Why the ASX was first to fall in global bond sell-off

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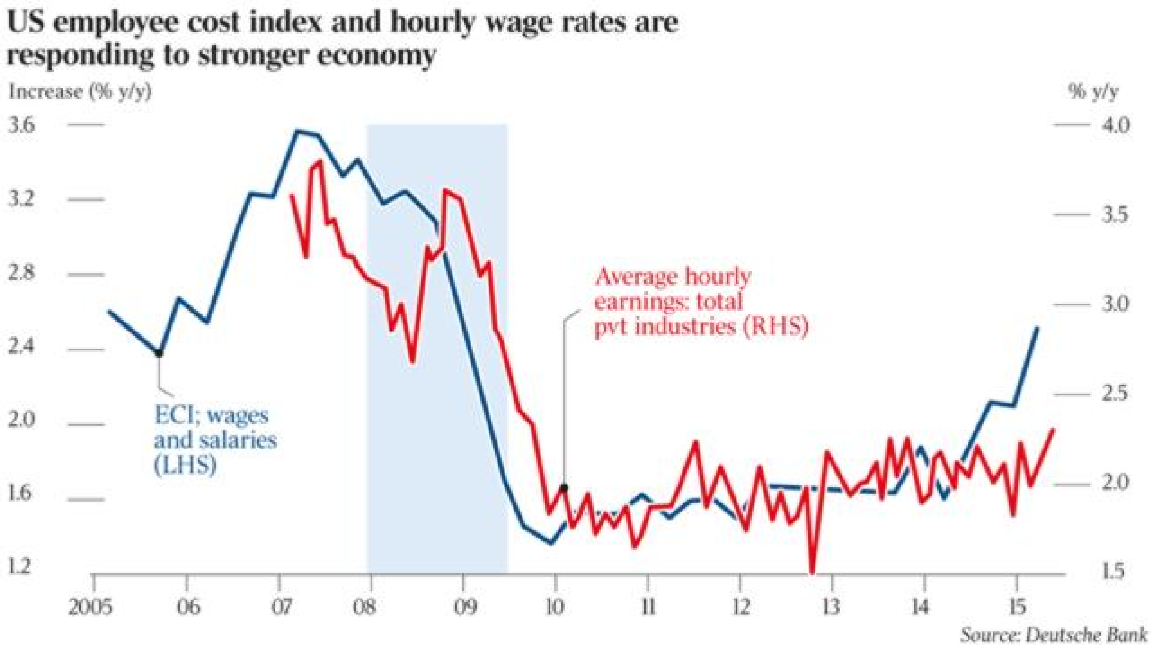

US rebound *Source:* TheAustralian

Over the years, I've learnt the need to allow for the powerful but generally unforeseen influences — the X factors — that from time to time impact heavily on investment returns.

To have respect for X factors is not a cop-out from considering the more predictable factors that shape investment returns, especially over the medium and longer term. It's simply a way of recognising the many uncertainties investors have to face and the need for sensible diversification.

At the start of this year, there were predictions, including in this column, that bonds faced a sell-off this year. (Bond prices and bond yields move inversely; lower prices mean higher yields). But no one picked how turbulent bond markets would become.

Why has this happened? And why, initially at least, was our sharemarket been more affected by the higher bond yields than shares in most other countries?

At the beginning of the year, 10-year German bonds yielded 0.5 per cent. In April, the price soared and the yield fell to 0.05 per cent. Many shorter-dated bonds issued by creditworthy European governments — including Germany, Switzerland and Sweden — carried negative yields for a time. Bond yields in other countries followed the direction of the lead from Europe. The US 10-year yield dropped to 1.7 per cent and ours to 2.3 per cent.

The unprecedented frenzy to buy bonds reflected two main influences. In March, the European Central Bank began a massive program of bond purchases to expand the money base of the eurozone. The general expectation was that Europe would, nonetheless, suffer recession and deflation.

In early May, bond yields in Europe spiked higher, suddenly and markedly. The German 10-year yield rose more than fifteen-fold from its low point, to 0.78 per cent. Late last week it yielded 0.9 per cent; on US and Australian 10-year bonds, yields were respectively 2.4 and 3.05 per cent. The sell-off in bonds in the last six weeks, in Europe and around the world, reflects upgrades in expectations for growth and inflation. GDP in the eurozone hasn't contracted, as was earlier expected; and it's now forecast to expand by about 1.5 per cent in 2015. Instead of the deflation that was predicted for Europe, slight inflation is now considered more likely.

Investor sentiment towards US bonds has also swung widely. US bonds rallied in price (yields fell) on the news that the world's largest economy had contracted in the March quarter (by 0.2 per cent as we measure it). More recently, US jobs growth has continued, other economic data have strengthened, and as the chart shows wage increases are quickening.

To date at least, share investors in most countries have mostly ignored rising bond yields. At the time of writing, US S&P 500 index is just a whisker below its record level and European shares have held up surprisingly well to what's happened to bonds.

However, the Australian sharemarket dropped by 10 per cent. The greater importance of dividends here makes our shares especially sensitive to sudden moves in bond yields. Our bank shares, particularly, reacted strongly — and perhaps excessively — to the gyrations in bond markets. And shares in our resources companies are still out of favour even though oil and iron ore prices have rebounded modestly from their low points.

There's little doubt in my mind that bond yields will rise further in the next twelve months as the global economy strengthens and inflation reappears — and the US cash rate is increased.

US magazine *Barron's* said recently that the US sharemarket was showing "relative resiliency in the face of rising bond yields. And that's typical of patterns when higher interest rates are seen as reflecting a stronger economy".

Provided better numbers for economic growth in the US and other major economies come through, our sharemarket, too, has good prospect of moving higher. But not without some serious bumps and wobbles on the way.

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