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Featured G

A Triple Bottom?

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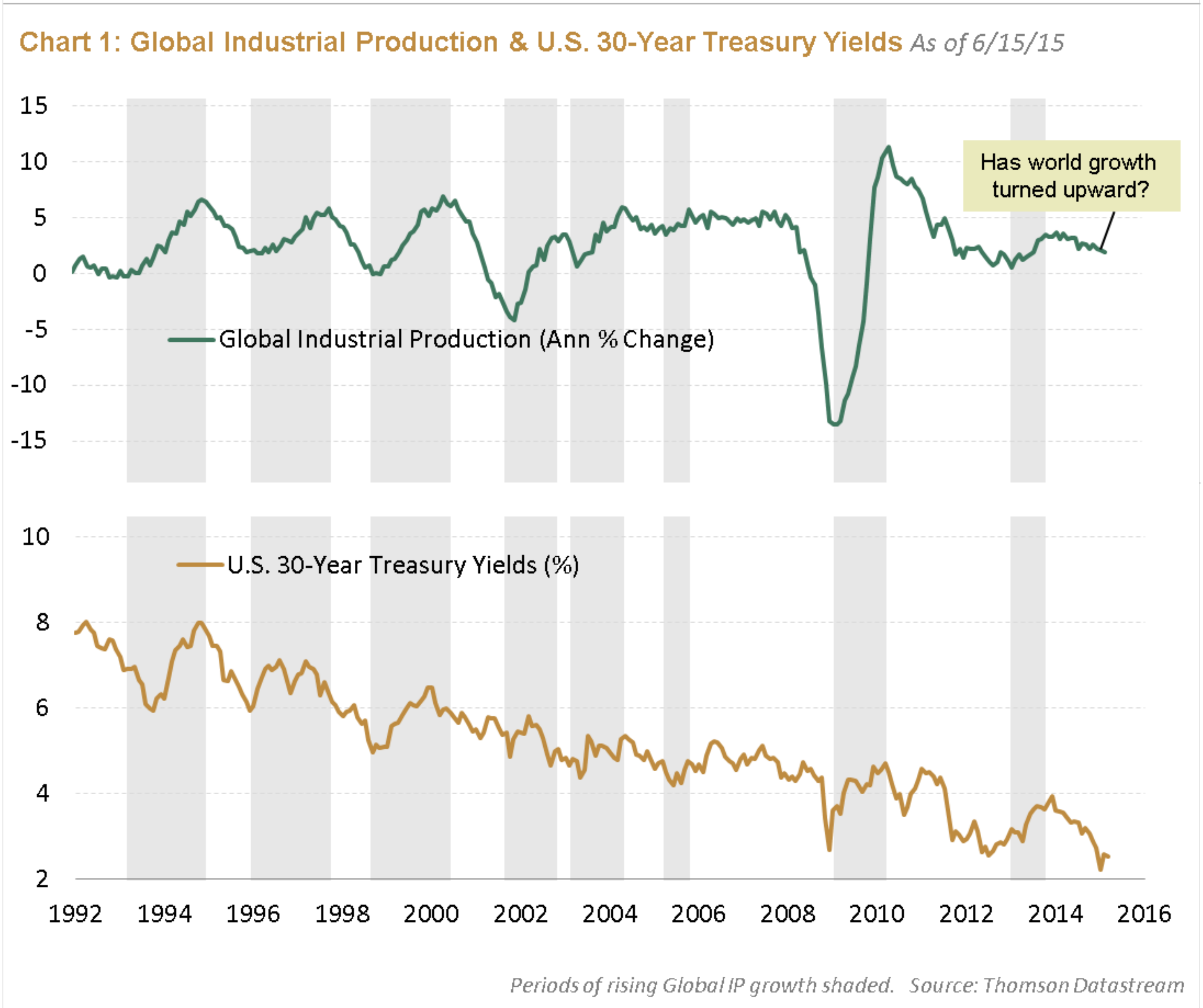
My expectation has been that the forces of reflation—which are so evident in the world economy—would get ahead of deflation sometime over the next 18-24 months. This year's steeper U.S. yield curve is one sign that this story is playing out. Most of the time, improving global growth coincides with rising long-term Treasury yields (see Chart 1). In other words, the downtrend in global growth (which prevailed last year and into 2015) probably ended a couple of months ago.



Obviously there are still plenty of economic landmines that could explode and sidetrack, or even derail the expansion; the uncertain outcome from the Greek negotiations is one of them. But the message from the yield curve is that reflationary forces are turning the tide in global growth. If this is the case, Treasurys could remain under pressure until the U.S. Federal Reserve (Fed) begins to lean in the other direction, although it would not take much on the part of the central bank to stop the uptrend in yields given the deflationary structural back drop. Nevertheless, the overall picture suggests that we have just witnessed a triple bottom in bond yields.

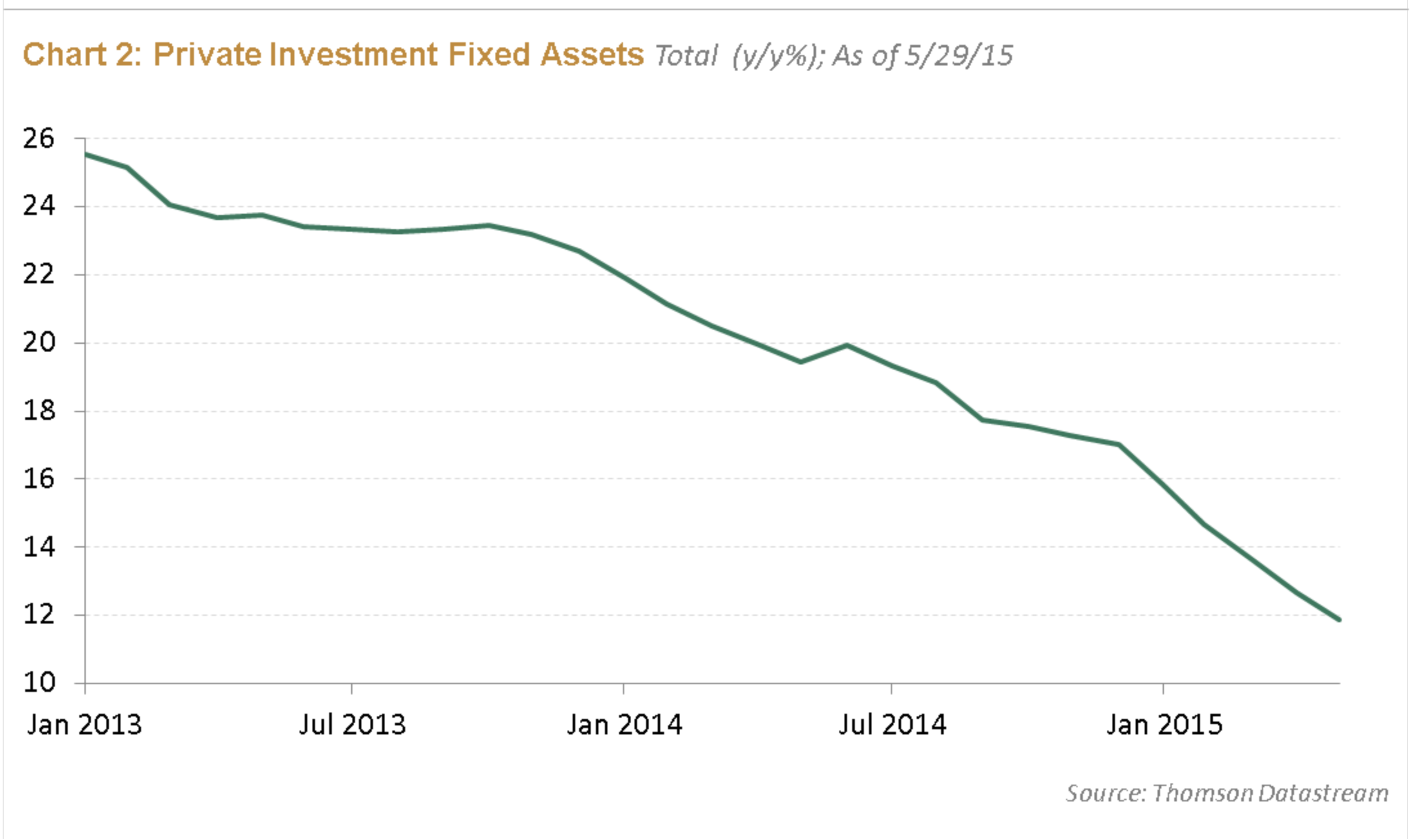
It is helpful to take a few steps back.

In 2008 the United States experienced the worst financial crisis since the 1930s. Long-term Treasurys—the traditional refuge for investors during periods of fear—collapsed in yield to almost 2.5%. Extreme situations require extreme measures and the G20 responded to this crisis with the largest, most coordinated package of policy stimulus in economic history. Bond yields made a slingshot move higher in proportion to this extraordinary stimulus, and reached a peak of over 4.8% in 2009 and again in 2010.

The second crisis came in 2011 when Europe's sovereign debt bomb exploded after the European Central Bank (ECB) misread the outlook for inflation and raised interest rates. The crisis pulled Bund yields lower and dragged U.S. yields with them. In July 2012, 30-year Treasury yields briefly pierced 2.5%, but they did not stay there long because later that month ECB President Mario Draghi promised to do whatever it took to keep the European Monetary Union intact. The Fed subsequently launched a third round of quantitative easing and Abenomics was in full swing in Japan by the fourth quarter. In my opinion it was this reflationary salvo that propelled 30-year Treasury yields back toward 4.0% by the end of 2013.

The third wave of stress came last year from the developing world, now 60% of the global economic pie. Growth in this region was so slow that it overwhelmed the acceleration in the U.S., pushed global growth lower, and helped drive 30-year Treasury yields towards 2.2% by early February of this year. The main culprit behind the slump was the policy tightening from some of the biggest countries in this bloc, which was fostered by their reaction to the taper tantrum. The terms of trade were already in decline for many of these countries because of falling commodity prices. So raising interest rates in reaction to falling currencies was a recipe for stagnation or worse, which has turned out to be the case.

China has been the biggest perpetrator of growth restraint in the developing world. Under new leadership, the government tackled corruption, reform, real estate speculation, and debt, while at the same time keeping real borrowing costs and the yuan at punitively high levels. The consequence of which has been an abrupt deceleration to the slowest pace of economic growth in 30 years. Private fixed-capital formation slumped from over 20% at the end of 2013, to 11.9% at May 2015, as shown in Chart 2.

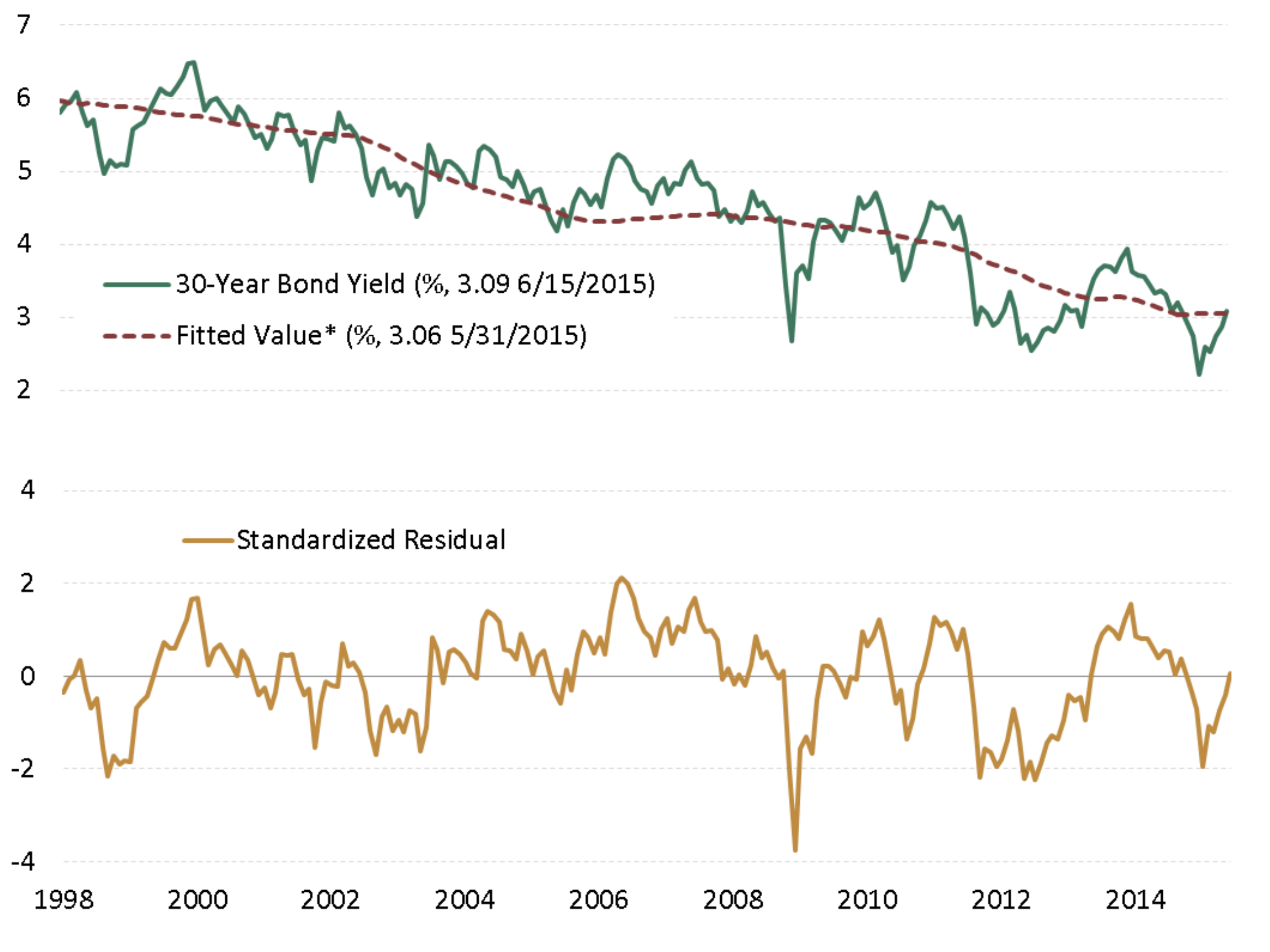


Capital markets responded to the global slowdown in typical counter-cyclical stabilizing fashion. The rally in Treasurys was part of a generalized push lower in G7 bond yields, providing some offset to intense deflationary pressure. The dollar surged, helping to redistribute U.S. strength to the rest of the world. Oil prices tanked, fostering an enormous tax cut for consumers of energy, which keeps getting bigger the longer prices stay down.

As with the earlier two bottoms in Treasury yields, the latest inflection point in Treasurys has come with another reflationary salvo. The ECB launched large scale asset purchases in the first quarter of 2015. More importantly, the Chinese did a complete policy flip-flop, shifting from benign endorsement of slower growth to proactive panic that growth was too slow. Rarely has a day gone by in the past few months without the announcement of another new initiative to boost the Chinese economy. India, Indonesia, and Russia have cut rates. The policy pendulum in the developing world has clearly begun to swing, and more stimulus is on the horizon as the global gross domestic product (GDP)-weighted short-term interest rate begins to decline after two years of uneven increases. So what does all this mean for Treasury yields, the world's "risk free" benchmark? The global economic forces that have weighed on Treasury yields and kept them depressed relative to domestic nominal GDP growth are starting to lift, albeit slowly.

1. Improving global growth and policy measures to encourage more growth—especially in the developing world—mean upward pressure on Treasury yields until the Fed starts leaning in the other direction. Most people think liftoff will start around September. Yields have already mean-reverted back to levels predicted by our models (see Chart 3) so I doubt that there is a lot more upside, but the trend should be up until the Fed acts. There could be a respite for yields late in the year with the Fed's rate increase. This is not the case for Bunds and Japanese Government Bond (JGBs) yields. Yields trade below equilibrium in both economies according to our metrics and are susceptible to continued mean-reversion higher on the back of the reflationary measures in play in both countries and abroad.

Chart 3: US30: Bond Model* *As of 6/15/15*



**Estimation Interval 1/1998 – 5/2015; Source: Thomson Datastream*

The risk of course is that return-sensitive investors who have piled into low yielding bonds in the past five years will panic as they did in 2013. Fear of capital loss increases the potential for more intense volatility over what should otherwise be a fairly mild and gently rising trend.

2. I am optimistic that the scale and determination of reflation in the three anchor countries of the world economy—U.S., Europe, and China—will be successful. Correspondingly, the triple bottom in yields should

be regarded as a powerful message that the long-term bull market probably is over. If I am wrong, the world is heading in a direction that the “Cassandras” have been pining about for years, and bond yields will make new lows.

3. The secular bull market may be over but a secular bear market is unlikely for a long time. A low and flat trading range for many years seems more likely to me. It would take excess demand and rising inflation to foster a secular bear market in bonds. This won’t happen anytime soon. In the developed countries the forces of debt, demographics, and deleveraging are still working. In the developing countries GDP growth is too slow, spending is too low, and policy is way behind the curve. China’s average real borrowing cost is still over 8% and rates need to be reduced substantially. The global economic and financial picture would be quite different if Chinese consumption surged and savings fell; the “One Belt, One Road” project may be the world’s best shot at boosting spending. Using the same vendor-financed model followed previously, this project would export China’s construction and manufacturing capacity and create the infrastructure for greater distribution and trade in Chinese goods, as well as products from the rest of the world. It is a great story but it is going to take years to play out. In the meantime, China will use its savings surplus to absorb the financial losses incurred during the last 30 years of rapid expansion. This will give the Chinese government plenty of maneuvering room in setting economic policy, but will also be highly deflationary for both China and the rest of the world.

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