The Countervailing Forces on Bond Yields and the Timing of a Rise

Bond markets have been a poor predictor of changes in Fed policy.

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Recent bond market action has the look of an irresistible force confronting an immovable object. The irresistible force is the rapid acceleration in inflation and nominal growth combined with a precarious supply/demand balance for bonds, and the level of nominal and real interest rates offering little incentive to take down the supply. The immovable object is the Fed and other central banks' desire to suppress a rise in interest rates that would otherwise offset the fiscal stimulation that is being applied. Their weapons are zero short-term interest rates, forward guidance pertaining to that, direct purchases of bonds, and a layer of private sector liquidity from aggressive MP3 actions.

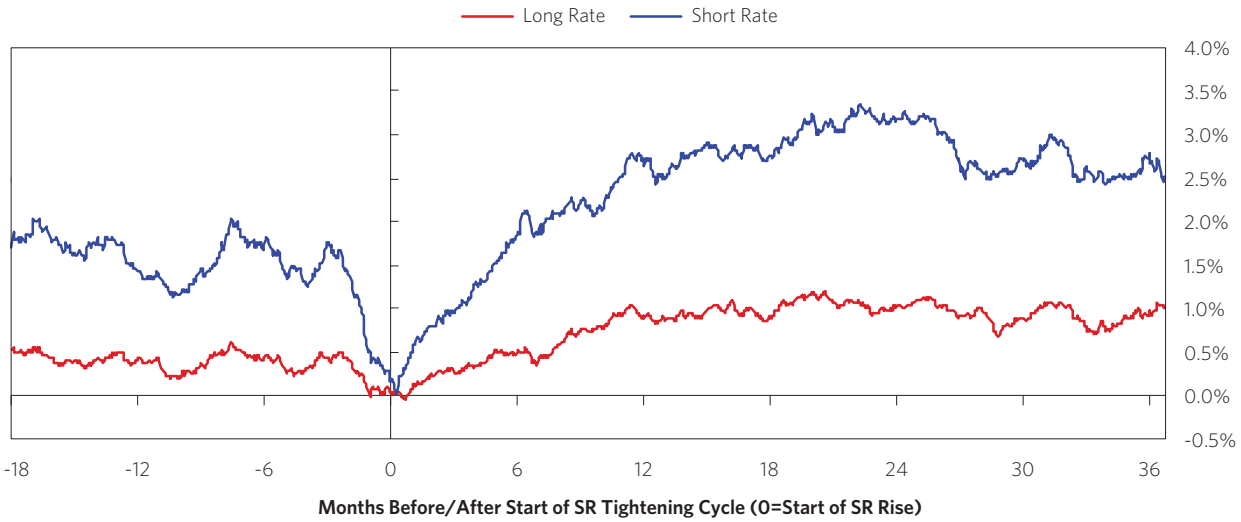
How long might this standoff last? The best answer is that it will last until conditions become incompatible with the Fed's economic goals (e.g., inflation or the currency getting out of control). Playing that out, given that the suppression of interest rates—intended to prevent a hot economy from pushing up yields—actually heightens those very pressures, the logical implication is that the Fed and other central banks will increasingly be pushed to change course and tighten policy. As for timing, uncertainty is increased by recurring waves of the virus, though the more virus waves occur, the less economic impact they are having. As we see it, it is a matter of time before policy preferences shift and the immovable object gives way to the irresistible force. And until then, the spread between cash flow yields and interest rates will remain very wide.

Historically, Bond Yields Haven't Led Central Bank Tightening by Much

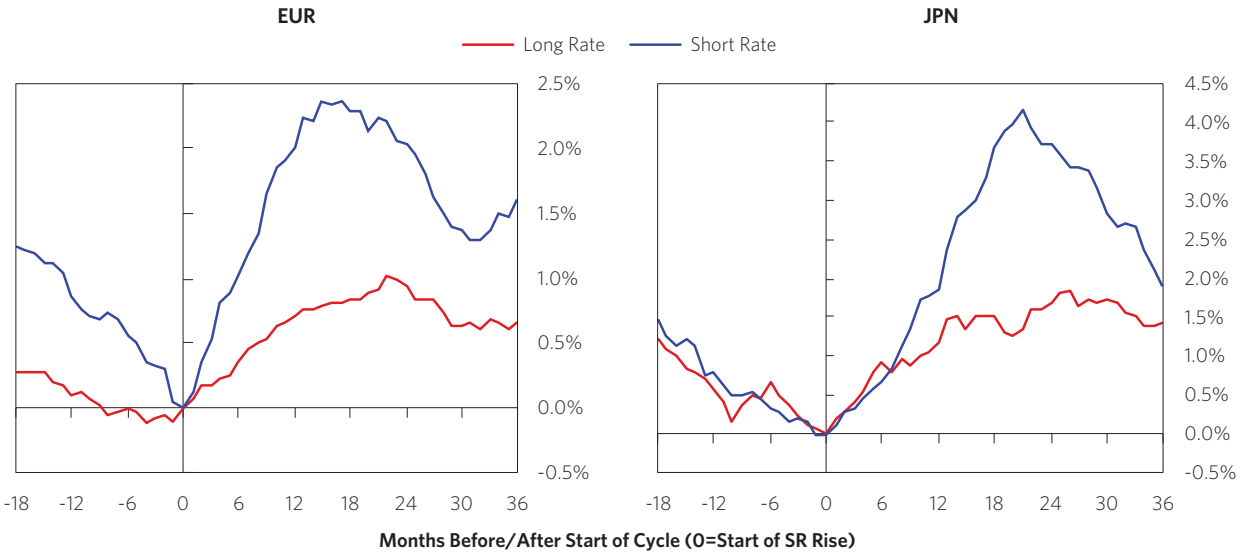
While the policy intentions of the Fed and other central banks are the primary weight holding down bond yields, it is an interesting observation of history that the bond market has not been a far forward discounter of future changes in central bank policy. In fact, even though most rises in short-term interest rates (the Fed's primary policy tool until recently) have been clearly foreshadowed by the economic conditions that caused them, the history of the bond market is that bond yields haven't risen until just before the rise in short-term interest rates takes place. The following chart shows the average pattern of US bond yields just before the bottom and initial rise in short-term interest rates in the US across 12 cases since 1955. On average, bond yields have only led the move in short-term interest rates by less than a month.

USA Nominal Rates Through Start of Tightening Cycle

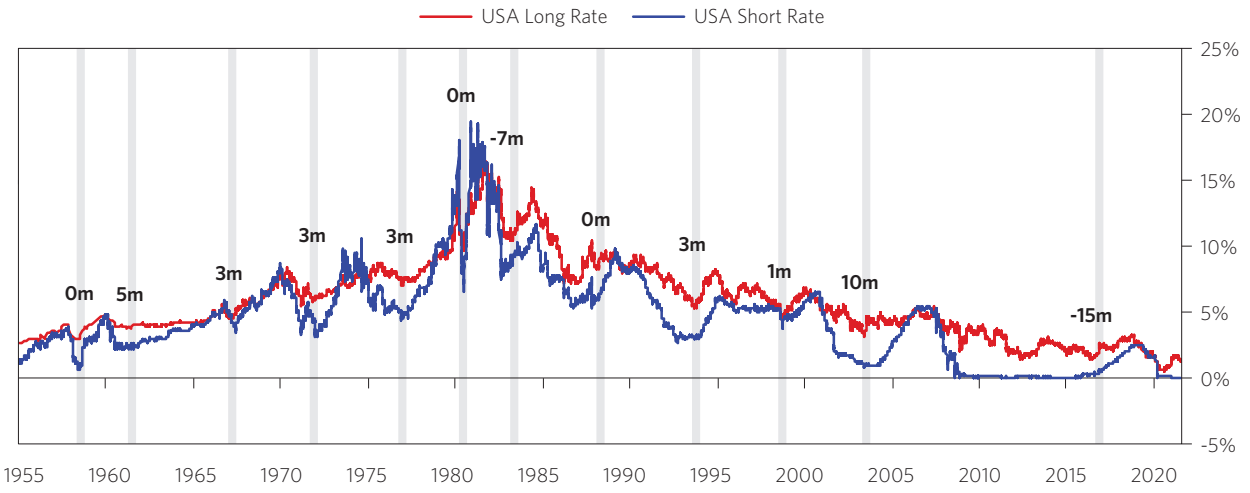
(Cumulative Average Rate Changes, Indexed to Cycle Start, 0=Start of SR Rise, Since 1955)

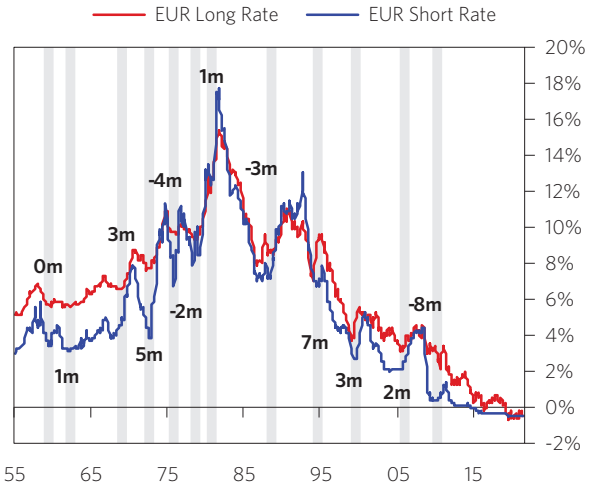


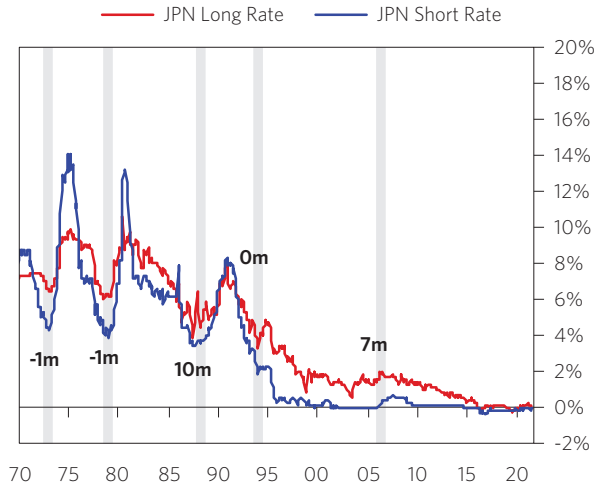
The same tendency has also been the case in Europe and Japan, with an average lead time of less than a month and three months, respectively.



The following charts show all of the cycles in the three economies, with each bottom in short-term interest rates marked in gray and the respective lead or lag time of the bond yield shown.







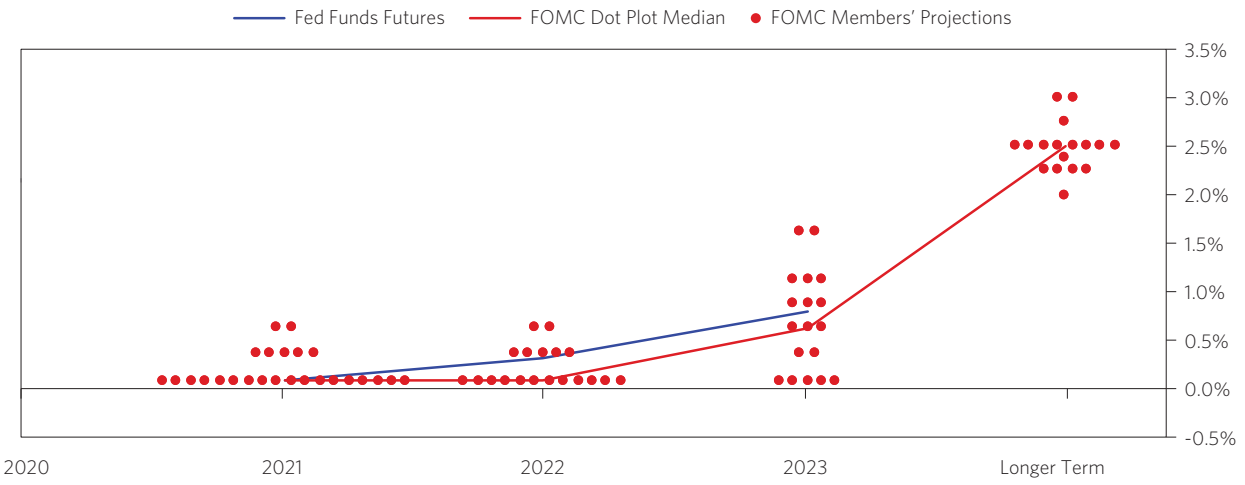
The following table summarizes all of the cases above. What is remarkable is that the bond market has hardly ever led a rise in short-term interest rates by more than a few months (a negative number means the bond market lagged the rise in short-term interest rates).

USA		EUR		JPN	
SR Bottom	**LR Lead (m)**	**SR Bottom**	**LR Lead (m)**	**SR Bottom**	**LR Lead (m)**
Jul 1958	0	Jul 1959	0	Nov 1972	-1
Oct 1961	5	Mar 1962	1	Oct 1978	-1
Jun 1967	3	Feb 1969	3	Mar 1988	10
Feb 1972	2	Aug 1972	5	Dec 1993	0
Apr 1977	3	Oct 1975	-4	Feb 2006	7
Jun 1980	0	May 1978	-2		
Oct 1982	-7	Aug 1980	1		
Mar 1988	0	Jun 1988	-3		
Feb 1994	3	Aug 1994	7		
Oct 1998	1	May 1999	3		
Apr 2004	10	Sep 2005	2		
Jul 2015	-15	Dec 2009	-8		
Average	0.5m	Average	0.4m	Average	3.0m
Range*	5m lead to 7m lag	Range*	5m lead to 4m lag	Range*	7m lead to 1m lag
Full Range	10m lead to 15m lag	Full Range	7m lead to 8m lag	Full Range	10m lead to 1m lag

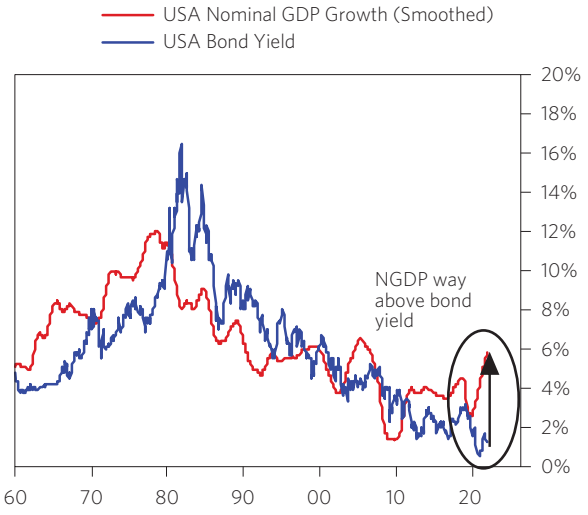
**Range excludes the largest and smallest values in each instance*

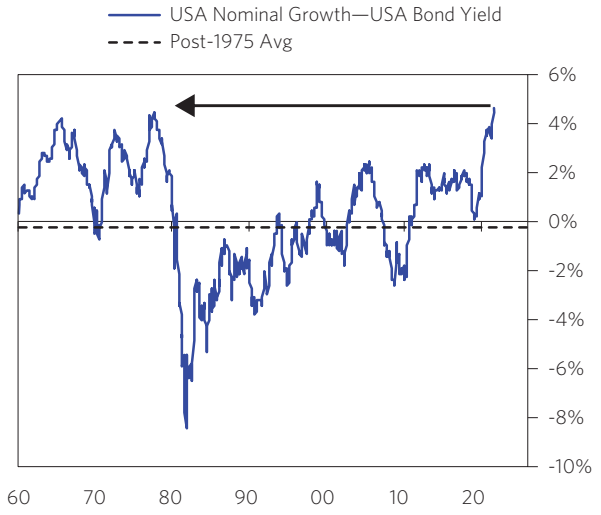
Of course, bond markets today are not the same as they have been in the past. Central banks are now major players and are using new tools, like quantitative easing, that add an additional variable beyond short rates for investors to consider (e.g., investors may sell bonds in anticipation of a tapering instead of a short rate tightening). But these changes make bond markets less equipped than ever to discount future conditions correctly. Interest rates are now less a market-based measure of economic conditions and more a reflection of what interest rate level policy makers think will generate their desired economic outcomes. So when we see markets pricing in a continuation of low inflation conditions and very little tightening despite inflationary pressures mounting across inputs and outputs in response to inflationary policies, we think it is likely another time when bond markets are under-discounting the extent of the inflation and tightening that lies ahead.

If things play out similarly this time around (i.e., the bond markets don't move until right about when the Fed does) and if you believe that the Fed will do what they indicate (two big "ifs," but good to consider), a rise in bond yields would be unlikely for a while, as the Fed has indicated that it will stay easy and continue to lag the economy. However, what is not considered in this scenario is that the Fed will respond to actual conditions as they unfold, and whatever they had previously indicated will have no bearing on what they actually do. Below are the current dot plots, which implicitly reflect an expectation of future economic conditions, including an expectation of a quick transitory path of inflation, which the unfolding evidence increasingly suggests is unlikely.



From a positioning standpoint, the longer it takes for interest rates to rise, the longer the current, very wide spread between nominal income growth and interest rates will persist, which favors high-cash-flow-yielding assets funded by bonds during the intervening period. With respect to our process, continuing to build out a diversified set of ways to capture this is an area of emphasis in our research.





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