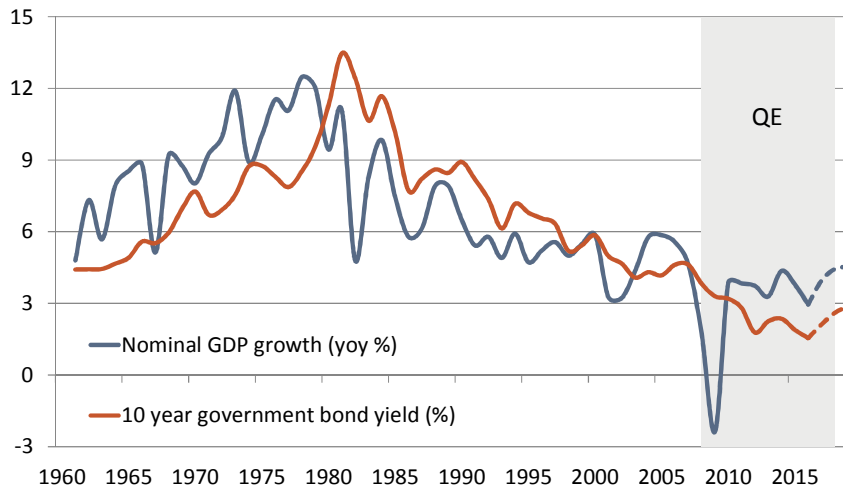


20 October 2017

Bond yields: what happens when easy money ends?

US, Germany and UK: GDP growth, 10-year government bond yields and Berenberg forecasts



Source: Bureau of Economic Analysis, ONS, Deutsche Bundesbank, US Treasury, Bank of England, Deutsche Bundesbank, Berenberg. Data is based on a GDP weighted average of US, Germany and UK. Grey area denotes the beginning of the Fed's QE in 2008 until Berenberg's expected end of the ECB's QE in 2018

- **The effect of the financial crisis:** Heeding the lessons of 2008, firms, households and governments have lived in the age of caution over the past nine years, opting to raise cash balances and pay down debt. While the much-needed balance sheet repair has strengthened underlying fundamentals – major economies are in better shape than a decade ago – it has weighed on growth and raised demand for safe assets. This process, along with extraordinary efforts by central banks to stimulate demand, has coincided with yields on government bonds falling to record lows.
- **Memories of the financial crisis are fading?** After almost eight years of sustained – albeit sluggish – recovery, economic agents are finally shedding their anxieties about the past. For the advanced world, the story of the past year is one of sustained gains in demand and investment. With many economies at, or close to, full employment, central banks are now beginning to slowly remove the monetary crutch. Since the Fed began its slow normalisation in late 2015, other central banks have signalled they will become less accommodative over time. We expect the BoE to go for a first hike next month. The ECB is likely to complete its balance sheet expansion by the end of 2018. But after the Fed's taper tantrum of 2013, central banks remain cautious as they creep towards the exit.
- **Remember the fundamentals:** Government bond yields are highly correlated with nominal GDP growth, as both are made up of real returns/growth plus inflation. The decline in both nominal GDP growth and government bond yields since the 1980s reflects falling rates of productivity growth and lower inflation. Much of the difference between the two can be explained by the extra component of bond yields – the term premia – which reflects the compensation that investors demand for holding long-term paper over several short-term riskier investments. Term premia rise across the curve when investors become more risk loving and vice versa. Since 2008, term premia have turned negative for some bonds, driving yields down. This risk aversion may have contributed more to the fall in yields than QE.
- **The day after QE?** Look at our chart; do you see a major change in the long-term trend in yields when QE started? Not really. QE has probably had a stronger affect on the price of riskier assets rather than government bonds. In absence of adequate market liquidity, QE has supported the prices of riskier assets via portfolio rebalancing effects. If market sentiment is strong and liquidity is ample, a gradual tightening in monetary policy should not hurt equity markets.
- **Central banks will not spoil the party:** Modestly higher policy rates and a gradual balance sheet unwind by central banks probably will only have a moderate effect on bond yields. While the post-Lehman caution is gradually fading, it still exists. And while nominal GDP growth could rise a little over the medium term, it will remain well below historical averages. Such a world will ensure still high demand for safe assets and a very gradual exit by central banks. Bond yields should rise only modestly unless there is a sharp acceleration in nominal GDP growth. At this point, that seems unlikely.

Economics

Chart of the week



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