ARDEA Investment Management

What's driving the bond rally?

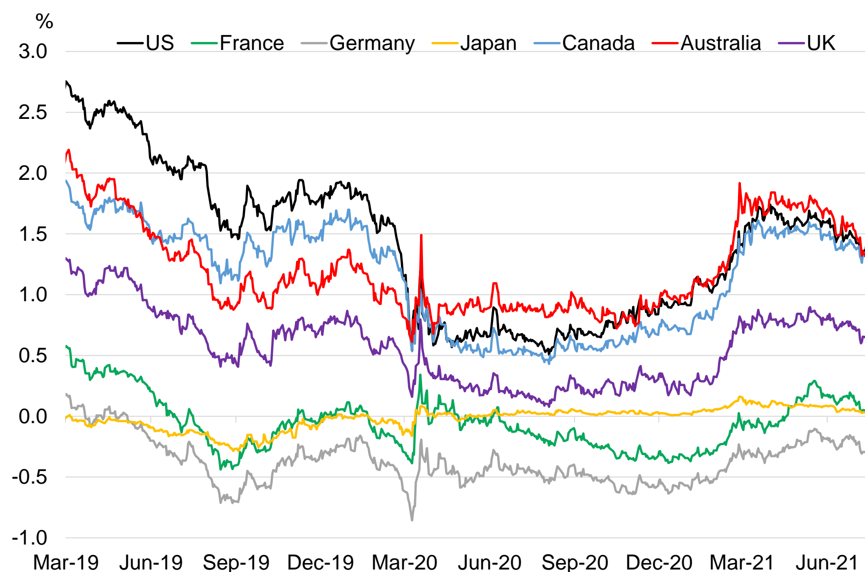
- Bond yields hit five-month lows in July, reversing much of the Q1 sell-off and confounding consensus.
- Lower yields partly reflect concerns over a rise in global Covid case numbers.
- There are, however, many other factors at play, including positioning technicals, a sense of data "peaking" in large economies and a perception that central banks will cap upside inflation risks.
- Long term forward rates at current low levels imply a pessimistic outlook for growth or a view that structural headwinds have significantly lowered the neutral policy rate.
- Market narratives can change quickly – the path for growth, inflation and QE tapering over coming months can challenge current low rate pricing.

Bonds rally despite a continued rebound in global growth and inflation

Bonds endured a rough start to the year, registering significant losses in Q1. Consensus subsequently shifted heavily against duration and forecasters lifted bond yield targets significantly alongside upward revisions to global growth and inflation. Q2 delivered stronger global growth and inflation outcomes, while many indicators suggest this solid pulse will be sustained. Equities remain close to recent highs. And central banks are incrementally signaling a shift away from super easy policy settings.

Yet despite this backdrop, bonds have rallied significantly over the last few months. Long term yields across developed markets are well below the highs reached in March (Chart 1). At the time of writing 10y nominal yields in the US and Australia, for example, are down 46bp and 73bp, respectively, from March peaks. The equivalent 30y yields have fallen even further. We outline the range of temporary and structural factors driving the rebound in bonds, along with potential catalysts for a turnaround.

Chart 1: 10Y Bond Yields

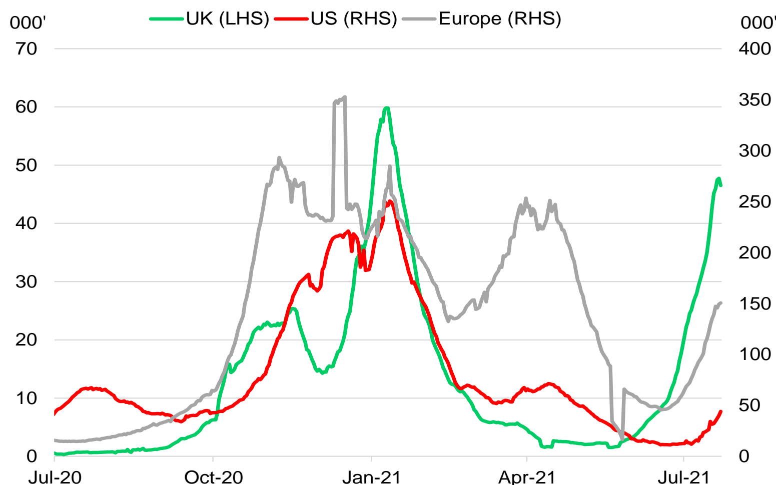


Source: Ardea, Bloomberg

Covid still poses risks to the recovery and relative bond market performance

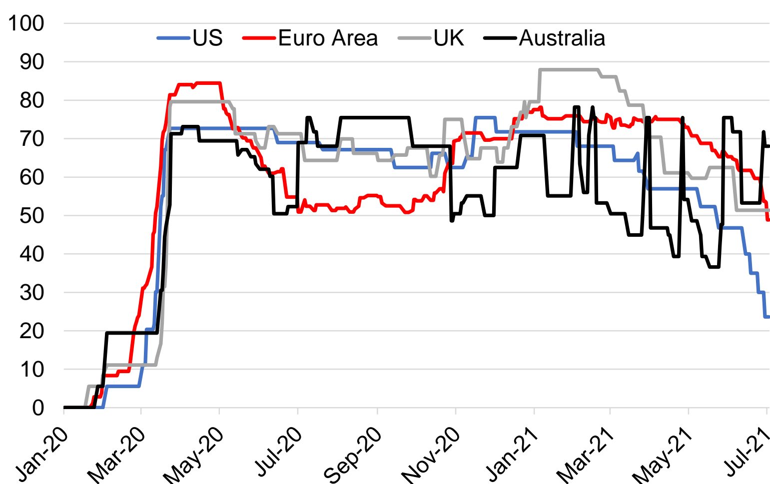
The recent rise in global COVID-19 cases and spread of the delta variant has added a sense of caution to markets. So far, the rally in bonds has been the clearer sign of this caution, with only a few wobbles in equities. Global case numbers have risen noticeably over the last month across many countries, including in large developed economies such as the UK, Europe and US (Chart 2).

Chart 2: New COVID-19 case numbers (7d MA)



The rise in case numbers may not lead to a significant global slow-down or further rally in bonds if vaccinations are effective. The UK, for example, has high vaccination levels and has seen cases rise to near January's peak but with much lower death and hospitalization rates, which has led to less stringent lockdowns and social distancing measures. The Oxford COVID-19 stringency index (Chart 3) shows a trend lower in restrictions over the last month in the US, Europe and UK even as cases are rising.

Chart 3: Oxford stringency indices



If large economies can remain open in the face of rising cases, bonds can reverse some of the recent rally. This may not prove to be a smooth or quick adjustment. Cross market variations can also be substantial. Chart 3 also shows the recent tightening of restrictions in Australia. At the time of writing, a large share of

the Australian population is in lockdown, which some economists estimate is enough to drive Q3 GDP growth negative. The rebound, when it comes, will be swift based on the experience of the last year. But the RBA does have flexibility with QE if lockdowns are prolonged (see here for latest policy details). That could see a further outperformance in Australian bonds relative to global peers, such as the US, until vaccination rates rise (Chart 4).

Chart 4: Aus-US 10y yield spread

Source: Ardea, Bloomberg

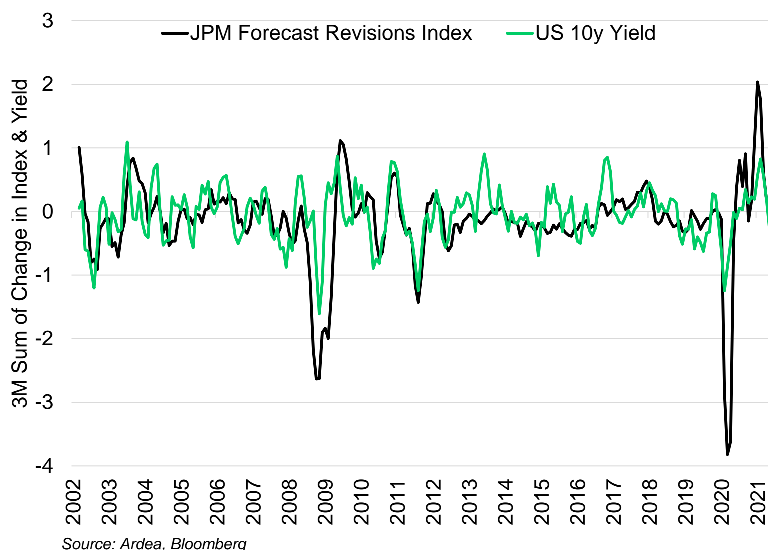
Economic data as good as it gets?

Global growth and inflation numbers have been strong over H1 2021, particularly in the US, where bond markets have typically been the most responsive to data (a function of the size of the market and recent US fiscal stimulus). To cite just a few recent indicators:

- Global PMI surveys are still consistent with well above average activity.
- The IMF recently upgraded its 2021 global growth forecast to 6%.
- The US economy added 1711k jobs in Q2 (including 850k in June).
- US headline CPI is running at 5.4% y/y and the core measure at 4.5% y/y.

Markets adapt and are forward looking. While some key data releases beat expectations, in Q2 yield curves were better priced and market participants less shocked by stellar numbers than in Q1. As Chart 5 shows, the first few months of the year saw an historically large upward revision to global growth forecasts, which helped to propel yields higher. Growth revisions were still biased higher over the last few months, but the momentum has slowed. The fact the recent rally has been more real than nominal yield led (inflation expectations have fallen only modestly) underscores greater market concerns with imminent downside risks to growth than inflation.

Chart 5: Global growth forecast revisions index vs US 10y yield



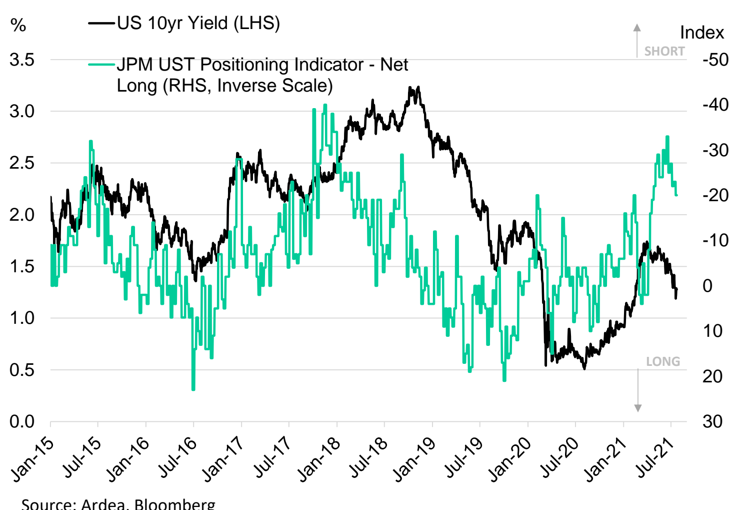
Source: Ardea, Bloomberg

Looking ahead it is inevitable that US growth rates will slow from very strong levels as reopening effects and (non-infrastructure related) fiscal stimulus fades. Similarly, in China, growth is set to moderate and the PBOC recently cut the reserve requirement ratio 50bp to support key sectors of the economy. While this moderation should be unsurprising and probably won't change how other central banks think about monetary policy, many bond market participants see information value in peaking growth momentum.

Positioning technicals supporting the rally

Market positioning has exacerbated the rally in bonds in recent months. The popularity of the reflation theme in the wake of large upward revisions to growth and inflation in Q1 led long term investors to underweight duration and shorter-term focused traders to pile into leveraged short positions in bonds. The JP Morgan duration survey in Chart 6 shows that investors were around the shortest levels in duration since 2017 near the year-to-date peak in yields. That left a rally in bonds as the path of least resistance. Covering of short positions could continue to suppress yields until positioning becomes more balanced. Thinner markets in the northern hemisphere summer could exacerbate this theme, but evidence of this effect is historically inconsistent.

Chart 6: Positioning indicator vs 10y yield



Source: Ardea, Bloomberg

Fed reaction function – a risk management approach

The June FOMC meeting surprised markets with a hawkish message. The Fed raised the prospect of earlier policy tightening, with the median governor forecasting two hikes in 2023, compared with none at the March meeting. The reaction in interest rate markets was a sharp flattening of the yield curve (Chart 7), initially via a combination of both higher short term and lower long term yields. The fall in longer term yields was the most significant move.

Chart 7: US 5y vs 30y yield curve spread

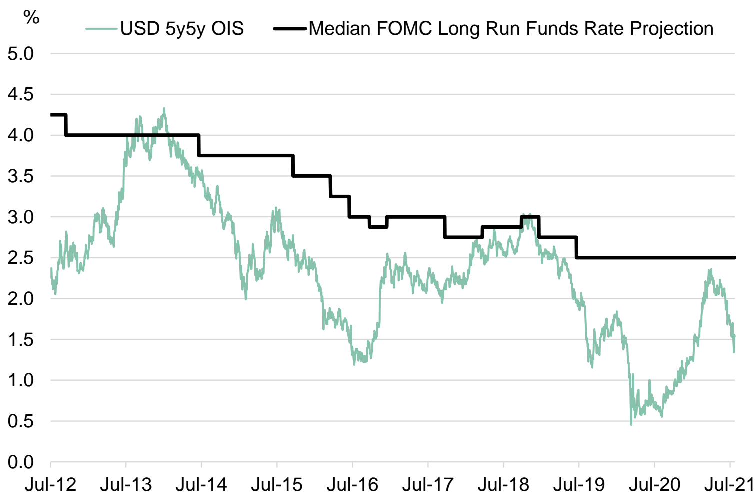
The counterintuitive result of earlier rate hike projections driving long term yields lower is the result of how markets see the distribution of future inflation risks. By acting earlier, inflation is thought to get less out of hand and therefore less overall rate hikes will be needed across the cycle. The cycle peak ultimately matters more for longer term yields than the timing of policy moves (although the two are correlated). Put simply, the Fed is exercising risk management around how it sees the future balance of risks. This shift is subtle, as policy is not on a pre-set course and will ultimately be guided by the data. Some observers suggest that a policy mistake is being factored in with longer maturity yields falling. But this view is inconsistent with the comparative resilience of equity markets through June.

The Fed is not the only central bank to signal a willingness to dial back on stimulus. The RBA, BoC and BoJ have provided guidance about reducing asset purchases and the RBNZ has stopped altogether.

Long term rates signal a pessimistic outlook

The extent of the recent fall in longer term forward rates stands out. Chart 8 shows the Fed's long run rate projection and the 5y5y OIS rate (the market expectation for the 5y average Fed Funds rate, 5 years forward), which has fallen 85bp since March. Over the longer term, the decline in market expectations for the neutral rate is often described as the "new normal". The market has tended to price a level well under the Fed's estimates. Two very notable exceptions were: the 2013 "taper tantrum" where expectations of reduced QE caused a major dislocation in bond markets and near the peak of the last Fed funds cycle in 2018 (the funds rate reached 2.5%).

Chart 8: Lower terminal Fed Funds rate priced



Source: Ardea, Bloomberg

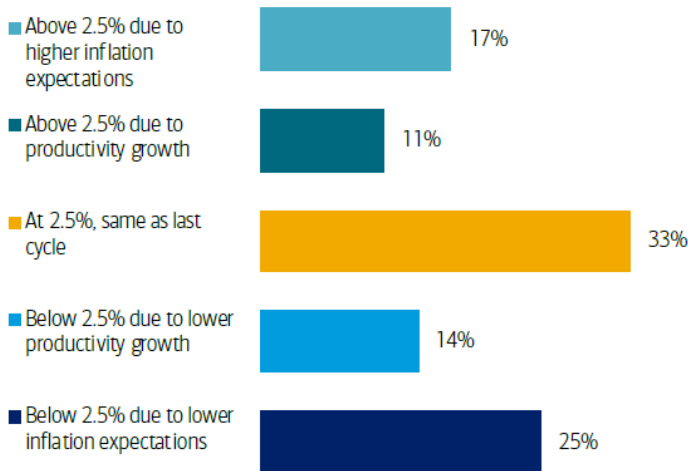
At the time of writing, the market is pointing to a terminal funds rate of around 1.5%, which is 1% lower than both the peak in the last cycle and where the Fed currently projects the long-run terminal rate. We could further decompose this rate into an implied "real neutral rate" of around -0.5%, assuming average inflation settles near the Fed's target level of 2% in the long run. At these low levels, bond bulls tend to make sense of market pricing by citing longer term macro themes:

- **Structural headwinds to growth have intensified.** As post-covid stimulus fades, potential growth rates will be lower, perhaps a result of the debt overhang, demographics or other constraints.
- **Inflation will be transitory and well contained in the long run.** Unemployment at 4% or below in the US (and other major economies) will not drive wages or broader inflation significantly higher. Underlying labour slack, technology and other forces will ultimately keep inflation low.

These themes are entirely plausible. But one could just as easily point to the fact that a hefty premium is already priced into bonds for these structural challenges with long dated forwards pricing the peak in the cash rate around 100bp under the previous cycle. Moreover, if the recovery progresses as the consensus expects and central banks start to shift towards tighter policy, yields could easily rise again and provide investors with a larger yield buffer for the more optimistic growth and inflation scenarios. In either case, it pays to be flexible in thinking about long term macro themes. Throughout the last tightening cycle in the US, long term rates traded in a nearly 200bp range.

The potential for large swings in expectations is also underscored by a recent Bank of America investor survey (Chart 9). The survey suggests slightly more investors see a 2.5% terminal rate in the coming cycle than a lower level, but with a reasonable portion of respondents also seeing a much higher level. Contained inflation is widely thought to be a bigger constraint than productivity or other structural growth headwinds.

Chart 9: Bank of America Survey – Where is the US terminal rate in this cycle?



Catalysts for a rebound in yields

The extent of the rally in global bond markets since Q1 has surprised many investors. The underlying drivers appear to be a mixture of growth sentiment, positioning technicals, central bank policy reactions to inflation and views on longer term structural themes.

Markets rarely move in straight lines and history shows macro narratives can change quickly. Even as the bond market has seemingly given up on the reflation theme that was so dominant in Q1, it's not hard to see some catalysts for a rebound in the other direction:

- **Global growth.** The narrative that the rally in bonds reflects engrained concerns about growth will be tested if major economies remain resilient to rising Covid cases and other headwinds. A moderation in US and China activity from recent elevated rates is already factored into most forecasts.
- **Inflation.** There is no accepted definition of transitory and the level of forecast uncertainty is very high. Continued upside inflation surprises could well shake the current comfort reflected in inflation pricing, which has also consequences for nominal rates and interest rate volatility (a point we highlighted in a recent research note on inflation pricing).
- **QE tapering.** The Fed is widely expected to begin a slow unwinding process of the current QE program from $120bn per month (across US Treasuries and MBS) in early 2022. The signal on this policy shift is likely to come in Q3 or Q4 2021.

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