Bond Market Reversal*

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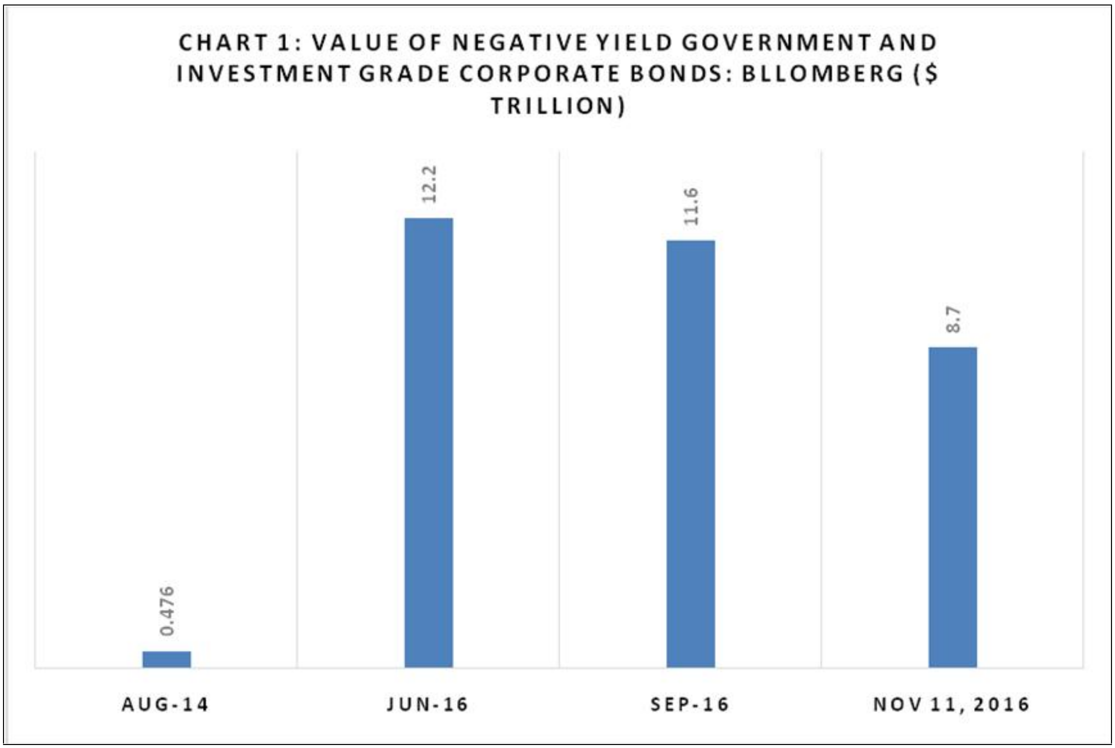
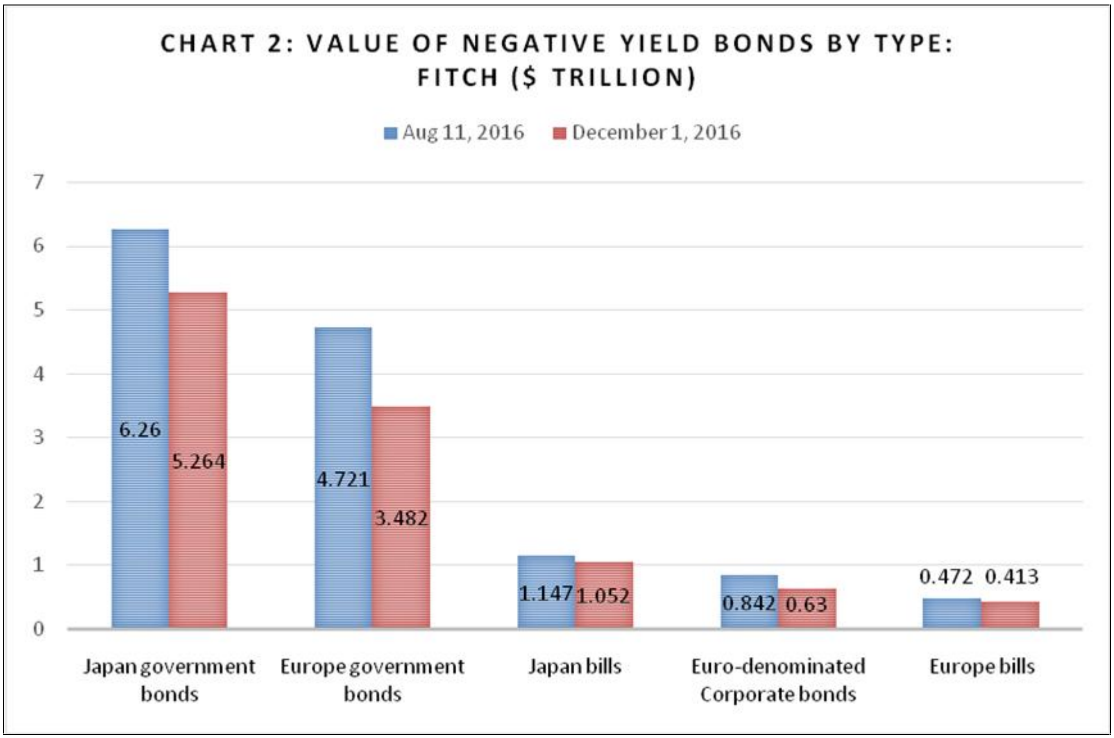
For more than two years now the world has been subject to a bizarre monetary policy regime in Europe, Switzerland, and more recently the UK. Interest rates paid on deposits held by commercial banks in central banks have been set at negative levels. This policy regime, by forcing banks and investors to move out of cash to low risk government and investment grade corporate bonds, resulted in a sharp rise in bond prices. Since higher prices meant that the current yield on bonds (calculated as the ratio of the annual coupon payment to the market price of the bond) fell, these bonds, if bought and held to maturity when their par value can be redeemed, could also involve a negative yield.

What followed was a sharp rise in the volume of negative yielding bonds, especially government bonds, being held by investors. Estimates of the total market value of negative yielding bonds vary, since it involves identifying such bonds based on some gauge of their prevailing market value. Bloomberg, for example, reports that the total value of such bonds rose from $476 billion in August 2014, to a peak level of 12.2 trillion in June 2016 (Chart 1).

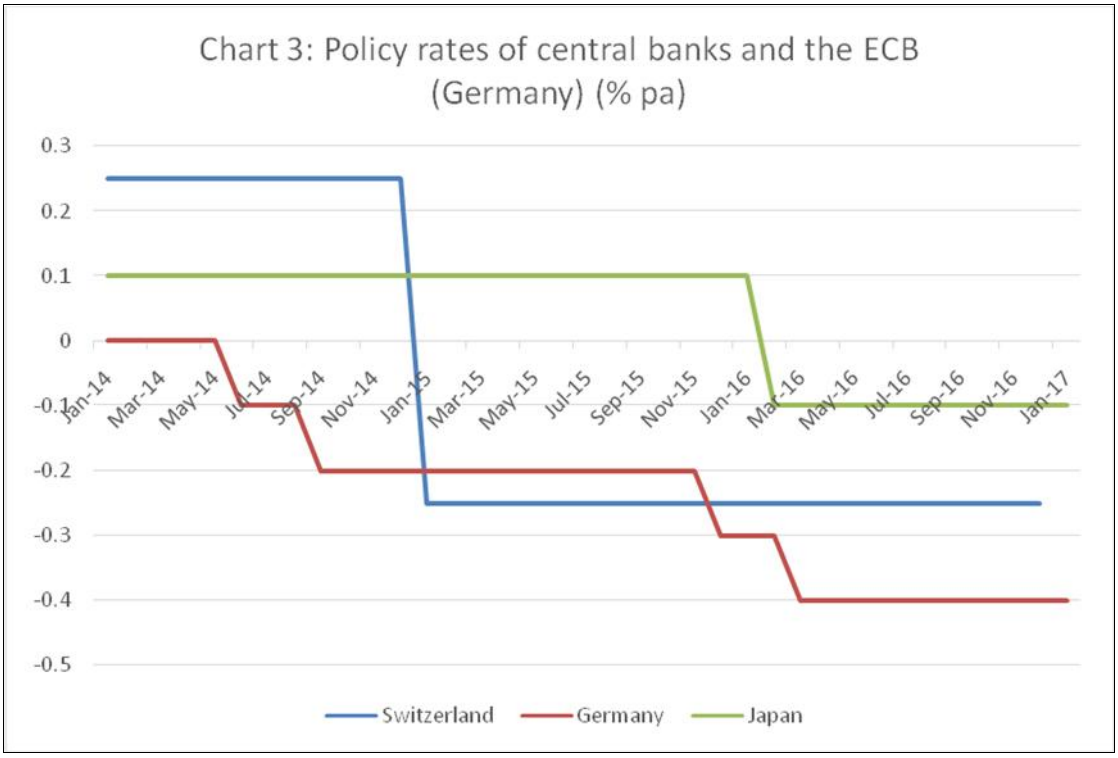


As is clear from Chart 2, most of these bonds were sovereign bonds, and had been bought in Japan, followed by Europe. Three factors, among others, seemed to have encouraged investors to move into bonds despite the promise of negative yields. First, the persistence of central bank quantitative easing (QE) policies in Japan and Europe, involving large purchases of government bonds. Second, the cost or/and risk of holding deposits or more cash being such that turning to these no-risk or low-risk bonds seemed sensible. Third, inflation was at such a low that the real (inflation-adjusted) loss of holding negative-yielding bonds may not have been as large even when compared with losses that may have been suffered on positive-yielding bonds in high inflation periods.



This unprecedented medium-term trend of investment in negative-yielding bonds has, however, reversed itself in recent months, influenced initially by changing Fed perceptions on holding down interest rates and the Brexit vote, but gaining momentum especially after the election of Donald Trump as US President. As Chart 1 shows, the Bloomberg estimate of the total value of negative yielding bonds, which had declined marginally from its peak of $12.2 trillion in June 2016 to $11.6 trillion in September 2016, stood at a much lower $8.7 trillion on November 11, 2016, having fallen by $1.4 trillion from November 4, 2016. Bloomberg's Phil Kuntz ('Negative-Yielding Bonds Plummet to $8.7 Trillion After Trump Win'), reported as follows: "The market value of the world's negative-yielding bonds plunged 14 percent last week to $8.7 trillion as investors dumped government debt at a record clip after Donald Trump's upset win stoked speculation that his ambitious fiscal plan would flood the market with new Treasuries and boost inflation … The Bloomberg Barclays index of the prices for such debt worldwide fell 3.2 percent last week, the biggest decline since at least 2000, as far back as the data goes."

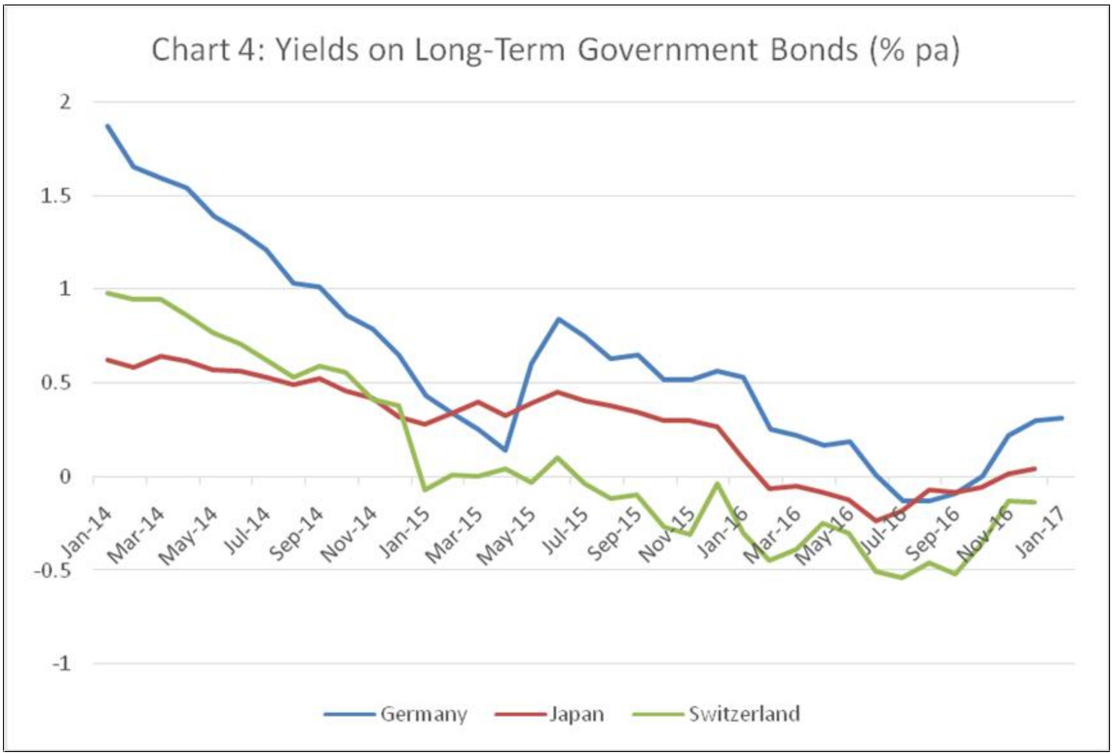
As was expected, the bond sell-off was concentrated in government bonds (Chart 2). But this was not because there had been any change in the policy rates that were being charged by central banks (Chart 3). Rather it was because of a bond sell-off that reduced prices and has begun increasing yields on long-term government bonds (Chart 4).



One implication of this is that bond trades, prices and yields are not driven by the policy rate alone, but by speculation regarding the role that fiscal policy will play. Clearly, expectations are that the Trump era would be one in which debt financed state expenditure on infrastructure and related areas would be an important instrument to raise growth. That would mean that (i) central banks may choose to retreat from low interest, easy money policies; (ii) new issues of Treasury bills would increase sharply, reducing bond prices and raising bond yields; and (iii) demand and prices in the real economy could turn buoyant, heralding a new phase of goods-price inflation. If these expectations are realised, many of the factors underlying the surge in the demand for bonds and in bond prices may unwind. In addition, opportunities for investment in the real, commodity producing sectors would increase, providing the basis for the rapid exit from negative-yielding bonds.

All this suggests that there is a difference in the factors driving negative policy rates affecting banks, and negative yields in bond prices, with the latter not merely the result of the transmission of the effects of the latter. Negative policy rates are being adopted by central banks to address the persistent recession in the global economy, and are supported by governments that see this (as opposed to fiscal policy) as the preferred instrument to engineer a recovery. Trump's rhetoric questions this perspective and has called for a greater reliance on expenditure measures, though how they would be financed is still unclear. Negative bond yields, on the other hand, are a fall-out of the deflationary environment (rather than the means to address it).

The mere expectation that Donald Trump's ascendancy could trigger a spending surge, and provide the space for the Fed and possibly other central banks to retreat from their failed monetary stance, which has for too long now been based on QE and low or negative interest rates, shook up bond markets. However, the initial sell-off seems to have abated, and what happens next would depend on whether Trump translates his rhetoric into actual policy.



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