Sovereign bonds

What’s behind the big bond rally?

The bond market rally is fast gaining momentum

Robin Wigglesworth and Colby Smith in New York 7 HOURS AGO

The 2019 bond market rally is gaining momentum, pushing down yields and lifting the value of the fixed income universe by roughly $1.6tn since just the beginning of March. Why are debt markets on fire, and what does it say about the health of the global economy?

Why are bond yields falling?

Fixed income markets have been buoyant for much of the year, as bond investors remained fairly downbeat about economic growth, and therefore inflation and the likelihood of central banks raising interest rates. Rising bond prices mean lower yields.

That pessimism has been largely validated by disappointing economic data in China, Europe and the US, and by a marked shift in the tone of the European Central Bank and Federal Reserve. Earlier this month both central banks surprised investors by just how downbeat they had become, with the former restarting a crisis-era bank lending programme and the latter dropping plans to raise interest rates this year and scaling back its balance sheet reduction programme.

Indeed, the extent of the U-turn alarmed some investors, who rushed for the safety of highly rated government bonds such as Treasuries, and triggered hedging by mortgage investors fearful of a wave of refinancing, which then exacerbated the rally.
“Why did the Fed need to out-dove themselves?” asked Seema Shah, global investment strategist at Principal Global Investors. “And if you put that with the ECB downgrading its growth forecast much more than people expected, you ask yourself, ‘What do they know that we don’t know?’”

---

**Swap spread slides as traders hedge against mortgage refinancings**

Ten-year US swap spreads (basis points)

![Graph showing the swap spread over time](source: Bloomberg © FT)

---

**Did growth fears drive the global bond rally this week?**

The fading-growth narrative was reinforced by New Zealand’s central bank on Wednesday, when it unexpectedly hinted at forthcoming interest rate cuts and warned that “the global economic outlook has continued to weaken, in particular amongst some of our key trading partners including Australia, Europe, and China”.

“It’s becoming increasingly clear that there are few central banks that want to be caught on the wrong side of the Fed,” said Brad Bechtel of Jefferies. “Meaning, why would you remain neutral or hawkish when the Fed is sitting neutral to dovish?”

As a result, New Zealand’s 10-year government bond yield dropped to a record low of 1.74 per cent on Wednesday, a move that then rippled out to Australian, European and US bond markets. Yields continued to move lower across much of Asia and Europe on Thursday.
“The trigger . . . is what happened in New Zealand with the central bank becoming much more dovish,” said John Taylor, co-head of European fixed income at AllianceBernstein. “Australia rallied in sympathy, and that mattered for the US because the 10-year note was sitting close to 2.40 per cent, an important technical level. When it broke through there, it had scope to rally.”

**Bond yields head south as economic pessimism spreads**

Ten-year government bond yields (%)

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>Germany</th>
<th>UK</th>
<th>Japan</th>
<th>Australia</th>
<th>New Zealand</th>
<th>France</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 18</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Apr 18</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jul 18</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oct 18</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan 19</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mar 19</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg

© FT

**Are central banks right to worry?**

The near-euphoria that surrounded the global economy a year ago has been replaced with gloom, as financial markets became more turbulent and a string of economic releases have come in well below expectations.

The IMF in January cut its forecast for global growth this year by 0.2 percentage points to 3.5 per cent, and there has been little good news since then. Citigroup’s global Economic Surprise Index, which measures how often data comes in better or worse than forecasts, has been in negative territory for almost a year. That is its longest sub-zero stretch since 2008.

At the same time, the US “yield curve” has inverted, a classic omen of a coming recession. The yield curve consists of Treasury yields of various maturities, and normally slopes upwards as longer-term US government bond yields are higher than short-term bill yields, to compensate investors
for inflation and locking up their money for a long time. But when the curve flattens it indicates that investors think growth is slowing, and when it actually inverts — in other words, when yields on bills are higher than on 10-year Treasuries — it has proven an accurate predictor of downturns.

The US yield curve inverted last week, as investors sharply marked down their expectations for growth, inflation and interest rates, and stirring concerns that the post-crisis economic expansion — which this summer will become the longest in history — is heading for a grisly end.

---

**What does this mean for stock markets?**

Equities have proven sensitive to higher interest rates, with last year’s turmoil initially kicked off by a sharp rise in US bond yields in early October. But falling bond yields are not necessarily good news either, given the message it sends about the global outlook for economic growth.

Many analysts and investors remain sceptical that the yield curve’s current shape is meaningful, pointing out that whether it is inverted depends on what arbitrary maturities one picks. Moreover, they argue, the global bond market remains distorted by post-crisis quantitative easing programmes, which render redundant any discussion about the shape of the curve.

However, it is clear that stock markets are on edge, with the FTSE All-World index tumbling 1.4 per cent last Friday, when the US yield curve inverted. It fell another 0.4 per cent on Wednesday, its fifth decline in the eight trading days since last week’s Fed meeting and denting its 2019 recovery.

“We think that the ongoing flattening, or outright inversion, of the US Treasury yield curve is a bad sign for equities, as it usually has been in the past,” Capital Economics said in a note. “While there
is some evidence that post-financial crisis regulatory and monetary policy regimes are keeping the curve flatter than it might otherwise be, we are still wary of the idea that ‘this time is different’.

---

**Global bond yields slide as pessimism spreads**

Yield of Bloomberg Barclays Multiverse index (%)

---

**So is it time to head for the investment bunker?**

Probably not. Professor Campbell Harvey at Duke University, who wrote the seminal paper on the predictive power of the yield curve in the 1980s, points out that the curve needs to be inverted for at least a quarter before it is a reliable gauge of recession, and even then a contraction can take a year or two to materialise.

Moreover, there are reasons to believe that bond markets might be overreacting to cues from the global economy. China is slowing but in a gradual way, Europe is weak but still seems unlikely to face a recession and the Atlanta Fed’s “nowcasting” model indicates the US economy is expanding at an annual rate of 1.53 per cent.

The Fed Funds futures markets indicate that traders think the US central bank will cut rates at least once this year, and possibly more, but some fund managers argue that looks excessive in the face of slower but still resilient growth.
“The bond market is sniffing out a global recession, but a little too aggressively,” said Abhay Deshpande, chief investment officer at Centerstone Investors. “We’ll probably see a muddle-through, slower growth and some growth scares, but I think the Fed may have averted the worst-case scenario.”

Grim expectations

Markets-implied odds on Federal Reserve interest rates by end of 2019 (%)

- Probability of one rise
- Three cuts (1.5-1.75%)
- One cut (2-2.25%)
- Two cuts (1.75-2%)
- Pause (2.25-2.5%)

Source: Bloomberg
© FT
Colby Smith
Robin Wigglesworth

How easy or hard was it to use FT.com today?

Leave feedback