In Focus

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ECONOMICS

Why Do They Love Bonds? Let Us Count the Ways

by Avery Shenfeld and Ian Pollick

It's not just a fixed income story. Because why the market has had such a love affair for government debt and what all this says about perceptions for where the global economy is headed, has implications for decision makers across the financial, business and government community.

The rally has seen German 10-year rates dive into negative territory. US 10-year Treasuries sit at their lowest yield since September 2017, despite the fed funds rate being up 125 basis points since then. In Canada, 10-years are at only 1.55%. All of that despite the fact that, in both the US and Canada, unemployment rates hover at multi-decade lows.

In essence, there are three elements to the story. The first, a fall in expected inflation, is generally benign about what it says about the future. The second, a declining neutral rate of interest, is a bit more concerning. The third, tumbling confidence about global growth, is the one to worry about.

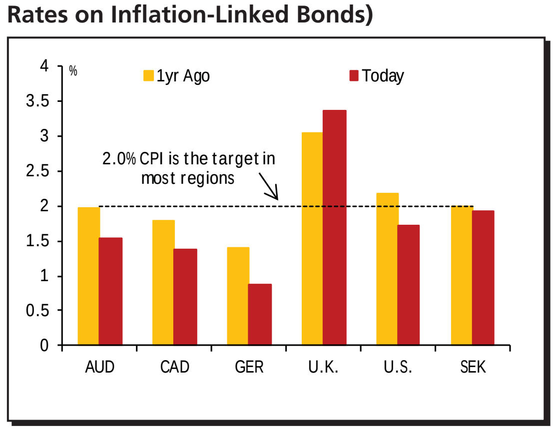
Inflation Worries Have Vanished

The most benign bond market driver lies in inflation expectations. Judged, if somewhat imperfectly, by where inflation-linked bond yields sit relative to ordinary government bonds, the expected rate of inflation over the next decade has dropped over the past year. The UK aside, major markets are betting that inflation in the coming decade will generally be below central banks' objectives (Chart 1). Not only can long rates be lower due to the lack of a need to compensate for inflation, but since inflation has also been seen as less volatile, its reducing the additional risk premium that long rates historically added for the uncertainty over where inflation might head.

While many think of low inflation as an unambiguous plus, given that on its own it boosts purchasing power, it's associated with sluggish growth in both prices and wages. Economists worry that excessively low inflation begets lower nominal interest rates at the peak of the cycle, which in turn leaves less room for central banks to lower them when a recession hits.

But in the here and now, there's a bright side to tame inflation. It's been key to letting the central banks err on the side of keeping policy rates lower, and thereby reducing the risk that they would spark a recession by hiking excessively. The US Federal Reserve, for example, has paused on rates after a much smaller deceleration in employment

Chart 1
10-Year Inflation Expectations (Breakeven Rates on Inflation-Linked Bonds)



Source: Bloomberg, CIBC

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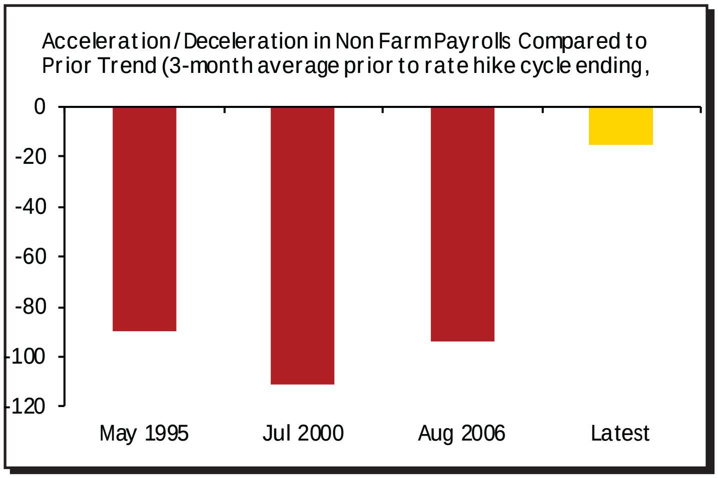
Chart 2
Fed Paused After Smaller Job Slowing This Time



Source: Federal Reserve, Bloomberg, CIBC

than what it took for it to put away the rate hike weapon in the past (Chart 2).

Are markets right about inflation? Perhaps not. Canadian inflation is still trending right at 2%. We're in Chairman Powell's camp in judging that the recent pullback in US price momentum looks temporary, tied to non-cyclical one-off developments. US wages have accelerated, raising both purchasing power and, unless productivity sustains a faster pace, labour costs. Even a return to a 2% expected inflation rate in the US will put some upward pressure on long rates.

Rethinking the Neutral Rate

Although it played a lesser role in the most recent leg of the bond market rally, a fall in expectations for where the so-called neutral rate lies has also helped sustain lower bond yields in this cycle. The neutral rate – defined as the level that would sustain full (non-accelerating-inflation) employment once the economy has reached that mark has been tumbling over the past two business cycles.

That reflects both the lower inflation noted above, and a lower real neutral rate. With more GDP growth coming from sectors that don't entail heavy capital spending, and the cost of technology-related capital goods steadily dropping , the economy generates less capital spending at any given interest rate. It therefore takes a lower real rate of interest to get enough capital spending to recycle what households save back into the economy.

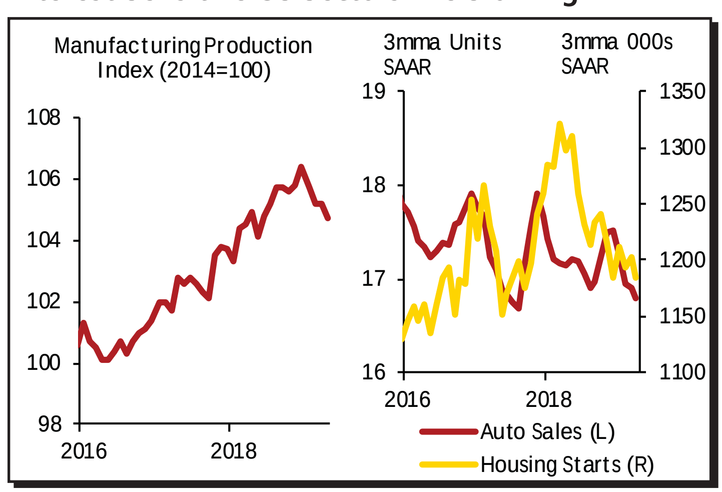
Recent evidence has reinforced perceptions that the current fed funds rate in the US, and the even lower overnight rate in Canada, are already acting as a braking force on interest sensitive demand. The Bank of Canada judges today's rates as stimulative, but that's not been in evidence in either housing activity or durable goods purchases in the past year. Stateside, we're also now off prior peaks in three interest-sensitive, cyclical indicators: manufacturing, auto sales and housing starts (Chart 3).

On neutral rates, our sympathies are mostly in line with the markets'. Even if Canada's neutral rate could be higher in the very long run, for the foreseeable future, heavy household debt levels are countering any stimulus from interest rates where they are. Moreover, raising rates while the US is on hold would send the Canadian dollar stronger, adding a drag on exports. In the US, we concluded some years ago that the real neutral rate might be only 0.5%, implying a nominal neutral rate close to where the funds rate now stands.

Low real neutral rates carry an undesirable side effect. Along with low inflation, they increase the odds that monetary policy won't have enough room for rate cuts to provide adequate stimulus in the next recession. And they increase the risk of generating bubbles in interest-sensitive asset prices that lead to harder corrections during such economic downturns.

But even if rates are now near neutral, where the bond market has headed implies that we will need to shift to stimulative rates in the near future. That's not as obvious, or at least, not for this year. In North America, no central bank speaker has called for a rate cut in 2019. Second quarter growth does look soft in the US, but some of that is just a correction after an upside surprise

Chart 3
Interest-Sensitive US Sectors Are Slowing



Source: Haver Analytics, CIBC

in Q1 tied to excessive inventory building. Income and employment gains in the household sector should see Q3 growth improve enough to keep the Fed on the sidelines. Canada's Q2 growth rate looks to top the Bank of Canada's low-bar forecast.

Setting aside global considerations, if there's a made-in-North-America driver for lower policy rates its going to come from the swing from US fiscal stimulus to fiscal tightening that could hit in 2020. But the bond market might have trouble sustaining today's yields if we're waiting that long for the Fed to lower rates.

This Means War: Trade War, That Is

The most worrisome driver of the latest leg of the bond market rally owes to a flight to safely from assets dependent on global growth. Investors are taking money off the table from after what has been a long bull market in equities, and parking money in what had been earlier judged to be unattractively low fixed income yields.

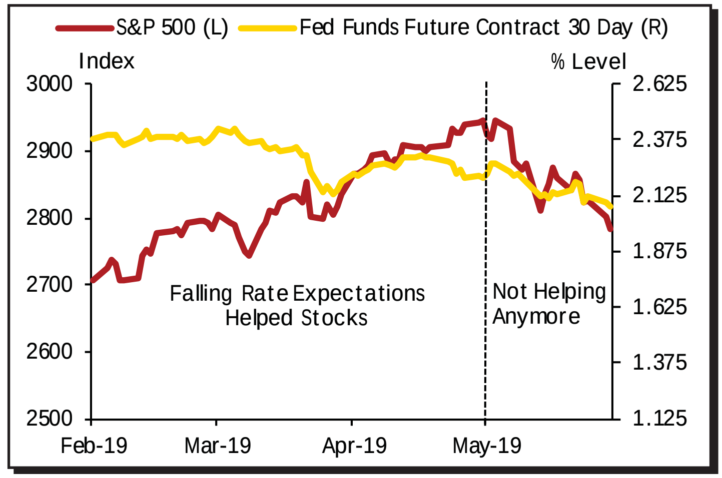
Its no accident that this retreat in stocks this has come alongside a breakdown in China-US trade talks. Earlier equity market jitters came and went with similar developments on the trade front. As CIBC Economics highlighted in an earlier piece (Trade War Impacts are All in Your Head), the risks to the economy go beyond what economists can readily quantify. A trade tiff between China and US, and the threat that after a 180 day delay the US will reopen the question of tariffs on European and Japanese vehicles, threatens to undermine business confidence, and thereby cut into hiring and capital spending plans.

Stocks aren't falling because investors suddenly decided that trailing earnings multiples were too high. After all, dampened interest rates should on their own raise equity multiples. They are falling in sympathy with fresh uncertainty over the global growth outlook. That's showing up in a rising VIX, a measure of implied volatility, a traditional benchmark for worries about what might lie ahead.

Note that when Fed rate expectations were falling earlier this year, that prompted a relief rally in stocks as markets worried less about growth-killing monetary tightening (Chart 4). Now, the bond market's message isn't one of hope that dovish policy will extend the economic cycle; it's a signpost of fear that the expansion will end. That

Chart 4

Falling Rate Expectations No Longer Helping Stocks



Source: Bloomberg, CIBC

hasn't yet become enough of a fear to send corporate spreads soaring, but it's material.

Is the bond market right about this third driver? We're betting again that it's not, because while it may now take quarters rather than weeks, some cooling of trade tensions seems likely.

A falling equity market will put pressure on the White House to re-engage with China, even if the President continues to believe that it's the Chinese who pay the US tariffs. A squeeze on China's trade sector, and the longer term damage that could come if facilities relocate, can't be papered over forever by Beijing monetary and fiscal stimulus. Canada's own China troubles could themselves be easier to deal with if there's a US-China rapprochement. Even a restart of US-China trade talks could therefore be a signal to the bond market to reverse some of the recent rally in yields.

Summing up, when it comes to low bond yields in this cycle, get used to it. Low real neutral rates are here to stay, inflation isn't due to surge ahead, and there's a US slowing coming in 2020 as fiscal stimulus fades out. But there are reasons to believe that today's rally will at least partially reverse in the next couple of quarters if trade tensions cool, US core inflation edges up, and most importantly, we takes steps towards avoiding a protracted all-out trade war.