Markets

The Bond Market Refuses to Accept Economic Reality

Traders are working off an outdated playbook that assumes this recovery will resemble the sluggish one coming out of the financial crisis.

By Kevin Muir +Follow
January 12, 2022, 6:00 AM EST

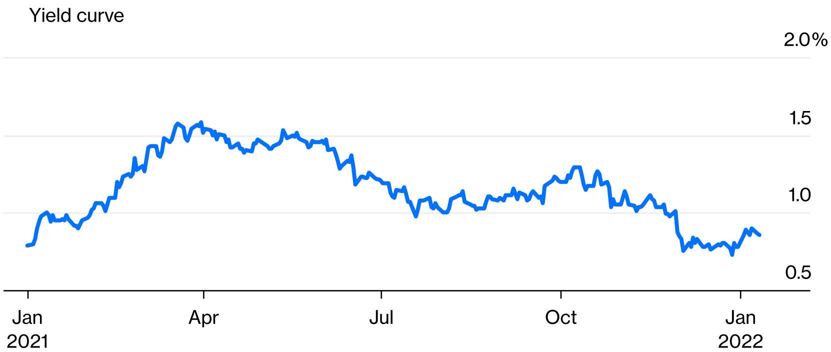
When will bond traders accept that the cost of money is rising? *Photographer: Paul Yeung/Bloomberg via Getty Images*

Bonds have been as close to a sure thing as there is in financial markets over the past four decades. Since 1982, the Bloomberg U.S. Aggregate Bond Index has only had four down years, and never back-to-back. Yet, after falling 1.54% last year, the benchmark is already down 1.62% in just the first few days of 2022. Might this be the end of the winning streak?

To answer that question, we need to understand that bond investors continue to forecast a hot economy that is poised to buckle under the strain of even limited interest-rate increases. That can be seen in the difference between short- and long-term bond rates, known as the yield curve, which is flattening as investors price in more Federal Reserve rate hikes this year.

Shrinking Gap

The difference between 2- and 10-year Treasury yields has collapsed



Source: Bloomberg

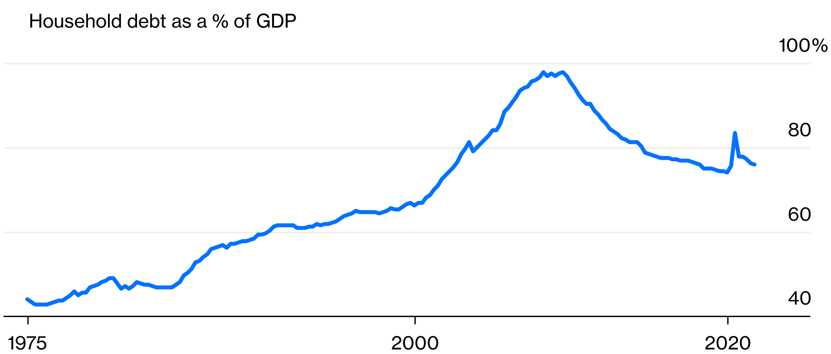
Over the past 40 years, central banks have used interest rates as their main tool to influence the economy. Inflation running too hot? Raise rates. Economy struggling? Lower rates. Changing rates directly affects private sector credit creation and recalibrates the economy as needed.

This reliance on monetary policy has also had the effect of goading the private sector into an ever-increasing debt burden. And yet, what we found in 2008 was that even lowering rates to zero could not entice any more debt expansion. In response, central banks enacted unconventional monetary policies such as quantitative easing, or QE, and yield-curve control. Some countries even tried negative rates.

Although many market participants worried these new policies would lead to hyperinflation, that didn't happen. Instead, the economy struggled, producing one of the most sluggish recoveries of modern times. Over the next decade, the market learned that when the private sector faces a balance sheet recession, unconventional monetary stimulus does little to affect the real economy. Monetary injections are trapped within the financial system and result in limited economic growth.

Getting in Fiscal Shape

Households have trimmed their debt obligations in the past decade



Sources: Federal Reserve, Bloomberg

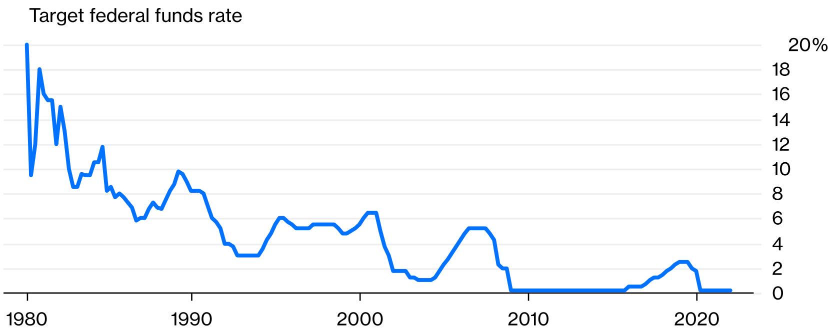
This lesson is partly responsible for the very different economic response to the Covid-19 crisis. Instead of leaving the heavy lifting to the Fed, the U.S. government engaged in the most aggressive fiscal stimulus since World War II. This massive deficit spending was accompanied by unprecedented QE by the Fed. Contrary to what many market pundits predicted early in pandemic panic, both bonds and stocks posted gains in 2020 after initially generating big losses. The speed of the market recovery stunned all but the most optimistic analysts, and it was due to the dramatically different government response to the economic downturn.

Still, the market assumes this recovery will resemble one from 2009 through 2012. Many money managers are more concerned about the economy's ability to weather higher rates than they are about the economic expansion accelerating. They cite the imminent pullback of fiscal stimulus combined with the reversal of monetary expansion to argue the Fed will have difficulties raising rates by any meaningful amount before there is an economic or market accident.

The collective wisdom of bond market participants accepts that the 40-year-long trend in which each economic cycle requires fewer Fed rate hikes is intact. The Fed's "terminal rate" is currently priced at around 1.85%, up from the current 0.25%, according to the one-month forward OIS curve. This means the market is predicting the Fed will boost rates by around 50 basis points to 75 basis points less than the previous cycle high before the economy or markets force another easing cycle.

The Zero Bound

The Federal Reserve's key interest rate is at an all-time low



Source: Bloomberg

The bond market is wrong.

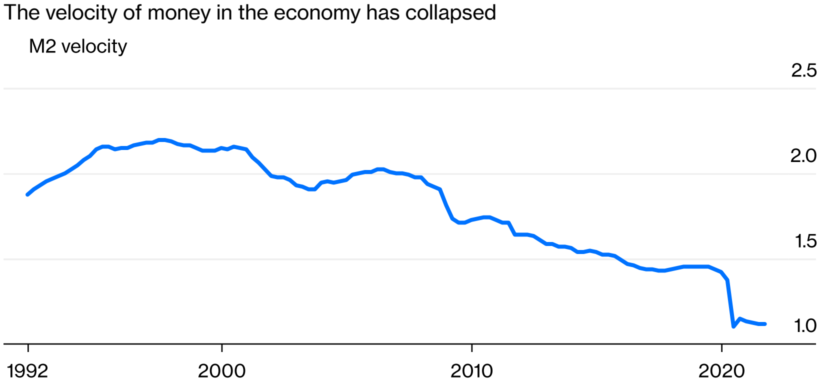
Prior to the Covid crisis, every economic downturn was met by the Fed encouraging more private sector credit expansion. This became progressively more difficult as the private sector had more debt than the previous cycle, which meant it took lower rates to encourage more borrowing and required fewer rate hikes to stall the economy.

However, the massive fiscal deficits from the pandemic response had a dramatic effect on private sector balance sheets. Many Wall Street strategists have an aversion to government deficits, but it's an accounting identity that the government's deficit is the private sectors' surplus. In other words, the government's red ink is the private sector's black.

During the financial crisis, many bond market participants were concerned that extraordinary monetary expansion would cause an explosion in inflation. But monetary velocity collapsed as there was little demand for money and even less supply due to tightening credit conditions.

Sluggish Money

The velocity of money in the economy has collapsed



Source: Bloomberg

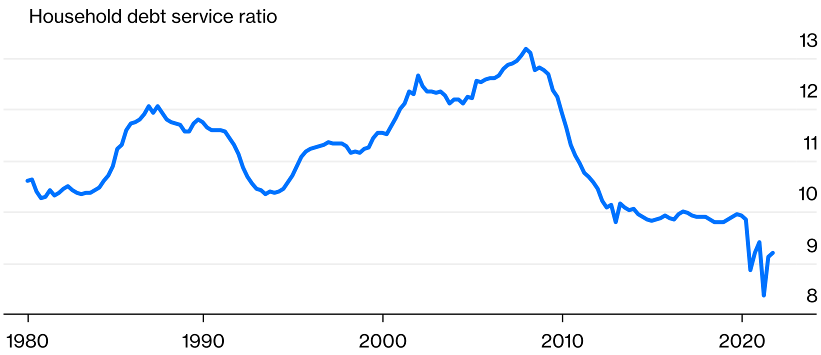
Few investors seem concerned now about a sustained uptick in inflation because they assume velocity will stay muted. But, what if improvement in the private sector's balance sheet has sowed the seeds for the next great credit expansion?

Many investors highlight the falling birth rate among Millennials as a contributor to the past trend of disinflation. For Millennials, lack of career opportunities and financial burdens certainly weighed heavy. However, the labor market is now approaching levels of tightness not seen in decades and the fiscal stimulus has improved consumer balance sheets considerably.

The amount of U.S. household debt as a percent of GDP has fallen from a high of almost 100% coming out of the last recession to around 75% currently. Combined with a decrease in rates, this means that debt service as a percentage of disposable income has not been lower in more than 40 years.

Dry Powder

A low debt service ratio is providing consumers with spending power



Sources: Federal Reserve, Bloombegr

Many market analysts focus on Boomers because they have the most wealth, but the largest cohort in terms of size are Millennials. If they are about to embark on their own mini-baby boom, it could mean that consumer private credit expansion is about to take off.

The other Covid-induced change to the economy is that the decades-long trend of offshoring has been exposed as a weakness in terms of secure supply chains. President Joe Biden has made the reshoring of manufacturing a priority, and it's probably one of the few things both parties can agree on. This will mean much more capital spending in years to come. This, too, has the potential to create a much more robust economic recovery than in previous cycles.

I don't know what would be a bigger surprise, an economic recovery that exceeds expectations or two down years in a row in the Bloomberg U.S. Aggregate Bond Index. But the chances of both are higher than many bond investors realize.

To contact the author of this story:
Kevin Muir at kmuir13@bloomberg.net

To contact the editor responsible for this story:
Robert Burgess at bburgess@bloomberg.net