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Around THE Curve

Low Bond Yields: Repressed or Something More Fundamental?

Francis A. Scotland |

Treasury bonds do not get much respect these days. Institutional fund manager bond weightings are at their lowest levels ever in the 20-year history of Bank of America's monthly fund manager survey. High profile investors treat them like the plague.

The revulsion in sentiment is easy to understand. Who wants to own a negative real yielding asset? Based on the personal consumption expenditures price index, also known as the PCE deflator, real bond yields have been lower only once in the last 60 years while inflation is already at its highest level in 30 years—the real culprit. Many investors see inflation as the number one tail risk in the economic outlook. The fear is that inflation proves hotter, higher, and longer lasting than Federal Reserve (Fed) officials think, a consequence of the staggering fiscal and monetary stimulus brought to bear on the economy over the last 18 months. In the wake of all that stimulus sit trillions of dollars in liquid bank accounts, theoretically a powder keg of inflationary firepower if households and businesses decide to spend the money.

So why is the 10-year nominal Treasury yield stuck near 1.5%? Yields are even below May 2021 levels despite an 11% growth rate in nominal gross domestic product (GDP) in the last two quarters. Is a bloodbath for the bond market lurking around the corner?

Financial Repression?

The usual answer for low yields is financial repression. Fed purchases of government debt artificially support bond prices and suppress yields, not to mention distort other asset prices and sustain zombie corporations.

Intuitively appealing, flow data supports the idea to some extent. Fed purchases have absorbed a whopping $4.4 trillion of Treasury and agency bond supply since the last week of February through late October. Accordingly, last week's announcement by the Fed of a $15 billion monthly tapering of purchases might be a game changer. It means an eventual reduction of $1.4 trillion in bond buying a year, which should imply higher yields based on this thinking. However, the government will be tapering its issuance of bonds by even more.

None of this allows for the flows generated from buying and selling of the existing stock of government debt. Presumably, the bearish argument for bonds should discourage holders of the outstanding stock of debt, implying far more potential supply pressure than represented by new Treasury issuance alone. That has not been the case. Instead, it has been the opposite.

The same flow data reveals a healthy private sector demand for fixed income despite low yields. Money has poured into bond mutual funds and ETFs, approximating $1.5 trillion over the same February through October time period, according to Investment Company Institute research. This inflow is significant considering that there were large net outflows from similar equity products until the last few months. Commercial banks own roughly a trillion more in Treasuries and agency bonds than pre-pandemic. Fed purchases have boosted bank deposits, which banks partly used to increase holdings of Treasuries because there has been little new demand for lending. Excess reserves—a substitute for short-term government debt—have increased by over $1 trillion as well, another indication of absent credit demand.

Or Something Different?

The private sector demand for Treasury securities invites another explanation for low interest rates: ex-ante investment demand is low relative to the ex-post supply of investable savings. In other words, there is not enough investment demand/spending relative to savings to drive credit. In that world, the equilibrium real yield would be very low, maybe zero or even negative. The investment and macroeconomic implications that follow a *fundamentally* low rate structure are very different than would be the case for a *repressed* rate regime.

There was evidence of this more fundamental nature of the low-rate regime long before large-scale asset purchases became a conventional tool of central banks. The 550-basis point drop in 10-year yields from the mid-1990s to the end of 2019 was led by falling real rates, which were down 500 basis points in total, and roughly 280 basis points by the early 2000s. In contrast, inflation was steady between 1% and 2.5%, based on core PCE. The explanations for that trend include weak demographics in the rich countries, which depresses demand; technological discovery and disruption, which boosts supply potential; and a more competitive global economy. China's ascendance on to the world stage in the late 1990s and early 2000s brought a wave of competition, but it also swamped the world in new savings. Former Fed Chair Alan Greenspan's 2005 "conundrum" reference to bond yields not following a 150-basis point rise in the federal funds rate was really the first official acknowledgement of at least one implication of this new regime.

The tendency toward lower real interest rates became even more severe after the global financial crisis with the collapse in U.S. household credit demand and surge in the savings rate. Real yields stabilized subsequently, due partly to a modest recovery in U.S. credit demand. However, the main reason was an aggressive shift in China's economy as policymakers boosted credit and spending for a short period to make up for the lack of foreign spending.

In this kind of world, any measure leading to restrained demand leads to some significant deflationary forces. It makes some sense that China's Producer Price Index (PPI) has been negative 81 out of 121 months ending December 2020 because the authorities have been trying to deleverage the domestic economy since 2014. Similarly, Fed Chair Powell's humiliating flip-flop on monetary policy at the end 2018 into early 2019 is consistent with the narrative that the equilibrium rate was a lot lower than he was thinking at the time. It is something to keep in mind as the world gears up for fiscal retraction and monetary normalization.

Pandemic-related lockdowns made the imbalance between excess savings and spending a lot more severe. The bust in aggregate spending drove the global rate structure to the floor. Massive stimulus has counteracted some of the contraction in spending, and re-openings have helped the world economy recover in varying degrees. Bond yields have generally renormalized in the developed world. However, overall global output remains short of its pre-pandemic trends. China was the first to renormalize policy, and bond yields retreated lower in tandem. The Fed has been tiptoeing toward tapering since April; bond yields have moved laterally since. So far, there is no sign of a drawdown in the accumulation of excess savings built up during the last 20 months, notwithstanding the recent decline in the savings rate.

Where Are the Bond Market Vigilantes?

Bond markets have historically acted as the governors of sustainable, non-inflationary growth. Yields rise when the economy has been unsustainably hot and fall when growth slows too much. There is a lot of inflation around, but so far, the bond vigilantes have been quiet. Why?

- First, the bond vigilantes' main assignment is to guard against excess demand pressures pushing inflation up. Rising rates curb demand. This time around, the main cause of inflation has been shortages and a dearth of supply. Higher yields do nothing to resolve inadequate supply and could create an economic hole if they did rise and pull spending lower.
- Second, in the world of supply shortages, factor markets are the new vigilantes. Instead of rising bond yields, commodity prices, energy, and wages are rising to bring demand into alignment with supply. Higher prices and slower real income/earnings growth put the brakes on real spending growth. The bond market does not need to act.
- Third, any possible wage price spiral resulting from higher factor costs depends on how policymakers deal with the current inflation and the duration of the supply shock. Their response remains to be seen, but 2022 is shaping up to be as big an historical retreat in macro policy as 2020 was a boost. Recent elections in the U.S. hint at what could be the start of a pivot back to right of center from left-leaning

fiscal policy. Dorothy is returning to Kansas if China's renormalization is an example of what is to come.

- Fourth, the world's second-largest economy has decided that the time is right to unwind the leverage in its property sector. So far, this transition has gone smoothly without any sign of distress or panic in general market prices, but clearly the risks tilt to the downside for the time being. Housing activity is responsible for 20% of all activity in China; and China drives a third of world GDP.
- Lastly, the uncertainty in the outlook over COVID-19 itself remains unresolved. New anti-viral medications from Merck and Pfizer offer promising hope of the pandemic becoming endemic. But vaccine mandates represent a new potential source of weak demand. China's latest outbreaks and zero-tolerance measures aimed at controlling spread make it hard to sustain growth momentum.

Believe the Bond Market

The financial market narrative on the economy begins with the bond market. The current story is that supply-side bottlenecks and shortages driving factor costs higher are containing and slowing real economic growth. This is a natural equilibrating mechanism that has kept the bond vigilantes at bay. Delays in the recovery of the supply side could sustain this profile of low real rates and elevated inflation expectations for a while yet. It remains to be seen what effect reining in macro stimulus measures will have in 2022. Longer term, recovery in the supply side of the world economy may influence the composition of the nominal Treasury yield between its real yield constituent and the inflation premia more than the level of the nominal yield itself.

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