Bemused by the Bond Market

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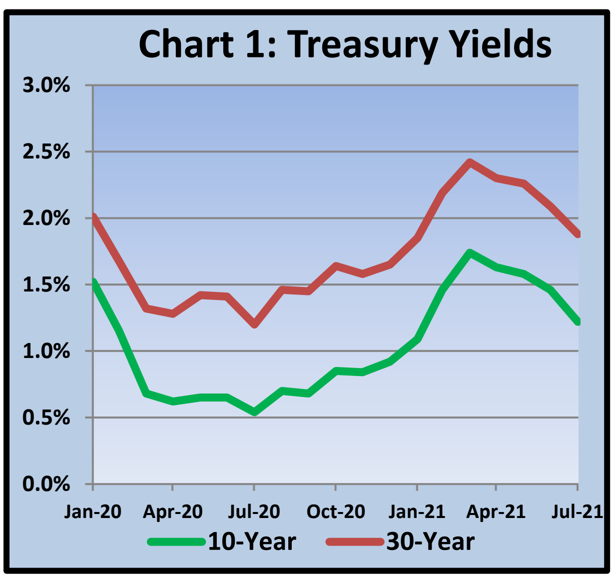
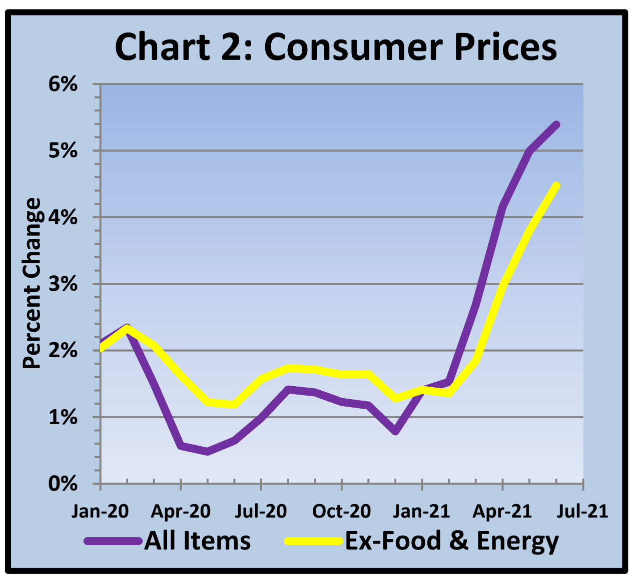
July 22, 2021

Sometimes markets seem to make no sense. Trying to understand the bond markets lately, for example, has required an exercise in creative thinking that doesn't come naturally to many investors. If they listen to Cowboy Junkies, as I do, they may well think Margo Timmins was singing directly to them:

> *I don't get it, I don't get it*
> *I ask my friends if they understand*
> *They just laugh at me and watch another band*
> *They don't worry, they don't worry …*
> *I'm looking for answers in so many places*
> *I open my mind, I don't get it*

In several respects, American bond markets have been acting perversely over the past few weeks, zigging when they should be zagging. This is a recent phenomenon; looking back over the past couple of years, bonds had been behaving normally: As the economy began to emerge from lockdown last summer and continuing through the first few months of this year, bond yields rose and prices fell, a classic textbook response to rapid economic growth and massive government spending that triggered fears of inflation (Chart 1). In the past couple of months, however, the Treasury market abruptly reversed course as yields tumbled, defying conventional wisdom.





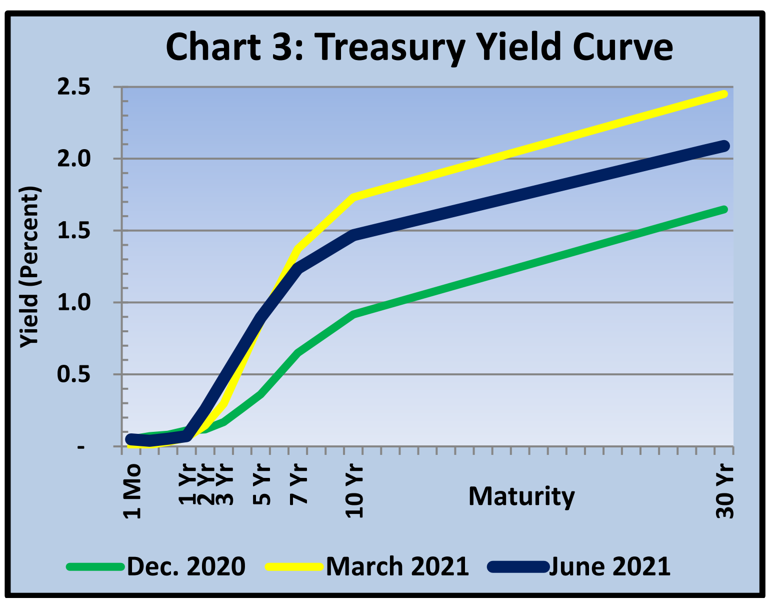
Source (both charts): FactSet

Chart 2 shows the Consumer Price Index over the same period. Throughout 2020 and into this year, inflation remained below the Federal Reserve's 2% target, despite the fears evident in the bond market's concurrently rising yields. While investors were focused on the potentially inflationary aspect of the CARES Act and the Fed's $120 billion of monthly bond purchases, consumers were in no mood to spree. Demand for some goods rose sharply, but much of the economy languished. Without consumer confidence and with many lockdown restrictions still in place, Treasury bond investors' fears of inflation were badly misplaced.

By early 2021, however, as vaccination rates rose sharply and the winter Covid surge petered out, the economy began to accelerate. Supply chains buckled, as rising U.S. demand ran ahead of the rest of the world's slower (and more Covid-constrained) ability to meet it. The resulting combination of sharply higher demand and bottlenecked supply led to shortages and the spike in inflation seen in Chart 2. By June, the 5.4% change in the Consumer Price Index was the highest annual jump in more than a decade. Yet at almost the same time that the Treasury market's worst fears began to come true, investors abruptly reversed course and began to push yields lower rather than higher.

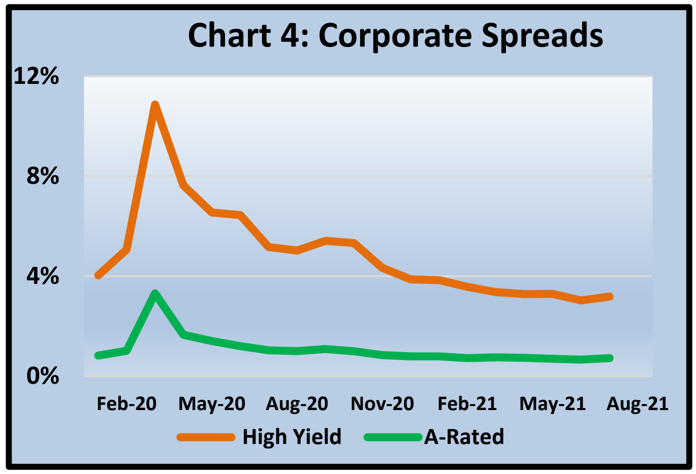
This odd behavior is even more puzzling when viewed in the context of the Treasury market's internal supply and demand dynamics. The Fed's market interventions often drive bond market movement, both because the Fed uses its bond market activity as a signaling mechanism and because adding *any* big buyer or seller to a marketplace will tip the supply/demand equilibrium price. When investors expect the Fed to slow its bond purchases, yields would be expected to rise. That certainly happened in the infamous Taper Tantrum of 2013 when the Fed's premature move to slow its bond purchases provoked a revolt in the Treasury bond markets. Fast-forward to this summer, when Fed Chair Jerome Powell began talking about another round of tapering purchases: A hapless investor might reasonably have expected the bond markets to object loudly – but instead they are giving him a standing ovation.

One plausible explanation is that Treasury investors may have turned more bearish on the state of the U.S. economy. Perhaps, these investors may be thinking, the economy's growth rate will slow as comparisons with year-ago quarters become more challenging. This line of thinking is borne out by the recent flattening of the yield curve, as longer-term Treasury yields have fallen while short-term yields have remained steady (Chart 3). Yet recent economic data and second-quarter corporate earnings growth both suggest that the absolute pace of *future* growth still looks good.



Source: FactSet

On the other hand, a sudden increase in Delta variant cases this month has called the growth narrative into question. That certainly explains why stocks have wobbled in the past few trading sessions. Were Treasuries simply ahead of stocks in acknowledging that the Delta variant posed a threat to sustained U.S. economic expansion? Perhaps, but that argument doesn't explain what's been happening in other U.S. bond markets. Corporate debt investors, for example, still don't seem to be perturbed by the Delta variant's perceived ability to derail economic growth.



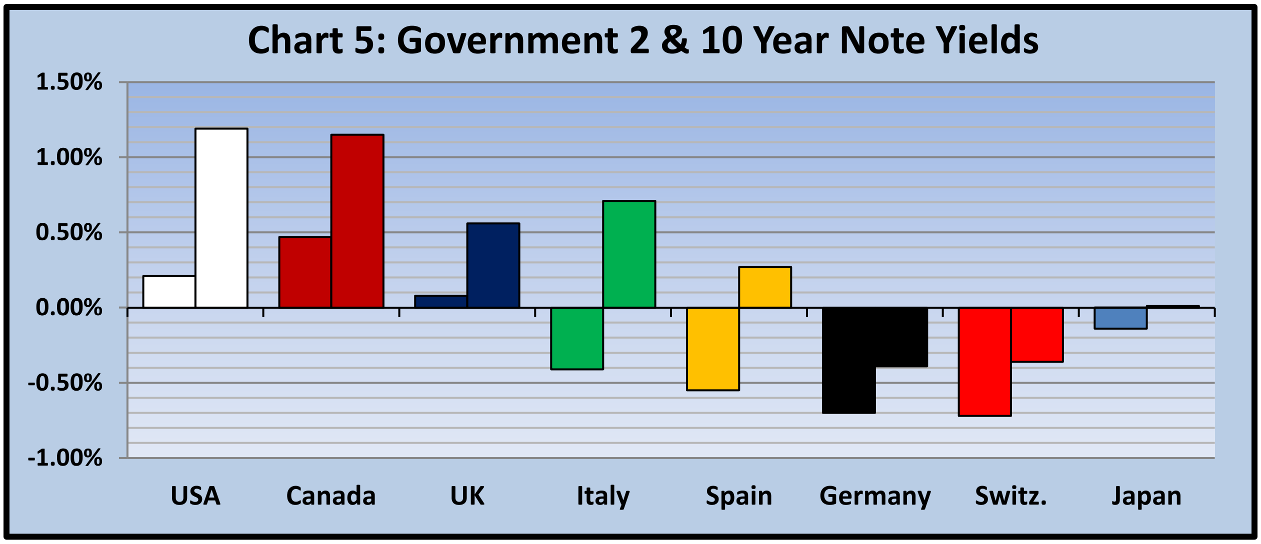
Source: Federal Reserve Bank of St. Louis

Chart 4 shows the difference in yield between Treasury debt and corporate debt of comparable maturity, for investment-grade and high-yield bonds. When credit spreads are low and heading lower, the implication is that investors don't see much default risk in holding corporate bonds; tight spreads are a sign of optimism about the economy. Spreads tightened sharply from the bottom of the recession 16 months ago, and they remain tight today: Corporate debt markets, more than either the stock market or the Treasury market, are sanguine about economic growth and don't seem to think that the Delta variant poses much cause for concern.

Thus the befuddlement facing bond investors today: Is inflation rising or not? Is the economy still growing well? Will the Delta variant short-circuit the recovery? Depending on where you look in the bond markets, you'll get different answers that don't appear to cohere. Cue the Cowboy Junkies: *I'm looking for answers in so many places / I open my mind, I don't get it.*

It may be fruitful to look for answers in one more place: Europe. Across the Atlantic, the major European nations have had a very different Covid experience than we have seen in the U.S. this year. They have not had nearly the same level of vaccination success, their Delta caseloads are much worse, and their economies are still under more severe restrictions.

Covid has certainly dimmed Europe's prospects in comparison to ours. But so too has the European Central Bank, which has stubbornly pursued its policy of keeping short-term interest rates below zero while maintaining a massive long-term bond-buying program. The ECB's yield suppression policies are plainly evident in Chart 5 (next page), which compares the 2-year and 10-year sovereign debt yields across several countries. Global investors wanting to buy 10-year government bonds have an easy choice: They can buy German or Swiss government debt that will *cost* them 0.7%, or American debt that will *pay* them 1.2%. In other words, the yield on Treasury debt is 190 basis points (1.9%) above that of its nearest international competitor. Or consider Italian debt, which has a yield of 0.7%; that's still a deficiency of 50 basis points in comparison to U.S. debt, even though Treasury debt is backed by a stronger government balance sheet and is fueled by a stronger and more diverse economy. It's a no-brainer, even after currency hedging costs.



Source: FactSet

The ECB's yield suppression policies, in other words, are forcibly driving investors out of Europe and into American debt.[1] Funds flows into American bond funds have been strong all year, suggesting that foreign investors are collectively a major reason that American long-term Treasury bond prices have started to rebound. If this is true, then falling U.S. Treasury yields don't indicate American investors' fear of slowing growth, but instead indicate foreign confidence in American growth overwhelming domestic market dynamics.

Putting all the pieces together, here's what the bond markets seem to be telling us: Tight credit spreads suggest that corporate bond investors are unafraid of slowing growth, while falling Treasury yields indicate both that inflation fears are abating as supply chains unkink themselves, and that foreign investors like what they see in the U.S. economy. For American investors, that's a surprisingly tough nut to chew: While the economic messaging is comforting, it still means that bond prices are very rich. We think the foreign enthusiasm may diminish (especially if the ECB abandons its negative-rates policy), which could send U.S. yields higher and bond prices lower.

[1] The ECB believes that negative rates make it cheaper and easier for consumers and businesses to borrow, thereby encouraging spending. Evidence in favor of this theory is sadly lacking. It's doubtful that the ECB is doing anything positive for Europe's economy, since negative yields also make it more difficult for banks to lend profitably; but that will have to be the subject of another *On Our Minds* commentary in the future.