INSIGHT

Investors must wake up to the global rally's impact on bond yields

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Since the financial crisis in 2008, the global economy has been characterised by slow growth, low inflation and extremely expansionary monetary policies. Markets seem to expect a continuation of this so-called new normal. They predict no interest rate rises in the foreseeable future from the European Central Bank or the Bank of Japan, and expect the Fed funds rate to stay lower than indicated by the Fed's governors themselves.

After years of sluggish growth, many seem to be stuck in a "great recession" or secular stagnation mindset. But there are signs of a cyclical recovery and it is accelerating.

First, global trade is staging a comeback — notwithstanding the protectionist rhetoric of some political leaders. After two dismal years in 2015 and 2016, the trade recovery is fuelled by the Chinese economy's rally and the turn of commodity markets. The interlinkages of trade are reinforcing global growth.

Second, globally, a new expansionary credit cycle is also supporting growth. In emerging Asia, credit growth remains strong, despite policy efforts to limit financial stability risk, especially in China.

In the US, the credit cycle turned about three years ago, with first the corporate sector and then households assuming more debt. The debt to gross domestic product ratio in the private non-financial sector, which had fallen hugely in the years after the financial crisis, has been rising again since 2014.

In the eurozone, the new credit cycle is still in its infancy, but here, too, loans to the private sector are rising again. The time of deleveraging and consolidation of private debt is over.

Finally, capacity utilisation in most developed markets is back to normal or above normal. Current estimates of output gaps indicate there is hardly any slack in the world's big economies. That is true even in the eurozone, where capacity utilisation in manufacturing is reported to be above average. While it is true that prices and wages in today's globalised and digitised economy don't react to capacity utilisation as strongly as in former decades, it seems unrealistic to expect no reaction at all. Improving business confidence, little idle capacity and tightening labour markets will at least gradually increase wage demands and output prices.

What does the economic upswing imply for bond yields and stock markets? Usually, we would expect bond yields to be roughly in line with nominal GDP, both on the basis of economic logic and historical experience. But while nominal GDP growth has averaged 2.7 per cent in the eurozone and 3.5 per cent in Germany in the past three years, bond yields have remained much lower.

One reason for this discrepancy is, of course, monetary policy. Our own estimates, as well as statements by ECB officials, suggest that the central bank's asset purchase programme has pushed down the German 10-year Bund yield by about 0.8 percentage points.

A normalisation of monetary policies, notably an end to QE, would drive up bond yields. By how much is an open question, as the phasing out of QE will to some extent have been priced into yields already. An exit, if done carefully and gradually, should therefore not unsettle markets. It would still leave eurozone bond yields much below nominal growth rates.

Bond yields could react more forcefully, if and when market participants upgrade their expectations on future growth and inflation. Once investors wake up to the return of the economic cycle, their expectations about interest rates and the course of monetary policy will alter.

The ECB is still cautioning against overly optimistic expectations and is expansionary in its forward guidance. But as the cyclical expansion gains force, central banks might have to take tougher action to correct an excessively expansionary path. Further delaying the exit from QE harbours risks.

Rising bond yields in an economic expansion are nothing unusual and should not cause a fundamental repricing of stocks. After all, even bond yields of 2 or 3 per cent imply price to earnings ratios for bonds way above stock market valuations. The transition from a new normal with a rather bleak outlook to a more cyclically driven expansion will inevitably generate volatility. Keeping it as low as possible is a challenge for the ECB. A timely, but gradual correction of monetary policy is the best option.

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