The Lords of Finance Rise Again: Central Bank Signals and the Outlook for Bond Yields

By Paul Brain
Investment Leader for Fixed Income
Newton

In our view, world markets today are also in the grips of the central banks, with no other factor wielding so much influence.

EXECUTIVE SUMMARY

Paul Brain, Newton's investment leader for fixed income, looks at bond investors' hyperfocus on central bank signals in anticipation of a potential tapering of the Fed's asset purchases. Paul discusses the main factors that might drive bond yields higher over the next months as well as what could prevent them from drifting too high as we enter the final quarter of the year.

The Lords of Finance are back in control again. In his award-winning book, *Lords of Finance: The Bankers Who Broke The World*, Liaquat Ahamed describes the period following the First World War, when the four most powerful men in finance were the central bankers of the U.S., U.K., France and Germany. In our view, world markets today are also in the grips of the central banks, with no other factor wielding so much influence: as central banks set the price of money and control the flow of funds, we see that investors have little choice but to play along.

What happens when these Lords of Finance decide enough intervention is enough? We had a taste of that when, in May, the U.S. Federal Reserve outlined the reasons for reducing its influence on financial markets through reduced purchases of bonds, which could possibly begin in the fourth quarter.

Following the First World War, as detailed by Ahamed, the "Lords" were united in their fear of inflation, and their common vision was to turn back the clock and return the world to the gold standard. Their legacy was the Great Depression and ultimately a period of high inflation and, some may argue, flagstones in the groundwork for the Second World War.

THIS TIME IS DIFFERENT!

Since the Fed's announcement of May 22 we have witnessed much speculation about the tapering of its quantitative easing program (QE), and the likelihood that it will raise bond yields and be negative for "risk assets." As a result, an adjustment phase has been experienced in all financial assets that have been buoyed by speculation over continued QE. We suggest this has created some anomalies.

NEWTON
The Power of Ideas

BNY MELLON

For instance, if we take the Fed at their word on maintaining ultra-low interest rates, why should the short end of the U.S. yield curve have priced in a rate rise? Short-dated bond yields have risen by as much as those at the longer end, despite being anchored by a “zero interest rate” policy. Suggesting, perhaps, that the markets had misinterpreted the Fed’s previous guidance, the Fed Chairman pointed out the error of their ways and stated that monetary policy would remain accommodative for a while yet. The other anomaly is that bond markets around the world have fallen (yields have risen), either in line with, or in some cases by more than, U.S. bonds. If anything, the economic statistics from these other economies have been weaker, led in part by concerns over Chinese growth.

We think that the market will continue to anticipate less bond-buying by the Fed, particularly as employment data continues to improve, causing Treasuries to remain under pressure.

So, apart from a rise in bond yields, what has changed over the last few weeks? The Fed maintains that any reduction in the pace of Q.E. is dependent on data: recently, we have observed that G10 economic growth is recovering gradually, but Asia and China seem to be slowing. The concern about China, in addition to the strength of the U.S. dollar, is weighing on commodity prices. Furthermore, longer-term concerns about emerging markets appear to have escalated: it is of little surprise, then, that emerging-market debt has been one of the worst-performing asset classes over the last few months.

U.S. bond yields have reached levels at which they are strongly influencing mortgage rates, but the momentum in the U.S. housing market suggests to us that yields may have to rise even higher before they turn the market.

In January, we identified a yield of 2.5% for the 10-year Treasury as a point where the market should pause. From here, we think that yields are likely to drift higher if employment figures continue to improve, or until we see clear evidence that higher yields are having a negative effect on the economy.

How far could yields rise in this environment? Or rather, how far will they be allowed to rise? The absence of sharp increases in the federal funds rate means we are not in the same situation as in 1994; the Federal Reserve raised rates by 3% between February 1994 and February 1995, the U.S. 10-year yield went from 5.84% to 7.93%, and inflation expectations rose sharply. We think 10-year U.S. yields are likely to stay in the 2.5% to 3.0% range in the near term. We expect that the market will be influenced by a number of opposing forces over the summer before being able to rally later in the year.

The following is a list of what we think will be pushing and pulling yields. First, the reasons why U.S. Treasury yields may gradually rise during the rest of the summer:

- In our view, the asset class is very over-owned, and is therefore vulnerable to fund outflows. Much of this could already be reflected in the price as, in light of recent market events, many funds may now be more defensively positioned and may have anticipated further fund flows. But we observe that there is usually a delay between initial price moves and flows, and we anticipate less buying activity by funds, and possibly a bit more selling.

- We think that the market will continue to anticipate less bond-buying by the Fed, particularly as employment data continues to improve, causing Treasuries to remain under pressure.

- We expect that the volume of emerging-market central bank buying of U.S. Treasuries may be anticipated to be lower in the future. In particular, if the Chinese decide that they too need a weak currency, we think there would be less need for them to recycle their current account surplus into dollar assets.

– We think there may be lower “safe-haven” demand from investors concerned about a eurozone crisis, who may be lulled into a false sense of security ahead of the German federal election on September 22.

– Finally, while perhaps not really a negative for Treasuries but certainly not a support as yet, we assert that it may take a bigger rise in mortgage rates to take the froth out of the housing market.

On the other hand, as we head towards the fourth quarter and as yields are higher, we find there are a number of factors that could prevent yields rising too high:

– Inflation is lower, so real (i.e., inflation-adjusted) yields will be increasingly attractive. Investors may, we believe, prefer the certainty of positive bond real yields to the vulnerability of equity income.

– Although U.S. growth may be stabilizing, there are signs (including data from the International Monetary Fund) that suggest that other areas may be slowing fast. Eventually, we think this will influence the U.S. economy.

– The Chinese economy in particular seems to us to be slowing, albeit that support from the authorities could lead to less money being available for authorities to spend on U.S. Treasuries. The eurozone could still be vulnerable, but we think it is unlikely to wobble too precariously before the German election later this year.

– The Federal Reserve will still be buying U.S. Treasuries even if they begin the process of reducingtheir rate of purchases.

– The broader U.S. economy is still, according to recent ISM data, not very robust.

On balance, in the absence of a significant shock, we would expect yields to rise steadily in line with improvement in the U.S. employment market. Accordingly, if employment gains fizzle out, we think yields would stop rising. The fragility of U.S. and global growth will, we believe, limit the rise in yields from here. We think the current debt-burdened global economy would struggle to cope with new government funding (in the U.S. at least) at a rate above 3%.

This leads us back to the Lords of Finance. We think they won’t allow rates to rise too much because the world simply can’t afford it. The Japanese central bank was disappointed by the market’s reaction to their intervention policies in April and managed to convince investors to push Japanese government bond yields back down (prices up). Both the Bank of England and the European Central Bank have reminded the fickle bond market that monetary policy is unlikely to change for a very long time. Finally, the Fed has also felt the need to remind the market about how accommodative monetary policy is. One could also add the Chinese authorities to this list of market manipulators, following their attempts to fiddle with interbank rates in recent weeks.[1]

The age of the Lords of Finance is with us again. The membership of the group has changed a little, but the need to keep a lid on borrowing costs in the face of high debt burdens suggests to us that we are stuck with this form of influence for some time yet.

The age of the Lords of Finance is with us again. The membership of the group has changed a little, but the need to keep a lid on borrowing costs in the face of high debt burdens suggests to us that we are stuck with this form of influence for some time yet.

1 “When Liquidity Meets Control in China,”*Financial Times*, June 18, 2013.

The Alcentra Group
BNY Mellon ARX
BNY Mellon Cash Investment Strategies
BNY Mellon Western Fund Management
CenterSquare Investment Management, Inc.
CenterSquare Investment Management Holdings, Inc.
Company Limited
The Boston Company Asset Management, LLC
The Dreyfus Corporation
EACM Advisors LLC
Hamon Investment Group
Insight Investment
Mellon Capital Management Corporation
Meriten Investment Management
The Newton Group
Siguler Guff & Company LP
Standish Mellon Asset Management Company LLC
Walter Scott & Partners Limited

BNY MELLON

本情報提供資料は、BNY メロン・グループ（BNY メロンを最終親会社とするグループの総称です）の資産運用会社が提供する情報について、BNY メロン・アセット・マネジメント・ジャパン株式会社が審査の上、掲載したものです。当資料は情報の提供を目的としたもので、勧誘を目的としたものではありません。当資料は信頼できると思われる情報に基づき作成されていますが、その正確性、完全性を保証するものではありません。ここに示された意見などは、作成時点での見解であり、事前の連絡無しに変更される事もあります。

BNY メロン・アセット・マネジメント・ジャパン株式会社
BNY Mellon Asset Management Japan Limited

金融商品取引業者：関東財務局長（金商）第 406 号
〔加入協会〕一般社団法人　投資信託協会
　　　　　　一般社団法人　日本投資顧問業協会