The Telegraph

Bond yields are surging despite deflation, and that is dangerous

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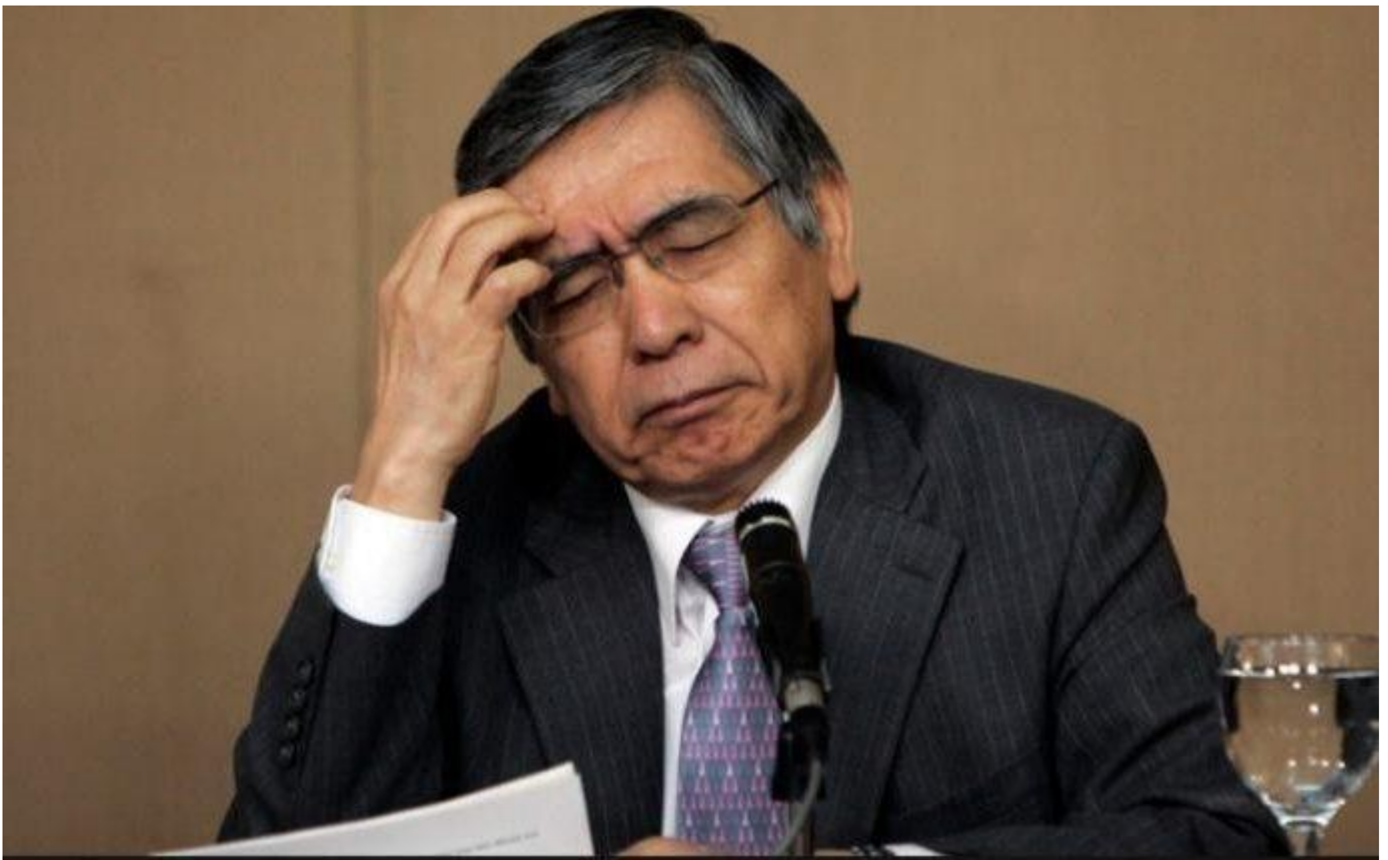


The Bank of Japan's Governor Haruhiko Kuroda is cornered, and Europe's Mario Draghi may be next

The growth rate of nominal GDP in the US has fallen to 2.4pc, the lowest level outside recession since the Second World War.

It has been sliding relentlessly for almost two years, a warning signal that underlying deflationary forces may be tightening their grip on the US economy.

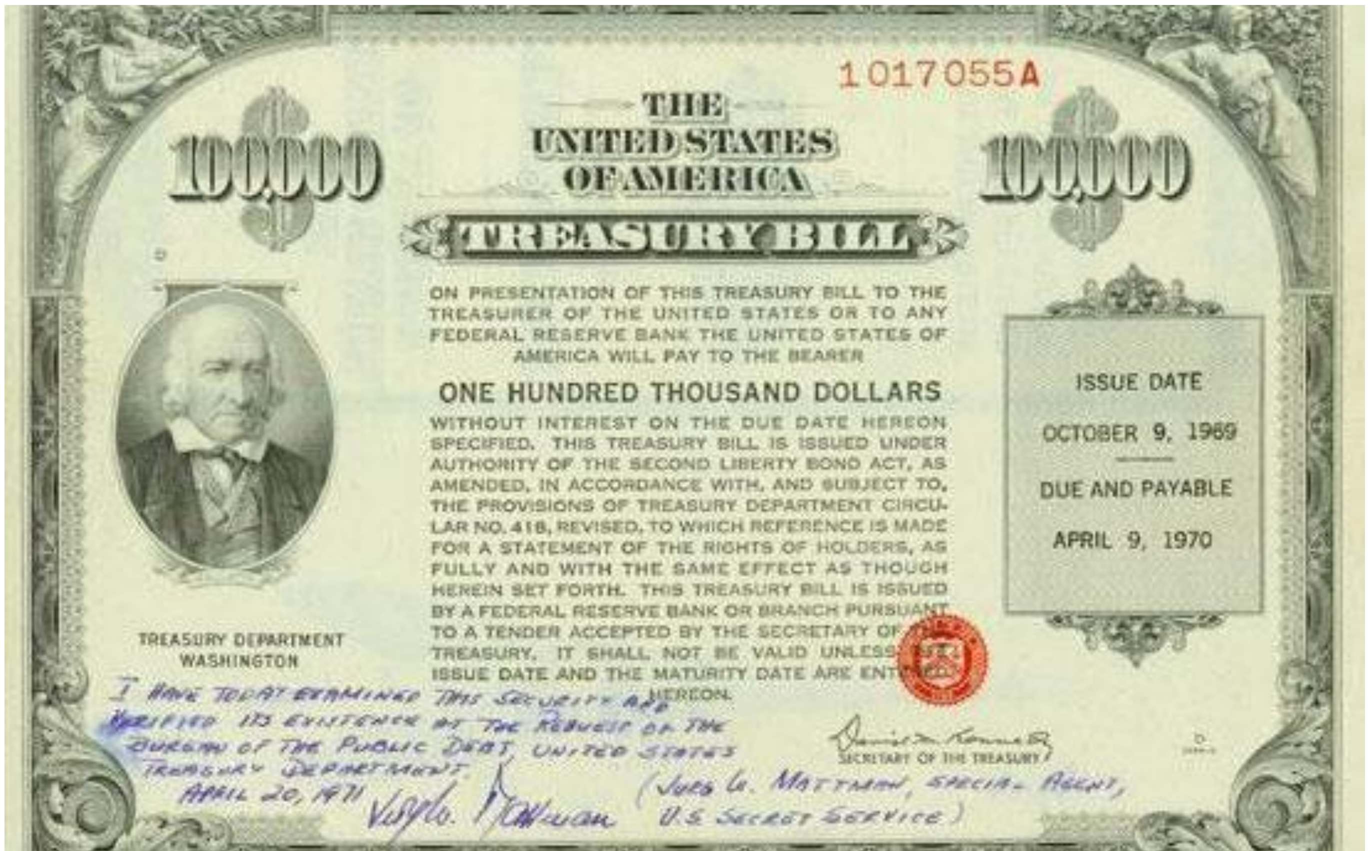
Given this extraordinary backdrop, the violent spike in US and global bonds yields over the last four trading days is extremely odd. It is rare for AAA-rated safe-haven debt to fall out of favour at the same time as stock markets, and few explanations on offer make sense.

We can all agree that oxygen is thinning as we enter the final phase of the economic cycle after 86 months of expansion. The MSCI world index of global equities has risen to a forward price-to-earnings ratio of 17, significantly higher than on the cusp of the Lehman crisis.

"We think that too much complacency has crept in," says Mislav Matejka, equity strategist for JP Morgan.

"After seven years of having a structural overweight stance on global equities, we believe the regime has fundamentally changed. We think that one should not be buying the dips any more, but use any rallies as selling opportunities," he said.

The correlation between bonds and equities has reached unprecedented levels, and that has the coiled the spring. The slightest rise in yields now has a potent magnifying effect across the spectrum of assets. Hence the angst over what is happening to US Treasuries.



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TREASURY BILL

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ONE HUNDRED THOUSAND DOLLARS

WITHOUT INTEREST ON THE DUE DATE HEREON SPECIFIED. THIS TREASURY BILL IS ISSUED UNDER AUTHORITY OF THE SECOND LIBERTY BOND ACT, AS AMENDED, IN ACCORDANCE WITH, AND SUBJECT TO, THE PROVISIONS OF TREASURY DEPARTMENT CIRCULAR NO. 418, REVISED, TO WHICH REFERENCE IS MADE FOR A STATEMENT OF THE RIGHTS OF HOLDERS, AS FULLY AND WITH THE SAME EFFECT AS THOUGH HEREIN SET FORTH. THIS TREASURY BILL IS ISSUED BY A FEDERAL RESERVE BANK OR BRANCH PURSUANT TO A TENDER ACCEPTED BY THE SECRETARY OF THE TREASURY. IT SHALL NOT BE VALID UNLESS THE ISSUE DATE AND THE MATURITY DATE ARE ENTERED HEREON.

ISSUE DATE OCTOBER 9, 1969

DUE AND PAYABLE APRIL 9, 1970

TREASURY DEPARTMENT WASHINGTON

SECRETARY OF THE TREASURY

I HAVE TODAY EXAMINED THIS SECURITY AND VERIFIED ITS EXISTENCE AT THE REQUEST OF THE BUREAU OF THE PUBLIC DEBT, UNITED STATES TREASURY DEPARTMENT. APRIL 20, 1971

(SPECIAL AGENT, U.S. SECRET SERVICE)

US Treasury Bill yields have jumped 19 basis points to 1.72pc since the middle of last week

Yields on 10-year Treasuries - the benchmark borrowing cost for international finance - have jumped 19 basis points to 1.72pc since the middle of last week. The amount of global government debt trading at rates below zero has suddenly fallen from $10 trillion to $8.3 trillion, with parallel effects for corporate bonds.

You would have thought that inflation was picking up in the US and that the Fed was about to slam on the brakes, but that is not the case. The markets are pricing in a mere 15pc chance of a rate rise next week, and the figure has been falling.

If anything, the US inflation scare has subsided. There were grounds for worrying earlier this year that Fed would have to act. In February, core CPI inflation was steaming ahead at a rate of 2.9pc on a three-month annualized basis. This has since dropped back to 1.8pc. Other core measures are lower.

It is striking that markets do not believe that the Fed will hit its 2pc inflation target for the next 30 years, based on the pricing of the "TIPS" breakeven curve. Michael Darda from MKM Partners says it would be "utterly absurd" for the Fed to give in to the chorus of calls for a rate rise in such circumstances.

Fed governor Lael Brainard clearly agrees. Far from capitulating to the hawks - as many expected - her speech on Monday night warned that business investment has been falling for the last three quarters, and now the housing market is softening too.

Federal Reserve Governor Lael Brainard has argued against riasing interest rates CREDIT: REUTERS

She said the real "neutral" rate of interest has fallen to zero, and that there is no margin for error. It would be very hard to extract the US economy from Japanese-style trap if the Fed ever allowed it to happen. "This asymmetry in risk management in today's "new normal" counsels prudence in the removal of policy accommodation," she said.

Even if the Yellen Fed does raise rates next week, the move will be hedged with such "dovish guidance" as to neutralise the effect. In short, the Fed cannot plausibly be responsible for the global bond rout.

What is true is that markets fear the Bank of Japan and the European Central Bank are reaching their political limits, and may not be allowed to press ahead with their experiments even if they want to.

Japan's Governor Haruhiko Kuroda has had his wings clipped by critics in the ruling party of Shinzo Abe, alarmed that the BoJ is swallowing up the financial system. They forced him to carry out a "comprehensive review" of his policies. "Japan has reached an inflexion point. The BoJ is clearly cornered," said Stephen Jen from Eurizon SLJ Partners.

The bank already owns 12pc of Fast Retailing and 13pc of the technology group Advantest, and these holdings are heading for 20pc next year as a mathematical effect on current policy. Japan's market economy is being nationalised.

The BoJ will soon hold 50pc of all Japanese government bonds. It is monetising the entire budget deficit. Mr Jen says the central bank is nearing the fateful point where it will have no exit strategy if inflation ever does recover, a worry shared by officials at the International Monetary Fund.

ECB chief Mari Draghi has lost the confidence of German elites CREDIT: REUTERS

A variant of this political saga is playing out in Europe, where the ECB's Mario Draghi has lost the confidence of the German elites. "Instead of new and always more extreme measures we need a little patience," were the acid words of Sabine Lautenschläger, Germany's member on the ECB's executive board.

The Bundesbank's balance sheet has surged sixfold to €1.2 trillion and it has built up claims of €660bn on other eurozone central banks through the Target2 payment system. Italy's liabilities have reached an all-time high of €327bn, mostly owed to the Bundesbank.

The ECB's fateful decision to opt for negative rates - now minus 0.4pc - in the face of vehement German protest was a step too far. The savings banks and insurers want Mr Draghi burned at the stake. Finance minister Wolfgang Schauble blames him for the gains of the right-wing AfD party.

The rise of the populist right-wing AfD party is Germany is blamed on the actions of the ECB CREDIT: GETTY IMAGES

It is true that Mr Draghi's €80bn package of bond purchases each month is no more proportionately than prior QE schemes by the Fed and the Bank of England, but the political effects are toxic within the awkward structure of the eurozone.

As markets discovered last week, he may have trouble securing German assent for an extension of QE when it expires in March. Investment funds are already reeling back their QE bets. Less bonds may be bought after all.

This is why yields on 10-year German debt are suddenly above zero again after three months in the underworld, with parallel moves in France, Holland, and Spain - and bigger jumps in Italy and Portugal. The European taper tantrum has begun.

Bond yields in Europe are clearly not rising because growth is picking up and inflation looms. Industrial output slipped 1.1pc in July. France and Italy are in stagnation. The share of items in the eurozone inflation basket increasing at less than 1pc is spreading, a precursor of deflation. In other words, yields are rising for the "wrong reason" in Europe.

We are entering dangerous waters. Markets are losing faith in the central bank "put", but governments are not yet willing to step into the breach with fiscal stimulus to keep the global show on the road. This is how accidents happen.