

The bond rally, secular stagnation & now Iraq

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Key points

- > The global bond rally so far this year can be explained by a combination of soft growth, dovish central banks, short covering and increasing belief in “secular stagnation”.
- > It's likely that the rally has gone too far and that sooner or later the focus will shift to when the Fed will start to raise interest rates. This could cause a resumption of the gradual rising trend in bond yields and volatility in shares.
- > Nevertheless, history tells us that it's only when rates reach onerous levels that they become a lasting threat to share markets and ultimately to economic growth. And that seems a long while a way yet.
- > Iraq is a worry but as with numerous other geopolitical threats it's unlikely to be enough to derail global growth.

Introduction

A big surprise this year has been the renewed rally in government bonds – both globally and in Australia. Since December 31 last year, 10 year bond yields have fallen from 3.03% to currently 2.65% in the US, from 4.24% to 3.74% in Australia and from 1.93% to 1.4% in Germany. The big question for investors is whether the renewed decline in bond yields is telling us the global economy is in trouble, whether it's an adjustment to lower long term interest rates in what some call an environment of “secular stagnation” or whether it's just an overshoot that has now seen bond investors become a bit too complacent again with the rising trend in yields set to reverse.

Our bias is more the latter. As often with major market moves it's the US that sets the direction and on this front it seems a Fed rate hike is gradually starting to appear on the horizon and debate will increasingly start to hot up as to whether it's closer than we think.

What's driven the bond rally?

Numerous lists have been put together on drivers of the bond rally this year. The reasons fall into four groups:

- **The global growth soft patch at the start of the year and various growth threatening geopolitical risks** – the US economy contracted in the March quarter, growth disappointed in Europe, Japan was consumed by worries about the impact of the April 1 sales tax hike, Chinese growth slowed and emerging country growth generally disappointed. On top of this, geopolitical risk has remained with first the crisis in Ukraine and now Iraq. So one might be forgiven for thinking: here we go again with another year of global growth disappointment.
- **Dovish central banks** – deflation fears and further easing in Europe, an easing bias in Japan and dovish comments from Fed Chair Yellen to the effect rate hikes are a still a considerable period away have reduced fears the world was closer to serious monetary tightening.
- **Short covering** – last year bond rates rose leading to poor returns from bond funds such that by the start of this year traders were short bonds and some pension funds may have been under pressure to rebalance towards bonds as share

weights had increased. News of growth disappointment and dovish central banks may have simply been the trigger to unleash this.

- **A growing pricing in of lower long term central bank rates** – in response to talk of a period of “secular stagnation” that has been gaining increased airplay lately. It basically says that as a result of a combination of factors including slowing labour force growth, slowing productivity growth (as a result of less investment and a lower payoff from recent innovation), slower credit growth (in response to tougher regulation and high private sector debt ratios) and rising inequality (reducing the spending power of low and middle income earners) will result in a slower trend of economic growth. This in turn will mean lower real interest rates over the long term, a bit like Japan's experience over the last two decades.

The reality is that each of these factors has probably played a role. And not just globally, but also in Australia where the decline in global yields has flowed through to a fall in Australian bond yields particularly as a combination of lower March quarter inflation, the Federal Budget's impact on confidence and a bounce back in the Australian dollar have pushed out expectations for the first rate RBA rate hike.

But is it sustainable?

My concern is that the bond rally has gone too far:

Firstly, while the global economy started the year on a soft note, abstracting from normal volatility, leading indicators point to a pick-up in global growth.



Source: Bloomberg, AMP Capital

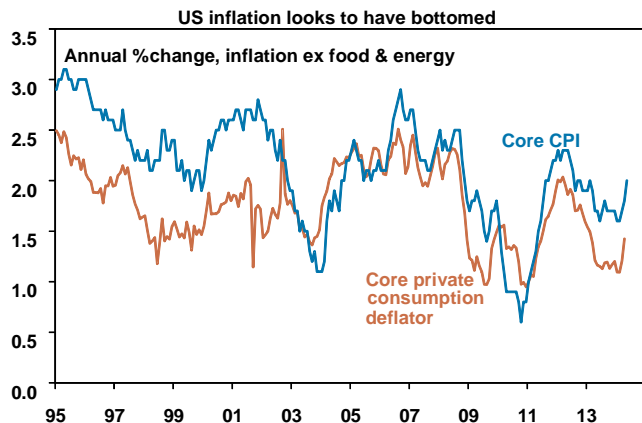
Stronger growth after the first quarter soft patch is particularly noticeable in the US:

- business conditions indicators (often called PMI's) are at levels consistent with solid growth;
- business investment looks to be strengthening;
- consumer spending has picked up;
- housing related indicators are continuing to trend higher;
- bank lending growth is trending higher; and
- the level of employment has finally regained its pre 2008-09 recession high.

Secondly, while central banks in Japan, Europe, Australia and China will likely maintain a dovish or on hold tone for some time to come,

the Fed is likely to start shifting its rhetoric in the direction of an eventual rate hike:

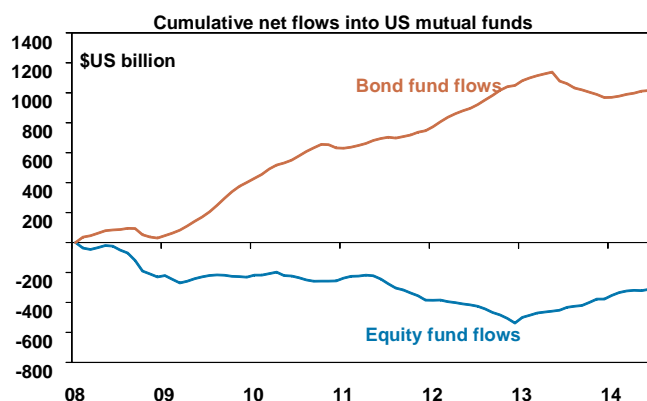
- if current trends continue, unemployment will have fallen to 5.5% by mid next year, which is often seen as full employment; and
- while inflation and wages growth remain low, both appear to have bottomed and with the core CPI (ie inflation ex food and energy) already at 2%, it's likely that the Fed's preferred measure of inflation, the core private consumption deflator, will reach 2% by year end. In other words inflation will soon be back at the Fed's target.



Source: Bloomberg, AMP Capital

This is still consistent with the first Fed rate hike being 9-12 months away, but as we get closer the Fed is likely to start warning of it and markets will start trying to anticipate.

Third, investor positioning regularly sets markets up for corrections that reverse the primary trend for a while. But short trader positions in bonds have been cut and more broadly the strong inflow into bond funds seen through the GFC and its aftermath have yet to be fully reversed. In other words the great rotation from bonds to shares may still be ahead of us.



Source: ICI, AMP Capital

Finally, while the secular stagnation story has some merit, it is worth noting that the US economic recovery to date has more in common with the sort of cyclical recovery seen after a debt crisis rather than the stagnation scenario experienced by Japan over the last twenty years. What's more, America's quick fiscal and monetary stimulus and bank recapitalisation stands in contrast to Japan's failure to move quickly on these fronts, so there is less risk of the US following Japan.

More broadly, the secular stagnation concept reminds me of the talk of new eras or permanently strong growth that were popular after the run of strong conditions around the end of last century. In other words, it looks a bit like a reflection of the classic behavioural finance tendency to extrapolate recent and current conditions into the future, in this case rationalise a more severe than normal cycle and turn into

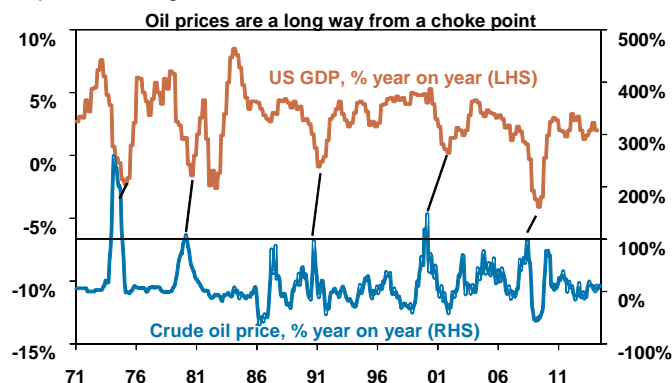
something more permanent. In other words just an ex-post rationalisation of the bond rally.

All of these considerations suggest that the bond rally might have gone a bit too far.

What about Iraq?

Just when we were getting used to the crisis in Ukraine and starting to see the risks as acceptable, Iraq has popped back into the headlines. In the low inflation era since the 1980s globally, oil supply shocks have been more of a concern to growth than inflation. There are two main concerns regarding Iraq: the loss of Iraqi oil exports which amounts to around 2.3 million barrels a day (compared to global production of about 91.7 mbd) and the threat of wider (Sunni v Shia) Middle East conflict dragging in the US and its allies (again).

However, it is worth bearing in mind that we have seen it all before: OPEC looks to have enough spare capacity of around 3 mbd to meet any short fall from Iraq; the Iraqi conflict is in the north of the country, but most of its oil exports (2.1 mbd) come from the south; US shale oil has reduced the threat to the US, which is likely to mean only a limited US intervention (eg air strikes as opposed to full on ground forces); and many Middle East conflicts seem to flare up regularly only to settle down again without turning into a broader conflict. So for these reasons, whilst Iraq could get worse before it gets better causing share market volatility along the way, it's hard to see it disrupting the broader global economic recovery and uptrend in share markets. Since the early 1970s it's clear that it's not the level of the oil price that poses a risk to global growth but its rate of change. Severe hits to growth have required a doubling in the oil price in the space of 12 months. And right now we are a long way from that. See the next chart that shows the relationship between the oil price and US growth.



Source: Bloomberg, AMP Capital

Concluding comments

Bonds have had a surprise rally this year. However this is likely overdone and with US growth picking up it's only a matter of time before debate about the start of Fed tightening hots up causing a resumption of the rising trend in bond yields. However, while this could contribute to a correction in shares, it's unlikely to be the end of the bull market in shares as even when US interest rates do start to rise we are still going to be a long way from tight monetary conditions.

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