Are Bond Investors Crying Wolf?

June 2, 2015

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“To me, consensus seems to be the process of abandoning all beliefs, principles, values and policies. So it is something in which no one believes and to which no one objects.”

Margaret Thatcher

Investment heavyweights challenge the consensus

On a regular basis I challenge the consensus. It is part of my nature, I suppose, but it comes at a price. Let me explain. We were recently contacted by a conference organiser, who would like me to participate in a panel discussion later this year at an institutional investor conference here in London. The subject? Investment heavyweights challenge the consensus.

I was foolish enough to accept the invitation before doing my homework as to who the other panellists would be. When I realised who they are, my heart sank. They are true heavyweights! You can do no more than wish me good luck, but look here if you fancy a bit of light entertainment on 7 October.

Trade du jour

Now to more sombre matters. Bond investors lost serious amounts of money in the bond market rout between mid-April and mid-May. One estimate puts total losses at approx. $0.5 trillion\(^1\) - not exactly pocket money for most of us.

I am not sure anything fundamental has drastically changed, though. Real rates accounted for virtually all the increase in interest rates between mid-April and mid-May (chart 1). As pointed out by Barclays in a recent research report, had the selloff been the result of QE doing its job, i.e. improving economic fundamentals, breakeven yields would have moved much more. Hence the sell-off was predominantly an unwind of term premia – not the result of enhanced economic expectations.

Having said that, the EU economy did perform somewhat better than expected in Q1 and, as a result, deflation fears abated. In the months leading up to the rout being long bonds had become pretty much one-way traffic. So convinced were investors that the ECB would prolong the 35 year bull market in bonds that it had become the trade du jour. We don’t know yet who lost the most, as few have announced results for the month of May, but it wouldn’t surprise me if parts of the hedge fund community ended up with a fair amount of egg on their face.

Chart 1: Real rates accounted for most of the sell-off
So desperate were many investors to pick up the ‘easy’ profits, they forgot to use common sense. As Ambrose Evans-Pritchard pointed out recently in The Daily Telegraph:

“Contrary to mythology, QE does not work by lowering bond rates. It works through a different mechanism: by causing banks to “create” money.”

Or as I wrote in last month’s Absolute Return Letter:

“I don’t expect interest rates to make a dramatic move upwards for many years to come. However, lessons from Japan have taught me that, even if rates stay comparatively low, they can easily move 0.5-1.0% over a relatively short period of time, and a 1% move in the wrong direction can do a lot of damage to the P&L.”

Chart 2a: German 5-year bond yield, % (short-term perspective)

Chart 2b: German 5-year bond yield, % (long-term perspective)
I don’t think the current flight from bonds is any more than that - a brief spell of panic attack. The long bond trade simply got immensely crowded, and investors (speculators) ended up paying a hefty price. I have two reasons for not believing this is the beginning of something much bigger, but before I go into those I suggest you take a quick look at chart 2a-b. The two charts illustrate precisely the same – German 5-year bond yields. Only the time horizon is different, and what a difference it makes!

When looking at chart 2b, it is hard to imagine that $0.5 trillion could have been lost (worldwide) as a result of what looks like a blip on the curve. In the bigger scheme of things it is indeed a very modest move. That alone tells you how crowded the trade had become.

**How will the Federal Reserve Board (and other central banks) unwind QE?**

The bond bears have argued for quite a while that the ultimate unwinding of QE - whenever it happens - will inevitably push interest rates higher. The Fed (and, by implication, other central banks as well) simply cannot avoid doing considerable damage to interest rates when it eventually begins to unwind its very large balance sheet that is the result of years of QE – or so the argument goes.

I disagree. Of course central bank action could ultimately have some impact on interest rates but nowhere near the levels which are often suggested by the drama queens amongst us. In the following, I shall use a presentation given recently by Stanley Fischer, Vice Chairman of the Federal Reserve Board, to the Monetary Policy Forum. It was called *Conducting Monetary Policy with a Large Balance Sheet*, and if you haven’t already read it, I will urge you to do so (you can find it here).

First and foremost, as pointed out by Stanley Fischer, QE in the U.S. has actually been limited in scope compared to many other countries when measured on a relative basis, i.e. as a % of GDP (chart 3).

Secondly, it is not the intention of the Fed to engage in wholesale selling at any point in time. As Stanley Fischer said in his speech:

“Finally, with regard to balance sheet normalization, the FOMC has indicated that it does not anticipate sales of agency mortgage-backed securities, and that it plans to normalize the size of the balance sheet primarily by ceasing reinvestment of principal payments on its existing securities holdings when the time comes.”

**Chart 3: Central bank assets**
Stanley Fischer can hardly say it more clearly. Don’t expect the Fed to flood the market. It just won’t happen. And I would be enormously surprised if other central banks conduct themselves any differently.

In his presentation, Stanley Fischer also provided some colour on the composition of the bond portfolio acquired by the Fed through QE and other open market operations (in aggregate called System Open Market Account or SOMA).

As you can see from chart 4 below, a significant part of the portfolio will mature in the next five years, but there will still be bits and bobs left until 2025. If the Fed has no plans to engage in any meaningful selling, one would expect monetary policy to keep interest rates comparatively low for another 5-10 years.

Chart 4: SOMA maturities
It goes without saying that bond investors will, at some stage, begin to discount the ultimate unwinding of central banks’ balance sheets. Fischer estimates – with some help from various researchers – that QE and other monetary policy programmes are currently depressing the term premium on U.S. 10-year Treasury bonds by approximately 110 bps. Ultimately that will go to zero, but only very gradually over the next 10 years or so. So to all those who expect the Fed to ultimately cause a major upward move in bond yields: You’d better be very patient.

Having said that, I am not at all suggesting that monetary authorities will continue to pursue a near zero percent interest rate policy. Not at all. All I am saying is that we are likely to have many years ahead of us where interest rates will be lower than you would normally expect given the overall performance of the economy.

The key drivers of economic growth

So that is my first reason why you shouldn’t expect a massive move in interest rates, but that alone won’t necessarily save our collective bacon. What if the economy is suddenly firing on all cylinders and inflation becomes a real concern? Obviously, all bets would be off if that were to happen, and that is where reason number two comes in.

Econ. 101 taught me that, at the end of the day, two fundamental factors drive economic growth – population growth and productivity. Everything else is essentially a bi-product of one of those two (or both).

The easy one first – population growth. As I have stated ad nauseam in recent months, in the years to come, population growth will turn negative in many countries with dramatic consequences to follow. The leading indicator in this respect is the fertility rate, which is now well below the replacement rate in many countries, Africa being the main exception (chart 5).

Chart 5: Low fertility rates will cut the supply of labour

Source: Maj Invest, United Nations

It goes without saying that, with negative population growth in virtually every corner of the world, it will be exceedingly difficult to generate respectable economic growth over the long term, and long term in this respect means at least until the mid-2020s (United States) and much longer in some parts of the world (in particular in Europe).

Shrinking populations are only half the story, though. The mix between working people and old-age pensioners is the other half. Once you retire, you don’t produce anymore; instead you become a liability on economic growth. Germany and Latin Europe (ex. France) are often accused of having the worst ratio between working-aged and old-aged people, but chart 6 below tells a slightly different story. Without in any way trying to disguise the fact that many countries in Western Europe face a serious problem, it is worth noticing that Eastern Europe and parts of Asia are even worse off (chart 6).

Chart 6: Working age population (aged 15-64) as % of total population

Source: OECD, United Nations, Eurostat
Now to the somewhat more complex one – productivity. The critical nature of productivity enhancements, at least as far as economic growth is concerned, is often underestimated. In a world of only modest changes to the age composition of society (which is what the world ex. Japan has experienced in recent decades), productivity improvements have proven by far the most important source of economic growth (chart 7).

**Chart 7: Productivity remains the most important driver of economic growth**

Note: Labour productivity (GDP per person employed)
Source: The Conference Board. Inc.

I should probably spend a moment explaining how productivity is defined. Academics distinguish between labour productivity and total factor productivity. The standard definition of labour productivity is output per hour worked in private non-farm industries, but the entire economy is increasingly used instead of private non-farm industries. Labour productivity is sometimes also measured on a per capita basis (as is the case in chart 7). Total factor productivity measures productivity gains from the more efficient use of both labour and capital as well as gains obtained from technological progress.

On average, Europe is less productive than the United States. Labour productivity in the Euro zone, measured as output per hour worked (in USD) was only 77% of the U.S. level in 2013, leaving an almost 25% gap in productivity between Europe and the United States. U.S. total factor productivity grew at approx. 1.75% per year from the mid-90s to 2004. The growth since 2005 has only been about half that level and was actually negative in 2014. European productivity has been virtually unchanged in recent years, leaving emerging markets to increasingly drive the trend in global productivity (chart 8).

**Chart 8: Emerging economies increasingly drive the trend in productivity**

Note: Total factor productivity
Source: The Conference Board. Inc.

Productivity is about a great deal more than having the swiftest possible broadband connection or the latest – and fastest – Intel chip in your desktop computer. Western Europeans are not exactly behind the Americans when it comes to the use of technology gadgets (although one or two of our American readers may disagree) but are still, as mentioned earlier, way behind when it comes to productivity enhancements. Why is that?

Various studies have found that excessive rules and regulations (e.g. strict labour laws or planning laws) make productivity gains harder to find and destroy economic growth, and European policy makers have proven themselves unusually adept at engulfing their citizens in excessive rules and regulations. I am not at all against (a reasonable amount of) rules and regulations but simply wish to point out that they come at the expense of economic growth – and therefore also jobs. This is going to be a major challenge for Europe with economic growth already hampered by the rapid advance of the elderly.

Other dynamics impacting productivity would include factors as varied as average age of the labour force, freedom of trade, competition, educational attainment, R&D spending, the price and availability of energy, (this one may surprise you) the
size of the financial sector (researchers have found a strong link between the size of the financial sector and productivity – bigger is better!) as well as urbanisation. I should also mention that there is a whole myriad of motivational factors impacting productivity as well, which are far less quantifiable.

Take urbanisation. As more people move from rural to urban areas, the supply of qualified labour in a modern economy will – at least over time - increase, improving productivity and therefore also economic growth. This is obviously a much bigger factor in rural economies such as India or China than it is in a very mature economy, but it works everywhere (chart 9).

**Chart 9: Urbanisation is inextricably linked to economic growth**

![Chart 9: Urbanisation is inextricably linked to economic growth](chart9.png)

Source: World Bank

Going forward, with an ageing work force all over the OECD, one would have to be extraordinarily optimistic (or simply naïve) to expect productivity gains in mature economies to bounce back to the levels of yesteryear. It is therefore highly unlikely that productivity gains can make up for the losses in economic growth as a result of the very unfortunate demographics on our doorsteps.

Relatively low economic growth across the OECD is therefore not only likely - it is virtually set in stone. Some countries will be hit harder than others, but they will all suffer. This is likely to keep inflation at quite modest levels and interest rates comparatively low for a very long time to come.

**Conclusion**

So, yes, I believe bond investors did cry wolf. The abrupt spike in interest rates from mid-April to mid-May is very unlikely to be the beginning of something much bigger and much more likely to be the sort of occasional panic attack that Japan has seen so many of in recent years.

Admittedly, productivity growth has always been at its weakest in the later stages of the business cycle, and we are late in the current cycle. This implies that the next economic downturn, which may not be that far off, may lead to a temporary lift in productivity, but it will, for all the reasons mentioned above, almost certainly prove temporary.

Energy prices are admittedly the joker in the pack and part of the reason behind the recent spike in interest rates. The oil price has risen from the mid-$40s to over $60 over a very short period of time, and this has undoubtedly eliminated some of the most deeply founded deflation concerns. As you can see from chart 10, inflation expectations in the EU began to pick up at about the same time as oil prices began to rise yet again (in the middle of January), but bond investors didn’t pay much attention until about 3 months later.
I will finish where I began – with some thoughts on consensus thinking. In our industry, one of the best ways to make outsized returns is to identify consensus thinking that (you believe) is plain wrong and then trade against it (assuming you are right and the consensus is wrong).

Chart 10: Bund yields v. inflation expectations

For several years following the great recession in 2008, it was a widely held view that central banks in general, and the Fed in particular, would do considerable damage to bond markets when they eventually begin to unwind years of QE. In the last 12-18 months that view has gradually been replaced by a deflationary view, although the interest rate hawks haven’t entirely disappeared, effectively dividing investors into two camps.

There are surprisingly few who subscribe to the view that we may actually end up in a dream scenario where inflation plods along at 1-2% - on the low side of historical norms but far from outright deflation. That outcome has, in my opinion, become more likely with the recent increase in oil prices and is certainly not the consensus at present.

Niels C. Jensen
2 June 2015

1 Source: Financial Times

2 See here

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