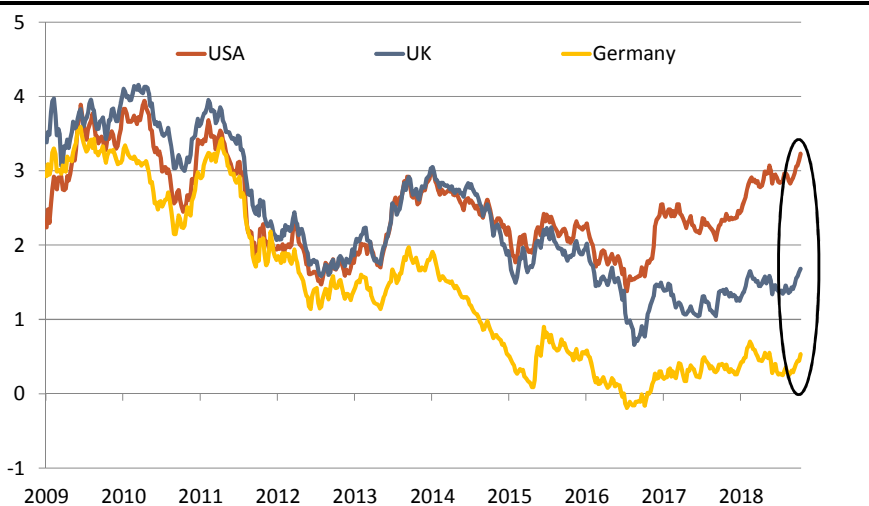


9 October 2018

Putting the rise in bond yields into perspective

Long-term bond yields remain low despite recent uptick (%)



Weekly data. In %. Source: Federal Reserve, Bank of England, Deutsche Bundesbank.

- No need to panic:** The jump in bond yields – of 20-40bp – across the Western world over the past three months risks a further jolt to the already-fragile market confidence in Europe. But the latest rise merely continues the somewhat uneven upward trend of the last two years. After reaching historic lows in 2016, caused by the sharp fall in the oil price toward \$30 per barrel of Brent crude, an industrial slump and China woes, long-term rates for advanced economies have gradually rebounded. The broad-based recovery reflects two major factors: 1) improved growth expectations; and 2) major central banks normalising monetary policies (albeit at varying rates).
- Widening spreads reflect local factors:** Relative to the mid-2016 lows, Bund yields are around 70bp higher, Gilt yields are up by 120bp, while Treasury yields have risen the most, by nearly 190bp – see chart. Treasury yields are pulling ahead as US growth, boosted by supply-side reform and a fiscal stimulus, has accelerated relative to growth across Europe. Monetary policy matters too. Of the major central banks, the Federal Reserve is furthest ahead with its policy normalisation. The Fed has hiked rates eight times and is well into its balance sheet unwind. On the other hand, the BoE has only hiked rates twice and continues to proceed cautiously amid Brexit risks. Still facing spare capacity and only modest inflation expectations, the ECB is only just approaching the end of its asset purchase programme (December 2018) and will likely not raise rates until before autumn 2019.
- Despite the rise, bond yields still remain low:** Considering that, for most of modern-history, long-term bond yields have tended to track nominal GDP growth closely, current rates look low almost everywhere. Even in the US where yields are highest among major-advanced economies, at c3.2%, the 10-year Treasury yield is still well below our and the markets' call that US nominal GDP will increase at annual rates of between 4-5% until the end of 2020.
- Which risk is it?** For much of 2018, markets have focused on the risks linked to a flattening US yield curve. In the past, the inversion of the US curve has been a reliable predictor of the end of the US cycle. Now that 10-year yields are rising, markets worry less about this risk than before. Instead, markets are now concerned that rising bond yields will slow growth. Both risks cannot be true at the same time. The likelihood is that neither risk will prove to be particularly pertinent. As always, fundamentals dictate economic performance more than any single asset class.
- Rising rates are no threat to growth:** Although European growth has sagged a bit this year under the weight of worry from trade wars, oil prices and Italian populists, current growth momentum and the outlook (ex. UK) has improved versus a few years ago. The Eurozone can probably manage real GDP growth slightly above trend (c1.7%) in the coming years. The UK can match that so long as it avoids a hard Brexit (20% risk). Meanwhile, the US probably has enough momentum to manage growth of around 2.5%. We see no logical reason why a continued gradual rise in bond yields that reflects economic fundamentals should pose any serious growth risk. In fact, it may indeed be beneficial (see [Conundrum: what if bond yields stay too low again?](#)). In the same vein, gradual central bank policy tightening that simply matches these positive trends need not weigh on demand either. At any rate, if the spike in yields threatens to turn into a genuine risk to the economic outlook, the Federal Reserve and other central banks will take that into account and, put simply, see to it that it does not.

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