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Bond sell-off reveals market's new equilibrium

James Mackintosh

Japan's bond bear market in 2003 offers clues on what is to come

When it comes to bond sell-offs, it is hard to beat the deeply illiquid Spanish 50-year: the *price* fell by a fifth at its worst point today.

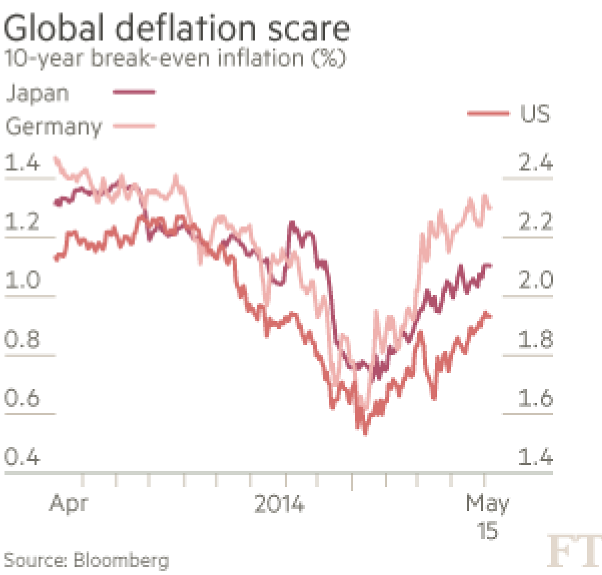
The real focus was on the wild swing in the German 10-year Bund, though, the benchmark for the eurozone. Its yield leapt 19 basis points, equivalent to the biggest one-day move since the market misinterpreted the European Central Bank in August 2012.

Was this capitulation by the bond market bulls, who drove Bund yields to an all-time low just fractionally above zero last month? The rapid reverse in the yield to end the day almost unchanged suggested it might be: once those who were betting on lower yields had finally sold in panic, the market found a new equilibrium.

Japan in 2003 offers a handy guide to what happens in the aftermath of a speculative bust in bonds. The 10-year Japanese bond yield hit its then-record low in June 2003, after a remarkable low-volatility rally. Just as with this year's Bund rally, Japan led global bond yields down, even as the US Federal Reserve was discussing when to start raising rates from their cyclical low.

The bust was remarkably similar to the past three weeks in Bunds. It started slow, had a big sell-off, a pause, a series of big sell-offs and then a wipeout mostly reversed within the day. The overall drop in price was very similar, at 5-6 per cent, though Japan took 17 days, against Germany's 13.

In Japan a sharp relief rally provided several weeks of falling yields, before a renewed sell-off took yields up to stand 1.2 percentage points above where they started in just 59 trading days.



There was some good news. As Jim McCormick at Barclays points out, Japanese shares rose with yields in 2003, and carried on up 40 per cent over the next year.

But while Japan might provide a lesson for the pattern of busts common to the unwinding of many popular speculative trades, it is less clear as a guide to shares. Back in 2003 Japanese stocks were deeply out of favour, having fallen by half from their bubble peak three years earlier. In Europe today stocks are the most expensive since 2002 and, before recent falls, had risen a third in just over six months. A lot of good news is already priced into European shares.

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