Bond market uncertainty a sign it’s time to fix rates

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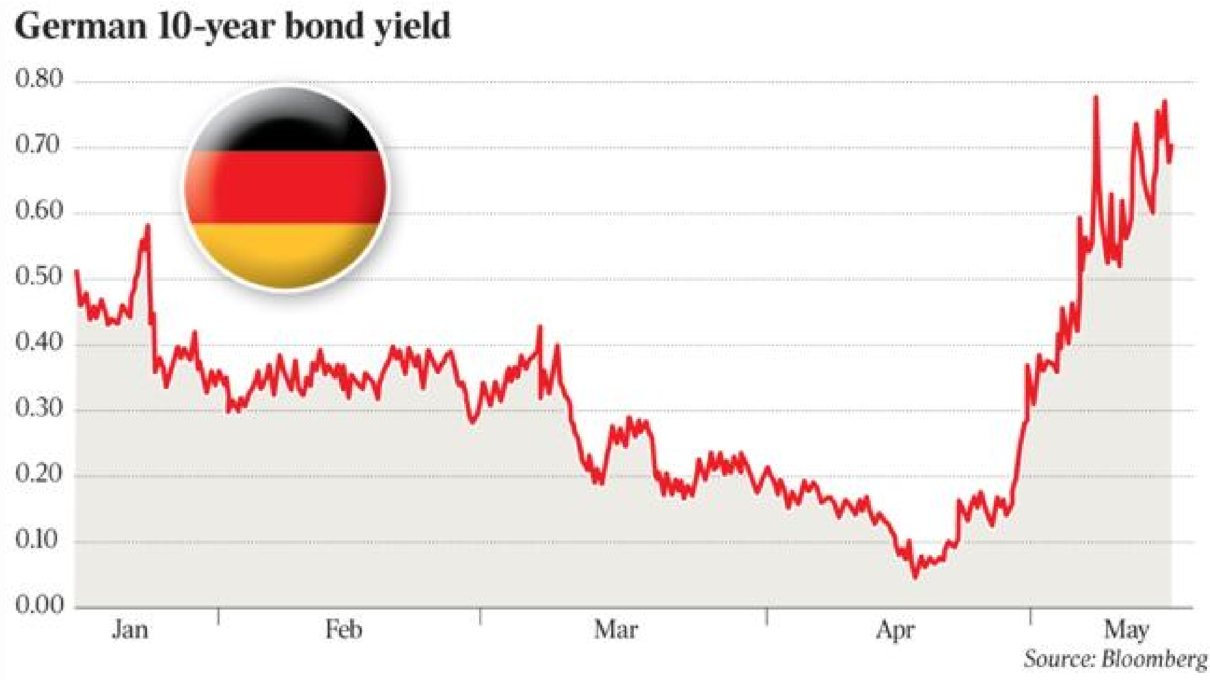

German bond yield. *Source:* TheAustralian

Bond markets in Europe are stressed. And it’s affecting the US and Australia. Investors should allow for further lively — and likely disruptive — times in bond markets, here and abroad, in coming months.

Five weeks ago, yields on government bonds in many countries were at their lowest levels ever. In Europe, $US3 trillion of government bonds were priced with negative nominal yields.

Investors, and not all of them central banks, were prepared to pay to lend money to the German, Swiss and Austrian governments.

But on May 7 there was a dramatic sell-off in the German bond market, traditionally lauded for its stability. The yield on 10-year bonds — German government bonds — went from their April low of 0.05 per cent to a brief peak of 0.78 per cent.

Concerns spread to other bond markets, including in the US and Australia. In Australia, 10-year yields have risen by more than half a percentage point from their April lows. There is, of course, an inverse relationship of bond yields and bond prices — and the longer-dated the bond the greater the inverse move in market prices.

There’s still no agreement on what caused the sell-off in European bonds.

In my thinking, it's an early sign of an emerging view that the global economy, which has been in the doldrums, is now close to an important turning point that delivers better growth.

Here's a list of how analysts and traders have explained the jump in bond yields:

● Some blame "technical issues", associated with a temporary shortage of buyers as some big investment funds switched from conventional bonds to inflation-linked bonds.

● Others point to the recent changes in bank regulation, which have constrained the activity of "market makers" in bond markets.

● Investors are starting to prepare for the level of bond yields that's likely from August next year, after the European Central Bank completes its program of bond purchases of 60 billion euros a month.

● The business outlook in Europe is not now as gloomy as investors had earlier expected. Though many problems have to be faced, the consensus forecast for economic growth in the eurozone this year has been raised to 1.5 per cent, pushing bond yields higher.

● Also, bond investors may have gone too far in their earlier expectations for sustained deflation in Europe.

Perhaps triggered by the rebound in oil prices, bond investors are again allowing for (mild) inflation.

If, as I expect, further signs emerge over coming months of an early pick-up in global growth, bond markets could turn decidedly bearish.

Yields on medium-dated and long-dated bonds will likely increase relative to yields on short-dated bonds, which are anchored, other than in the US, by the prospect of cash rates remaining unchanged for some time. Perhaps it's time for bond investors to consider favouring shorter-dated bonds, floating rate notes or cash, relative to their holding longer-dated bonds. And investors in bond funds might favour absolute return funds in preference to funds that focus on outperforming the average returns the market is delivering (which may well be negative).

Borrowers might consider locking in some fixed-rate debt while term rates remain relatively low. To date, the mood swing in bond markets has had relatively little effect on share markets. It's prudent, I believe, to allow that forthcoming increases in bond yields will hurt investor confidence — and initially reduce share prices. However, if bonds sell off because of an upgrade in global growth, which would raise expectations for company earnings, share markets might soon rebound.

There's also the point Nick Nelson, a European equity strategist for UBS, makes that "equities hate deflation so if bond markets are moving away from deflation that should be constructive (for shares)".

The fractured confidence in the bond market is a reminder, too that the US Fed will be skating on thin ice when it begins to "normalise" its US cash rate without, it hopes, unsettling the US bond market.

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