FINANCIAL TIMES

MARKETS INSIGHT

July 23, 2015 9:37 am

Bond markets out of kilter with rate reality

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Complacency on policy expectations keeps front-end yields low

Any nasty bear market for bond investors usually involves the two-year sector, reflecting its proximity to overnight borrowing costs set by central banks.

In previous cycles of rising interest rates, the so-called "front end" of government bond markets, where debt maturities extend for upwards of 30 years, has been the epicentre of pain for traders and portfolios.

Once a central bank starts shifting overnight policy rates higher, the animal spirits of the market are feverishly aroused, spurring investors to shun two-year paper as they price in the risk of further rate increases.

That certainly characterised the performance of short-term Treasury paper in 1994, 1999 and 2004, when the US Federal Reserve tightened policy, with two-year yields surging and prices plummeting.

This time, the typical reaction function of bond markets in the US and UK is strikingly absent even as the drumbeat of rate rises starting later this year has intensified on both sides of the Atlantic.

Such behaviour amounts to the Treasury and Gilt markets calling the bluff of their respective central bankers, or displaying a remarkable degree of complacency that leaves investors at the risk of being surprised by any aggressive switch in policy over the next couple of years.

While many economists forecast a shift higher in Federal Reserve policy beckons in less than two months when the central bank meets in mid-September, the bond market's barometer of policy intentions is stuck in a rut.

The current US two-year note yield of 0.7 per cent is where the benchmark was trading in late 2008, way back when the Fed embarked on its grand easy money adventure.

Moreover, the extent of the market's sangfroid over US policy expectations is illustrated by how the US two-year note yield has remained below 1 per cent since April 2010.

That is the last time investors seriously priced in a sustained series of tightening shifts from the Fed. One can therefore discern that the bond market believes or trusts Janet Yellen when she says the path of forthcoming rate increases will be very gradual in nature.

"The message has not been lost on the front end of the curve, helping essentially eliminate its usual overreactions in front of the start of a protracted rate tightening cycle, despite widespread expectation that the first rate hike is likely to take place by the end of the year," says Anthony Karydakis, chief economic strategist at Miller Tabak.

A similar story prevails in the UK, and at a time of heightened speculation over when the Bank of England may also call time on the era of near-zero rates.

After a recent priming by Mark Carney, the BoE governor, that rates could be shifting upwards at the turn of the year, the release of minutes from this month's Monetary Policy Committee meeting on Wednesday, only fanned the flames.

No matter growing concern over firmer UK inflation in the future, the current two-year Gilt yield of 0.64 per cent sits just above the Bank's overnight rate of 0.5 per cent, while May 2011 represents the last time this benchmark was north of 1 per cent.

Such low levels for front-end yields represents faith in the idea that there are plenty of headwinds facing the global economy, translating into modest and protracted US and UK tightening cycles in the coming years.

Bond investors also have an ace in their pocket in the form of a rising dollar and pound. A firmer currency helps tighten financial conditions and it remains to be seen how many US multinationals and the economy will cope with renewed dollar strength.

While currencies have appreciated during past rate rise cycles, the US and UK stand out as the only major central banks likely to walk that path in the coming year. At a time when some 25 other central banks have eased policy in the past seven months, there is a real risk of the dollar and pound rising much further than warranted by policy expectations, weighing on economic activity.

Hence the confidence of bond investors in maintaining low front-end yields, but such thinking means any significant acceleration in the economy and inflation that prompts a faster pace of tightening, will represent a genuine market shock.

There may well come a time for the restoration of the front end's normal reaction function, challenging the current assumptions of US and UK bond markets.

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