Global Strategy Weekly

Investors becoming convinced bond yields have seen their lows – again!

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One striking feature of the 33 year bull market in government bonds is that each occasion of a sharp rise in yields has been greeted with a rush to declare the long bull market finally dead and buried. The rapid upward move in yields over the past month, most especially in the eurozone, has produced the usual chorus of bears. We however doubt that government bond yields have witnessed their secular low – and most especially not in the US.

- An integral part of our Ice Age thesis has been to overweight longer dated government bonds as deflation becomes an ever more immediate threat. That strategy has produced superior returns, even relative to global equities. Clearly at some point this 33 year bull market in government bonds will end, but why are market commentators just so keen to pronounce its demise? It is because the continued bond bull market mocks the paucity of the recovery with its accompanying deflation, thereby threatening the asset class they *really* want to be bullish about – the equity market.

- I have read a lot of very convincing commentary in recent weeks to the effect that we have seen the lows for 10y+ government bond yields with various explanations surrounding the dollar's recent decline and the recovery in the oil price, etc., etc. And to be sure we did certainly enter some sort of twilight world recently when German 10y yields sank to 0.05%. The sharp dip in German yields below Japanese yields, even at the 30y end of the curve, was also accompanied by a bizarre dive in Spanish yields well below the US – a curious state of affairs indeed. All that has happened though over the past few weeks is that *some* sort of normality has been restored (see chart below).

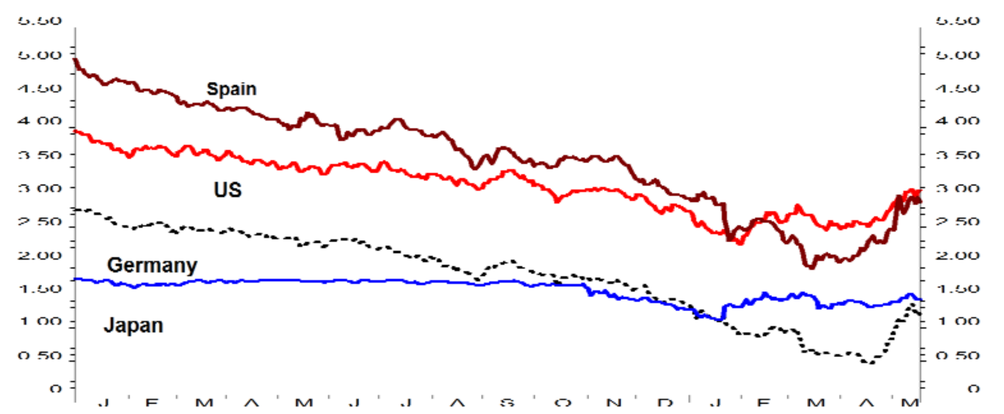
- I do not see this as the end of the bull market for long government bonds. Despite the oil price rise, core inflation remains extraordinarily low at a time when the global economy is still struggling to gain traction. Aside from continued growth disappointments in the West, the outlook for the oil price and the Chinese economy will be key. And on that latter score we remain far more concerned about China than most market commentators. And notwithstanding the (over)-confidence evident among central bankers, Europe and the US remain only one recession away from outright deflation.

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

Source: SG Cross Asset Research

A little bit of normality has been restored to eurozone bond yields (30y yields)



Source: Datastream

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To judge from the recent pronouncements of central bankers the recent deflation scare has been all but vanquished. "Enjoy it while it lasts" said Bank of England Governor Mark Carney subsequent to April's annual decline in UK consumer inflation – the first since 1960. But the sound of backs being slapped in self-congratulation are most audible at the ECB. Now, even allowing for the need of central bankers to show a confident face to market participants, recent rises in inflation expectations of around 25bp in the eurozone and 10bp in the US are hardly spectacular (see chart below). The actual *core* inflation data has barely yet risen - in the eurozone core CPI inflation remains stuck at the 0.6% lows yoy, while in the US the Fed's favoured core PCE deflator, at 1.3%, remains close to its cyclical low (and measuring core CPI on the same basis as the eurozone – ie ex imputed rent – US core inflation is just as low as in the eurozone). There is nothing for central bankers to be complacent about here.

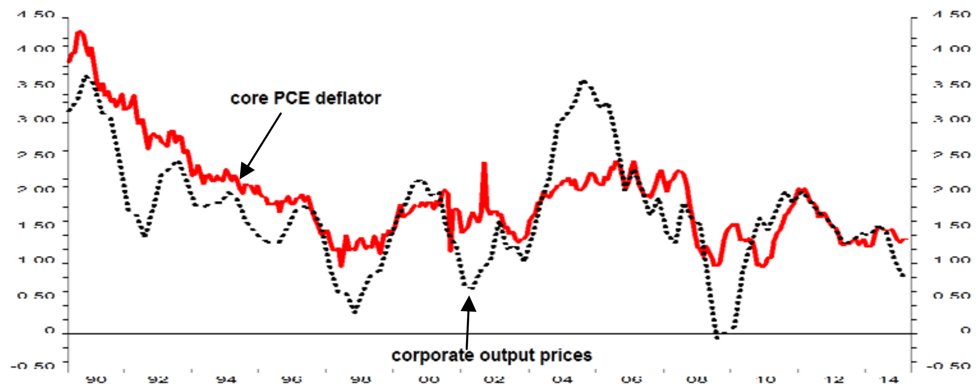
US and eurozone 5y inflation expectations in 5 years time

Source: Datastream

One key part of the deflationary tide that has gone virtually unnoticed is corporate pricing power. We monitor closely the implicit corporate sector price deflator released as part of the US productivity and costs report. Corporate output prices closely follow the measure of core CPI and PCE inflation but tend to offer more direction, so the recent slump in the Q1 data to 0.8% yoy in Q1 was significant at a time when other inflation measures are showing some stabilization or slight improvement (see chart below).

The ongoing loss of corporate pricing power is exacerbating the downturn in the corporate margin cycle. The Q1 data shows productivity declined sharply for the second quarter in succession (something David Rosenberg has pointed out seldom happens outside of recession). On a yoy basis the resultant 1.1% rise in unit labour costs is running ahead of the 0.8% rise in output prices. With revenue growth now declining for the corporate sector overall, these deflationary winds blowing through the corporate sector - and the resultant profits squeeze – leave the economy vulnerable to a renewed recession.

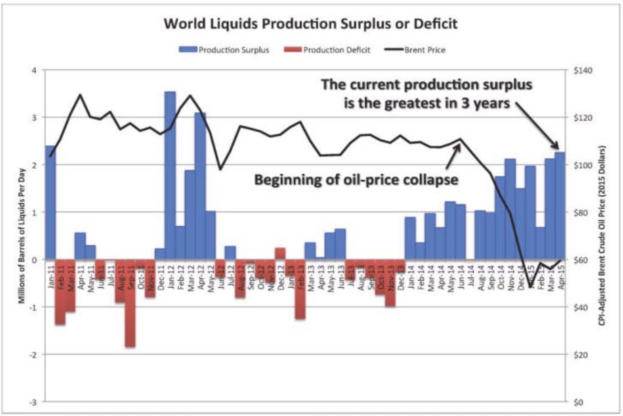
US corporate pricing power declines sharply in Q1 2015 (yoy, %)



Source: Datastream

But it is not just in the US where the macro data continues to disappoint. The recent improvement in the data out of the eurozone seems to have gone into reverse recently. Some commentators think this may help explain the ECB's recent announcement that they will frontload their QE measures (see right-hand chart below). But for many, it has been the recent rally in oil prices that has been the primary cause of the recent rise in bond yields. As Zero Hedge recently pointed out, many believe that the oil price rally will be short-lived as record surplus production has continued into Q1, according to the International Energy Agency (see left-hand chart below and link). Fundamentally the oil rally may be on very shaky ground indeed. And to the extent that recent gyrations in bond yields have been driven by the headline oil price and inflation rates, then we could be revisiting the lows again quite soon.

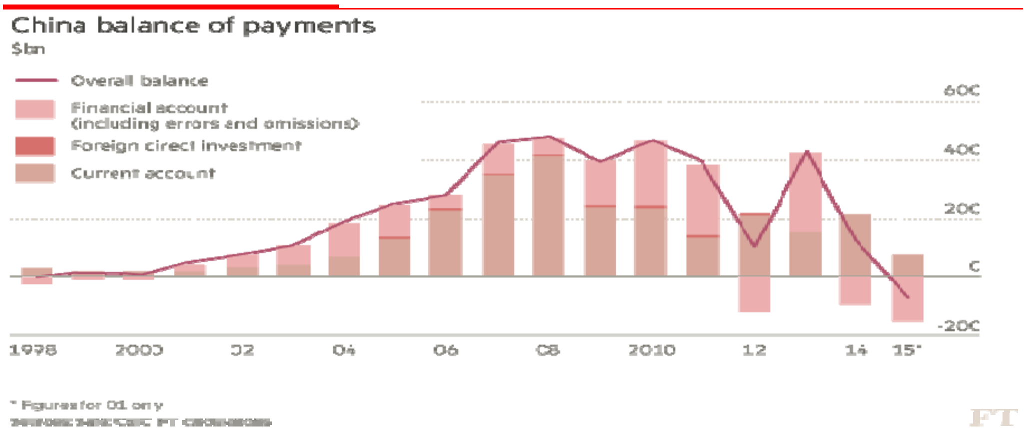
Suplus oil production does not bode well for the oil price



Eurozone positive surprises slipping away

Source: Zero Hedge

The weakness in commodity prices over the past year or so is indicative of the weakness in global aggregate demand - a function of economic weakness in China as well as in misfiring western economies. **Crucial to our thesis of ongoing weakness in the Chinese economy is the transformation in China's Balance of Payments (BoP) situation**. We have always cited Russell Napier on this subject, who believes the boom and bust cycle in emerging economies is closely related to the ebbs and flows of their Balance of Payments situation. In that context an excellent article by the FT's Gabriel Wildau in Shanghai highlighted that record recent capital outflows from the capital account are *"complicating efforts by the People's Bank of China to support the economy through monetary easing. For the past decade, central bank purchases of foreign exchange inflows were the main source of base money creation in China's banking system. Now, outflows are threatening to shrink the money supply."* Lower Chinese interest rates to stimulate growth merely exacerbate the outflows, requiring heavier FX intervention to hold the currency steady (for now), hence shrinking the domestic money supply still further. China is in a bind with its virtuous BoP loop turning vicious. The consensus remains too complacent on China's ability to escape this BoP-driven slow growth trap.



Source: Financial Times

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