can to ensure that when it does start to tighten it does not kill off the economic recovery. Indeed, a rise in equity market volatility in response to the Fed’s actions has already caused Fed officials to try to reassure markets. For example, Richard Fisher, president of the Federal Reserve Bank of Dallas, said “what we’re talking about here is dialling back” and “the word ‘exit’ is not appropriate here”. Wednesday’s downward revision of Q1 US GDP growth from an annualised pace of 2.4% to 1.8% will give the Fed further reason to be cautious about the pace at which it tapers bond purchases.

Near-term bond yields may well fall, but longer-term trend is upwards

The combination of these more soothing words from the Fed and surveys showing that investors' bearishness on US government bonds is at an extreme level suggests that in the coming weeks bond yields are more likely to fall than to rise. However, we believe that the longer-term trend for bond yields is upwards. By the end of 2015 we expect the US 10-year bond yield to be 3.3%, 80bp above its current level.

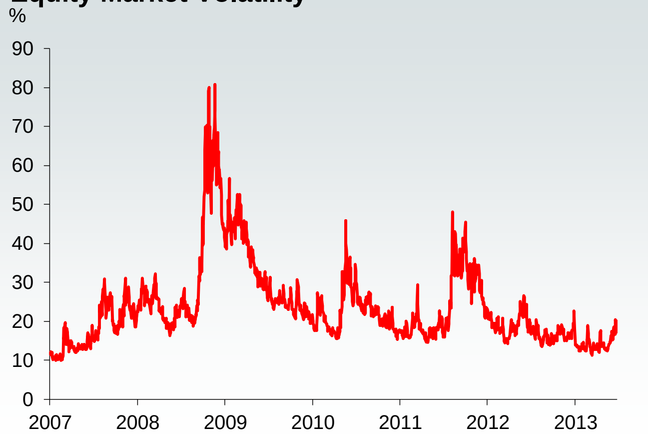
Such a rise is unlikely to prove sufficient to kill the US recovery. We continue to expect the US economy to gather pace, with GDP growth of around 2.5% in both Q4 2013 and Q1 2014 and then growth of 3% later in 2014. Consequently, we believe that the US equity market is still on an upward trend. The spike in market volatility, to a level last seen late last year when concerns about the US sequester were at their peak, will probably come to be seen as a contrarian buying opportunity.

Bullishness on bonds



Source : Oxford Economics/Haver Analytics

Equity Market Volatility



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