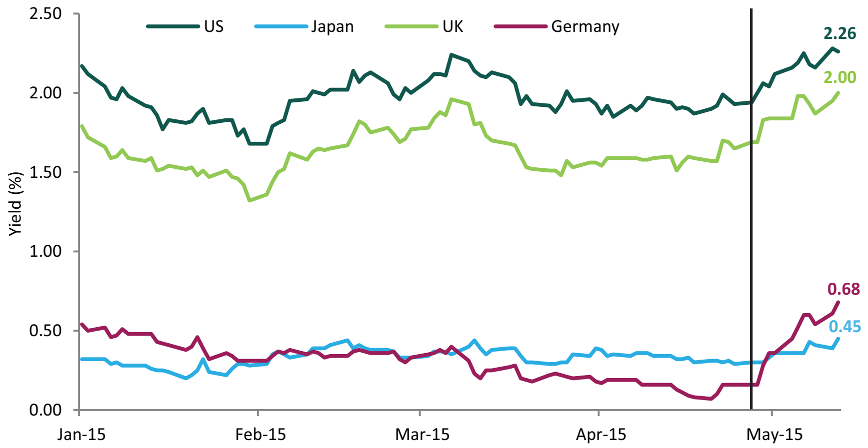
Insights

The global bond market volatility

In early May, global bond markets suffered their sharpest sell-off since the 'taper tantrum' in the summer of 2013. BlueBay's **Head of Credit Strategy, David Riley**, considers some of the lessons from the recent rout and resultant volatility.

At the end of April and beginning of May, global bond markets suffered their sharpest sell-off since the 'taper tantrum' in the summer of 2013. The sell-off began in earnest on 29 April, a day of relatively heavy supply in Europe, with German and Italy planning to auction as much as €12.5 billion of debt and a meeting of the US Federal Reserve monetary policy committee (the FOMC). 10-year German bund yields nearly doubled on that day from 16bps to 29bps. The 10-year US Treasury bond yield followed bunds higher, though by a modest 4bps, on the day despite the release of weaker-than-expected estimates of real GDP in the first quarter (just 0.2% annualised) and a mildly 'dovish' FOMC policy statement.

'Core' government 10-year bond yields



Data source: Macrobond, as at 12 May 2015

The sell-off in bunds intensified and reached 0.78% intra-day on Thursday 7 May, just a few weeks after posting an all-time low of 0.05% and closed the week at 0.54%, still higher than before the European Central Bank's (ECB) announcement of full-blown quantitative easing (QE) on 22 January. The US Treasury 10-year yield is 2.20% at the time of writing (11 May 2015), the highest since the New Year. The volatility and increase in core benchmark government bond yields spilled over to the equity markets as well as to European peripheral bond markets.

The volatility and increase in core benchmark government bond yields spilled over to equities and peripheral bond markets

Fundamental and technical factors drive yields higher

In contrast to the 'taper tantrum', there was no apparent catalyst for the German bund sell-off in terms of a notably stronger-than-expected economic data release and/or surprise monetary policy pronouncement. At the post-meeting press conference of the ECB's mid-April meeting, Mario Draghi re-affirmed the commitment to maintaining QE to at least September 2016. Rhetoric from key members of the FOMC had also signalled that 'lift-off' in US policy rates in June was increasingly unlikely. In our opinion, the pace and scale of the sell-off primarily reflected a reversal of crowded long positions in the German bund market (especially by leveraged market participants), which was exacerbated by market illiquidity.

The fundamental underpinning of the sell-off is a shift in investors' mindset from a fear of deflation to an anticipation of global reflation. Market measures of inflation expectations have been rising since late February following a swathe of policy easing by central banks globally, including by the People's Bank of China, as well as the rise in oil prices since the lows reached in mid-January. The cumulative effect of better than expected Eurozone economic data implied that long-term real interest rates of minus 1 percent were simply too low. German bunds went from dragging down global bond yields to driving them higher as real and nominal rates rose during the sell-off.

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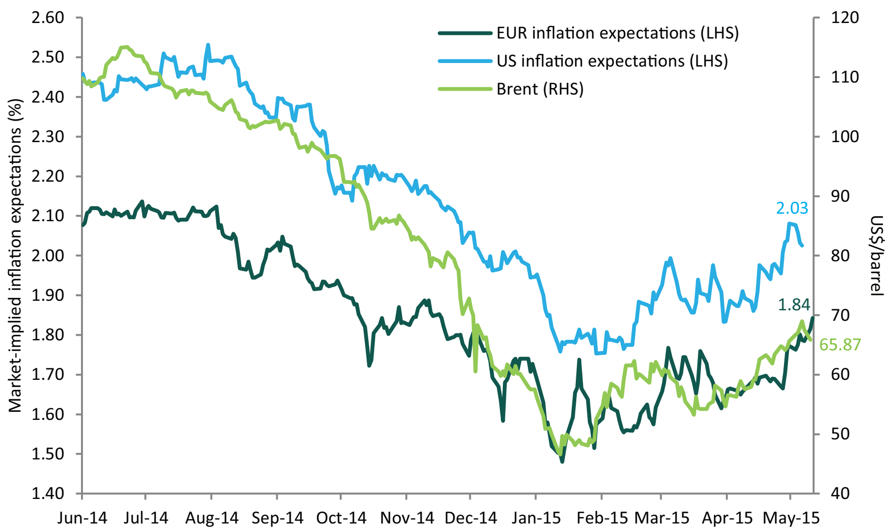
Market inflation expectations and oil prices



Data source: Bloomberg and Macrobond. Data as at 8 May 2015
Note: EUR inflation expectations are derived from EURO inflation swaps; US inflation expectations from 5-year forward breakeven inflation rate implied by US Treasury Inflation Protected securities

The emergence of negative yielding core European government bonds (EGBs) and the apparent relentless fall in the 10-year bund yield attracted leveraged 'momentum' investors to take ever more duration risk on the assumption that the ECB wanted to buy more bonds (and especially bunds) than were available. However, extraordinarily low yields and the flat yield curve challenged that assumption as increasing numbers of the 'natural' buyers of EGBs concluded that it was uneconomic to do so. Despite favourable regulatory treatment, European insurers and pension funds were faced with locking in yields that were far below the returns they had guaranteed - implicitly or explicitly - to policyholders and began to buy overseas assets (including emerging market bonds) and allocate capital to real estate and other assets. Even for banks able to leverage carry positions in EGBs because of low capital charges on sovereign debt, extending loans to the private sector became an increasingly attractive alternative. Moreover, despite the constriction of fiscal rules and budget targets, government debt managers understandably sought to exploit historic low borrowing costs by bringing forward and extending the term of their debt issuance. The favourable supply and demand 'technical' dynamic created by QE that underpinned the extraordinary rally in EGBs in the first quarter became increasing fragile.

Media reports of large losses incurred in recent weeks by macro hedge funds utilising algorithms to exploit market trends, confirm that such leveraged investors, along with the ECB, had increasingly become the marginal buyer of EGBs. Once the sell-off started, such investors were forced to unwind positions in low liquidity markets, triggering a further round of stop losses and selling.

Negative long-term real interest rates (and, even more so, negative nominal yields) are not consistent with a global economic growth cycle that remains intact and which we expect to strengthen over the remainder of 2015. US economic growth is set to accelerate despite the weakness in the first quarter. The economic outlook for the Eurozone and Japan is improving and a recent move by the People's Bank of China to ease lending policies should provide a fillip to the country's struggling real estate market.

The partial rebound in oil and other commodity prices, monetary policy easing earlier this year and the US economy approaching full employment have dispelled fears of a global deflationary downturn.

The spike in market volatility, exacerbated by crowded investor positioning and markets drained of liquidity by regulatory initiatives warrant higher risk or 'term premium' in global bond markets. In contrast to credit risk spreads, the term premium remains at historic lows even after the recent volatility in bond markets.

Lessons from the sell-off

Markets don't evolve in straight lines – or at least not for long, as the reversal in bond markets in recent weeks has dramatically illustrated. Our current judgement is that global bond yields are biased to the upside in light of our fundamental assessment that global economic activity and inflation bottomed in the first quarter and are set to rise, albeit moderately, over the remainder of the year. Nonetheless, we believe uncertainties regarding the evolution of oil prices and the US dollar – two key global macro prices – will at times dominate the direction of bond markets, as will central bank policy actions.

There are three key lessons from the latest bout of volatility in global bond markets. Firstly, the risk-return profile of long-duration 'safe' government bonds with yields near zero is highly asymmetric and unappealing, even for highly regulated and constrained investors. In our opinion, the recent sell-off and volatility in markets has established a floor on long bond yields that lies above zero, despite QE and financial repression. The second lesson is that the largely regulatory-induced decline in financial market liquidity extends beyond credit to 'core' fixed-income markets. Distortions created by central banks and diminishing market liquidity are becoming more acute. Retaining a focus on valuations and fundamentals as well as central bank influenced market technicals is essential for successfully navigating such an environment. Third, the combination of low yields and illiquid markets underscores the value of active management of duration as well as credit risk for preserving capital.

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