ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Financial Market Outlook

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Dr. Michael Heise

A new interest rate conundrum?

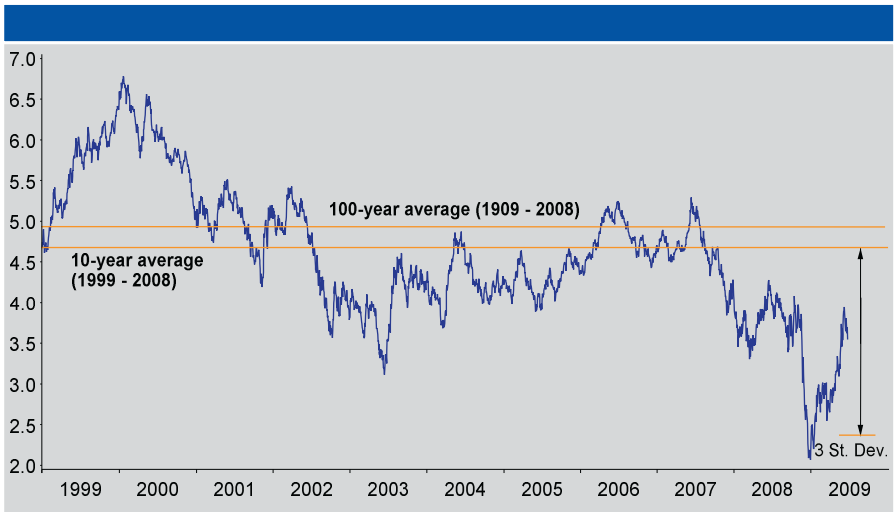
Allianz

A NEW INTEREST RATE CONUNDRUM?

Sentiment on bond markets has turned in recent months. Since the lows at the end of 2008 bond yields have climbed up more than 100 basis points for 10-year US Treasuries and 50 basis points for German bonds. We are almost back to "pre-Lehman levels". At first sight, this seems to be quite at odds with the real economy and inflation. After all, since the fall of 2008, the world economy has seen the steepest slide in production for decades and inflation has been declining rapidly. So why this strong rise in yields, unexpected by so many forecasters? Here are some possible explanations:

Mean reversion? First of all, it is important to note that by all statistical standards interest rates had fallen to unusually low levels after Lehman. In December 2008 rates in the US had fallen about 250 basis points or three standard deviations (one percent of all cases) below their ten year average (Chart). The "flight to quality" had bloated the demand for government bonds and pushed up their prices. As risk aversion slowly faded, so did the demand for government bonds. Their yields may just be returning to normal. There is no natural downward trend of interest rates, especially if central banks anchor inflation expectations around 2%.

Yield on 10yr US government bonds

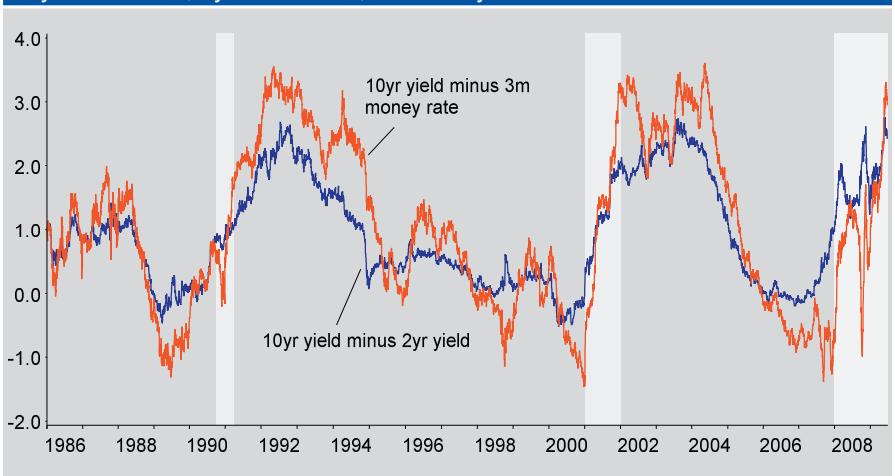


Expectations matter. In the midst of the very weak economic environment, market participants slowly seem to be embracing the story of the green shoots signaling a recovery. In doing so, they are quite a bit ahead of very downbeat official forecasts like those from the IMF, the OECD or central banks. Also, inflationary expectations have edged up (to around 1.8% in the US) in recent weeks. This is partly due to the mutterings about the "inevitable" inflationary consequences of aggressive central bank liquidity generation and Keynesian fiscal stimulus packages. While it is true, as Paul Krugman rightly observes, that the banks are still sitting on their extra reserves and in effect sending the money right back to the Fed, it would be naïve to assume that the concern about higher medium-term inflation will just disappear in the near future. Inflation expectations are likely to persist, at least on a moderate level.

Flood of government bonds. Even without high inflation expectations, the rise in yields can be explained by heavy government borrowing on capital markets. So far, large issues have been absorbed quite easily, as government paper was the safe haven for investors worldwide. But there is much more in the pipeline and, with investors' risk appetite slowly rising, government bonds are starting to look less attractive. Of course, risk aversion could suddenly return due to some kind of shock that ends the recovery. But even if it does, it will not be a permanent effect and it will not prevent a repricing of government bonds indefinitely. A counter-argument could be that prematurely rising bond yields could kill off the economic recovery and thereby trigger a self-correction towards low levels again. For two reasons, this does not seem very plausible. First of all, despite the recent rise, long-term bond yields are still at a very low level, even taking only moderate inflation expectations into account. Secondly, the yield curve is already fairly steep – with money market rates, e.g. the EURIBOR at around 1% and 10-year government bond yields at around 3.5%. Such a steep yield curve is quite typical for economic recovery phases and has proven to be quite a good forward-looking indicator signaling expansion.

USA: Interest rate structure (long-term minus short-term)

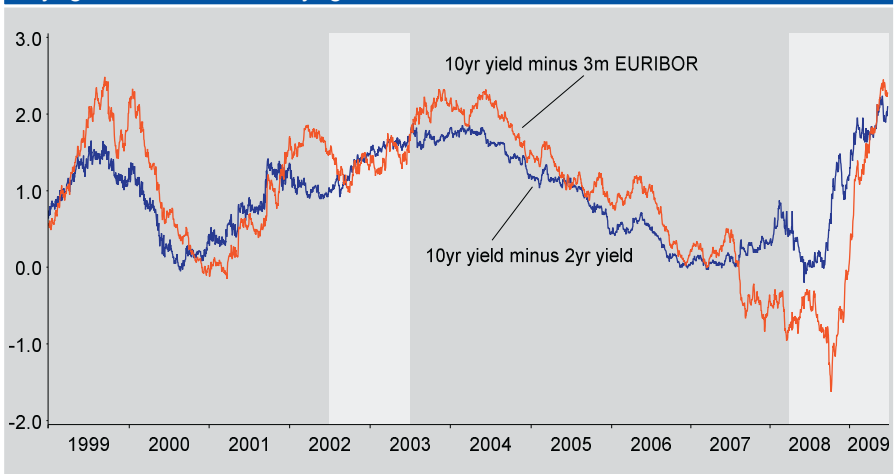
10yr Treasuries, 2yr Treasuries, 3m money



Recession phases according to the Business Cycles Dating Committee of the National Bureau of Economic Research.

EMU: Interest rate structure (long-term minus short-term)

10yr government bonds, 2yr government bonds, 3m EURIBOR



Recession phases in Germany.

The conclusion is quite clear. If nothing derails the recovery, longer-term interest rates will be going up in the coming months, maybe not in the very near future but over the next six or twelve months. This would be magnified by an early re-appearance of inflation, a scenario that does not seem very likely at present, but which cannot be ruled out completely. On the other hand, there is the somewhat higher risk that the recovery falters and the economies get ensnared by deflation. After all, in a still very fragile situation with excess capacity, further deleveraging needs and rising unemployment, even small shocks could end the recovery and lead into a double-dip recession. Many things – even big ones – are conceivable: military conflicts, pandemics or renewed oil price shocks or banking crises. While these shocks are possible, they are in a certain sense unpredictable exogenous events – and therefore should not dominate a yield forecast.

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