

USTs No Longer Driving Global Bond Yields

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Unconventional Monetary Policies Exacerbate ‘Reflexive’ Markets

Unconventional monetary policies have rendered ‘core’ government bond markets increasingly unstable and ‘reflexive’. The traditional global dominance of the U.S. Treasury market on long bond yields has been replaced by multiple and multi-directional relationships between government bond markets with each the cause and effect for the other. Even as the yield on traditional fixed income disappears, the potential for contagion and volatility across global government bond markets is on the rise.

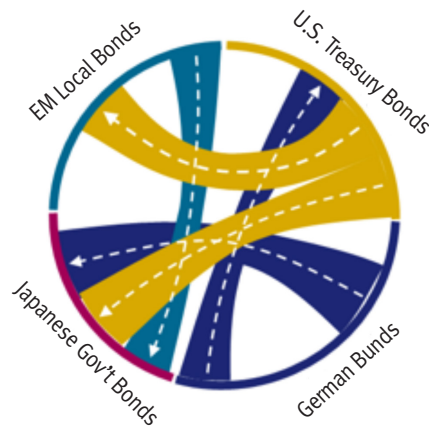
Historically, the U.S. Treasury market had the greatest influence on longer-term government bond yields worldwide. Central banks set national short-term interest rates but the yield on the most liquid asset denominated in the world’s dominant global reserve currency – U.S. Treasury bonds – was the undisputed benchmark for global long-term interest rates. That largely remains the case for the local bond markets of emerging economies, but German government bond yields (bunds) and more recently Japanese Government Bonds (JGBs) are also influencing global markets, including the U.S. Treasury market.

In the following charts, the direction of the arrows (and colour) indicate yield movements in one bond market that precede – ‘Granger cause’ in statistical jargon – movements in others. The width of the bands around the arrows indicates the degree of statistical confidence in the relationship (wider the band, the more confident).

Fig. 1: U.S. Treasury Market Dominates



Fig. 2: ECB QE and the German Bund ‘Shock’



Note: Fig. 1 sample period 1 January 2010 to 21 August 2014; Fig. 2 sample period 22 August 2014 to 14 August 2015. The arrow indicates the direction of ‘Granger Causality’. The width of the bands indicates the significance of the Granger causality test statistic. The widest band represents significant at the 1 percent level, the medium band at the 5 percent level, and the narrowest at the 10 percent level.

Source: BlueBay calculations; data at 1 March 2016

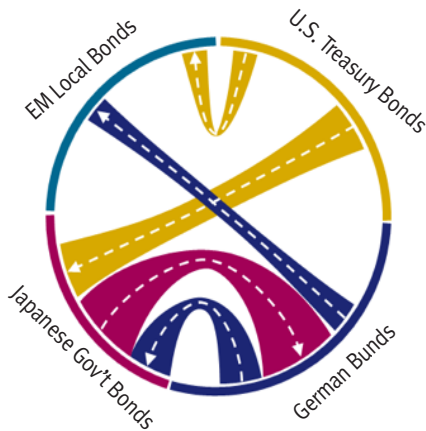
In Fig. 1 for the period January 2010 to August 21 2014, movements in U.S. Treasury 10-year bond yields preceded (Granger cause) movements in other major ‘core’ (German and Japan) bond markets as well as in emerging market (EM) local markets. Even the evidence of some influence of EM bond markets into Germany and Japan was another transmission channel whereby the US Treasury market dominated all others.

However, following the signal from President Draghi at the Jackson Hole conference in August 2014 that the ECB was likely to adopt quantitative easing, statistical analysis confirms that bund yields began to dominate Treasury yields (and JGB yields) rather than the other way round (the blue arrows running from Germany to the U.S. and Japan in Fig. 2). The subsequent rally in German bunds that ended with the sell-off in the early summer of 2015 consequently reverberated across global bond markets.

Since the end of the ‘bund shock’ in August 2015, it appears that changes in yields on JGBs have been an important influence on German bund yields (see Fig. 3). This influence is likely to have increased since the surprise cut in the BoJ’s bank rate to -0.1% that proved the catalyst for the 10-year

JGB yield to turn negative. Lower bund yields are also being fuelled by speculation – well founded in our opinion – that the ECB will announce further unconventional monetary policy measures at its meeting on Wednesday March 10. For now at least the U.S. Treasury market is not the primary driver of global bond yields.

Fig. 3: JGB and Bund Market Become ‘Reflexive’



Note: Fig. 1 sample period 17 August 2015 to 1 March 2016. The arrow indicates the direction of ‘Granger Causality’. The width of the bands indicates the significance of the Granger causality test statistic. The widest band represents significance at the 1 percent level, the medium band at the 5 percent level, and the narrowest at the 10 percent level. Source: BlueBay calculations; data at 1 March 2016

Note: Granger Causality

Granger causality is a statistical test for determining whether the past values of one variable – for instance U.S. 10-year Treasury yields – can help forecast another such as EM local bond yields. If so, it can be said that U.S. Treasury yields ‘Granger cause’ EM bond yields inasmuch as U.S. Treasury yields precede and contain relevant information for EM local bonds. However it is not statistical ‘proof’ of one-way causality, as the ‘true’ relationship may involve several variables and an extension of the Granger causality test with multiple variables is vector auto-regression (VAR).

As with all statistical analysis, the results are sensitive to the sample period with the periods chosen for this analysis corresponding to broad market episodes. The first is the post-financial crisis era from the beginning of 2010 to the Jackson Hole conference in August 2014 where ECB President Mario Draghi firmly signalled the likelihood of unconventional monetary policies from the ECB. The second episode is for the twelve months following Jackson Hole characterised by the rally and then sell-off in the German bund market. And the final period is simply from August 2015 to 1 March this year.

The arrows in the charts indicate the direction of Granger causality and the width of the band is based on the significance of the test statistic for Granger causality. The widest band represents the greatest confidence in the statistical significance of the relationship with the broadest band set to the 1% confidence interval (ie. 99% chance of being ‘true’); the medium-band at the 5% level; and the narrowest band at the 10% level.

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