

Beware the Bond-cano!

Tim Farrelly | farrelly's | 05 March 2018

World economies are growing again. Employment is tight and wages are set to rise after years in the doldrums. Central banks are behind the curve and about to call time on easy money to head off rising inflationary pressures. Cash rates will rise. Quantitative Easing will become Quantitative Tightening. The Trump tax cuts will become the Trump deficits, requiring massive bond issuance. Bond yields are set to explode. All markets will be affected, with the February ruckus just a taste of what's ahead. Beware the Bond-cano! Take defensive action!

This is far from the worst narrative we have seen in the past decade. But it is worth pulling apart. Economies are growing, wages will increase, central banks will call time on ultra-loose monetary policies and cash rates will rise. That's the easy bit.

The difficult part is to estimate how far central banks will raise rates. If the increases are not significantly larger than the bond markets anticipate, then bond rates will probably rise modestly or even fall from here.

Implicit in the yield curve is that the bond market thinks the Fed will raise US cash rates three times next year and twice the following. In the long-term, the market expects a US cash rate of around 3% per annum. This is in line with the Fed's announced expectations.

The question we need to ask ourselves is what are the chances that the Fed will go much faster than this? We think it unlikely that the Fed views the fallout from raising rates too quickly to be much worse than the impact of raising rates too slowly.

Low wages growth and rising income inequality trouble the Fed – so rising wages growth of itself is not the end of the world. Similarly, US inflation has been below target for some time and the Fed could allow it to rise above the target in the short term without exceeding the medium-term target. They can live with these outcomes.

On the other hand, the Fed is painfully aware that, for the past seven years, the US economy has grown much more slowly than their models forecast. These models have consistently underestimated just how low interest rates needed to be to allow the economy to recover from the GFC. They worry that their models will continue to under-estimate the damage that higher rates have on economic growth. Raising rates too fast could send the economy into a recession – disaster. Three rate increases this year, at most four, should be plenty.

If rising cash rates don't send bond yields higher, then perhaps increasing deficits and bond sales could do the job? Maybe, however the Japanese experience of the past 20 years suggests that this is no certainty. As Japanese government debt has soared to over 240% of GDP, bond rates have consistently ground lower. A higher supply of US Treasuries may make some difference, but it is unlikely to be much in a world where investors still love US Treasuries.

Further, in the past 18 months, US 10-year bond yields have risen from 1.5% to 2.9% per annum. Over this time, US equities have risen by 30%. Even if bond yields rise sharply, which we doubt, the medium-term link between bond yields and the share market is far from obvious.

Finally, it is absolutely unclear what to do about all of this. Sell bonds? Sell equities? Buy equities? The peddlers of the Bond-cano narrative give very different recommendations. Even if we buy the story, it's just not clear what to do – all of which suggests that the Bond-cano narrative is just that, a wonderful narrative.

But a call for action? It's nuts and you can clearly see it's nuts.



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