Selling Sweeps Global Government Bonds; U.S. 10-Year Yield Above 1.8%

Better-than-expected U.K. economic growth and Bank of Japan governor's comments drive investors

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A fresh wave of selling swept government bonds in the developed world on Thursday, sending the yield on the benchmark 10-year U.S. Treasury note to the highest level in more than four months.

Two factors drove investors to shed holdings: The pace of economic growth in the U.K. last quarter beat economists’ forecasts, soothing concerns over the fallout from the Brexit vote in late June. Bank of Japan Gov. Haruhiko Kuroda said Thursday said that “it would not be strange” for long-term bond yields to rise.

Government bond yields have been climbing after plunging to historically low levels during the summer, highlighting the market’s vulnerability at a time when their valuations have been stretched.

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The combination of low global growth, subdued inflation and ultra loose monetary policy among major central banks has been sending bond yields to unprecedented levels. Yet over the past few weeks, the narrative has appeared to shift.

Concerns have been growing over less support for the bond market from central banks in Japan and Europe as their bond buying is reaching limits. Economists and analysts have started talking about a shift toward fiscal stimulus to combat low growth. Such fiscal action typically raises supply of government debt for funding and is seen as a negative for long-term government bonds.

Demand for haven bonds has also been diminishing as data lately have pointed to some positive signs on the global economic outlook. Meanwhile, inflation expectation is rising, driven by a rally in crude oil prices this month and comments from major central banks to tolerate inflation slightly above their desired targets to tackle still low inflation.

The bond market has been "feeling the squeeze from multiple angles,'' said Aaron Kohli, interest-rate strategist at BMO Capital Markets.

In recent trading, the yield on the 10-year Treasury note rose to 1.864% from 1.790% Wednesday, according to Tradeweb. Yields rise as bond prices fall.

Bond yields in Europe rose at a faster pace as selling pressure was stronger than the U.S. bond market. The yield on the 10-year German bund was up about 0.07 percentage point to 0.161% and the 10-year U.K. gilt yield was up about 0.1 percentage point to 1.259%, according to Tradeweb.

The 10-year break-even rate, or the yield premium investors demand to hold a 10-year Treasury note relative to the 10-year Treasury inflation protected security, reached 1.734 percentage point Thursday, the highest level of the year. It has been rising from a recent low of 1.36 percentage point in June.

At the current level, it suggests that investors expect the U.S. inflation rate at 1.734% on average over the next 10 years. Some analysts say the break-even rate has room to rise toward the Fed's 2% target.

Inflation chips away the fixed returns on bonds and is the main threat of long-term government bonds. Investors have been selling Treasurys to buy TIPS this month, suggesting growing demand for inflation protection.

The selling in bonds this month underscores the risk that bondholders may be prone to abrupt and large capital loss if investors exit holdings in droves at the same time.

Still, yields remain at very low levels. The 10-year Treasury yield has risen from its record close low of 1.366% made in July, but it traded at 2.273% at the end of 2015.

Many investors are still hesitant to declare that the superlong cycle of low yields has ended. The 10-year yield has been falling since hitting a record high of around 18% in 1981.

“The ultralow yield cycle may be nearing an end, but yields should not be able to rise sustainably” given the aging demographic, still subpar economic growth and the Fed’s shallow path in raising rates, said Christopher Sullivan, who oversees $2.3 billion as chief investment officer at the United Nations Federal Credit Union in New York.

"I think yields around or approaching 2% should be bought, and I think the ability for the market to sustain that yield or anything much higher will be limited,’’ he said.