The NewsLine

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FINANCIAL MARKETS

Uptick in yields: Keep calm

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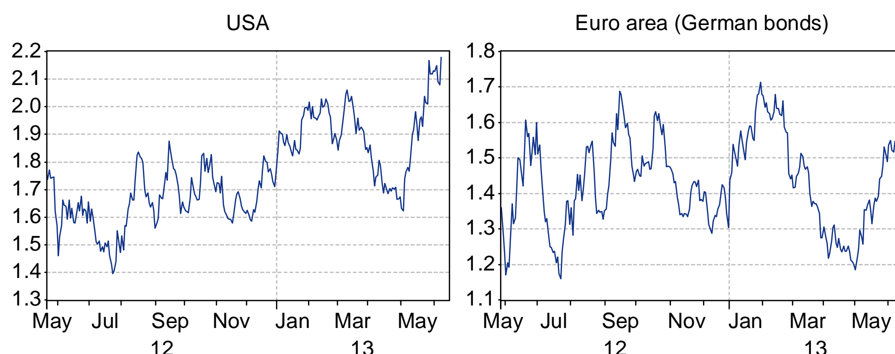
Following the rise in government bond yields in recent weeks, talk of the turn of the interest rate cycle is doing the rounds. Since the end of April the yield on 10-year government bonds has risen by around 50 basis points in the US and by around 30 basis points in both Japan and Germany.

Despite the correlation of yields on the major markets it would be wrong to conclude that the factors driving the increase are the same. In Japan the central bank, with its plans to purchase government bonds and double the monetary base, is aiming to raise inflation expectations or, put more precisely, eliminate deflation expectations. Central bank success on this front affects the inflation component in long-term yields. This is likely to have been a key factor on the Japanese bond market. By contrast, in the US and Europe there is little to suggest that rising inflation expectations were the trigger for rising yields. In both the US

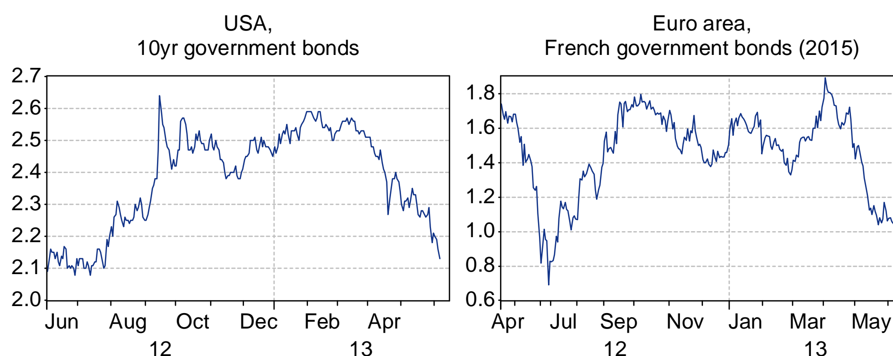
10-year government bond yields



and Europe inflation expectations derived from inflation-indexed bonds are currently lower than at the start of the year and fell particularly sharply in the course of April and May. The main factor behind the yield rise in the US was a

string of positive economic numbers and statements by Fed president Ben Bernanke that might indicate a tapering of the government bond purchasing program. Given the international context, yields on the German market also rose. Unlike in the US, where the yield on 10yr Treasuries now stands at a 12-month high, yields on German bonds have been higher than at present several times over the past twelve months. So, what we have seen so far in Germany is at most a marginal correction from an extremely low level.

Inflation expectations (break-even-inflation)



The pivotal question for the future trend in yields is whether an end of the Fed's quantitative easing might prompt a global surge in yields – possibly even on a par with the 1994 bond market crash. In our view this is unlikely as in 1994 inflation expectations had arisen. Although these did not subsequently materialize, they did serve to badly spook the bond markets. Rate hikes by the Fed to ward off the possible threat of inflation aggravated investor concerns. At present inflation is subdued and central banks are highlighting risks on the economic front rather than on the price front.

In our view the recent rise in yields is attributable to the protracted overvaluation of safe-haven government bonds over many quarters. Our econometric model using traditional fundamental factors such as inflation, economic growth and key rates would, without the unconventional central bank monetary policy, suggest a yield level of 3% for the US and marginally lower for Germany. The deviation of the model readings from actual yields, which for Germany amounted at times to almost 200 basis points, has been shaved to around 150 basis points by the recent rise (USA: 100 basis points). A portion of the safety premium on US and German government bonds and some of the impact of unconventional monetary policy has thus been eliminated. We expect this normalization process to continue and yields to rise in 2014 to 2 to 2.5% in Germany and to 2.5 to 3% in the US. This assumes that central banks in the US and Europe enact a circumspect withdrawal from crisis mode and do not

announce a sudden drastic U-turn. It also seems plausible that US policymakers will make the first move towards normalization. This should lead to a strengthening of the dollar which has lost ground against the euro in recent days. This scenario of a moderate rise in yields poses no risks to the economy nor will it fundamentally call into question stock market valuations. Nonetheless, even a "gentle" exit scenario is likely to heighten market volatility as investment decisions based on the assumption of ultra-low rates will need to be reviewed and possibly revised.

An abrupt and radical exit from unconventional monetary policy would trigger severe market reactions that could jeopardize the economy. However, monetary policymakers will be aware of the risks inherent in an all too swift rise in yields and avoid such an approach. A steep and sudden jump to, say, 4% for German government bonds and US Treasuries would trigger marked losses on the stock markets and for corporate bonds and accelerate capital outflows from emerging markets. With the economic situation still wobbly in many countries, the central banks will do their utmost to avoid such a situation. By contrast, a gradual and moderate rise in yields, as we are expecting, would not spell doom for economic growth but rather contribute to equilibrium.

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