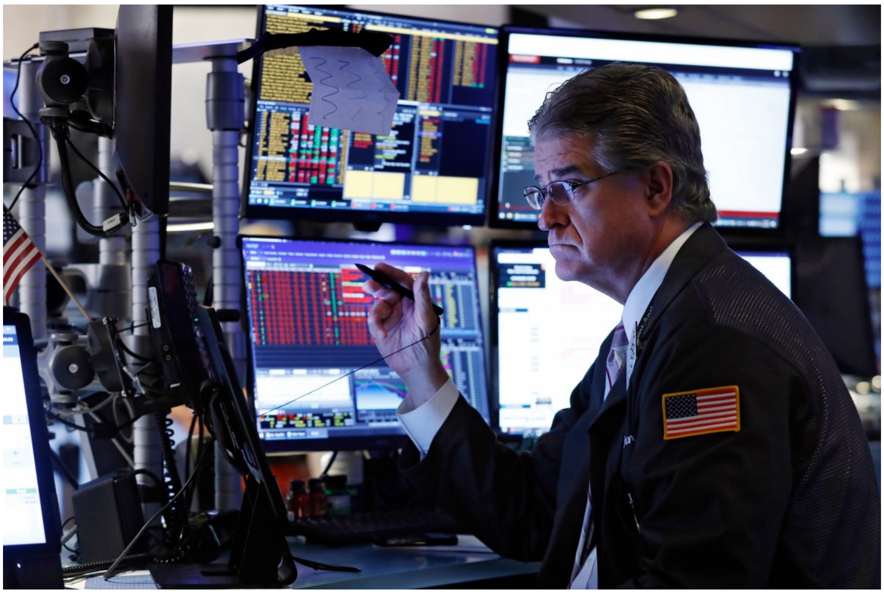
Opinion | 22 February 2021

Rising yields aren't necessarily bad

Financial journalists are making a lot out of the recent rise in US Treasury yields - firstly, relative to where they were not so long ago, bond yields haven't risen that much - secondly, this isn't bad news for everyone.



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If you read nothing else, read this...

I do like to give a plug to others' work in this note, where deserved of course, and today, I would like to draw your attention to an excellent and also short article by John Dizard in the Weekend Financial Times. The article is called "Do not rule out a market panic next month", and breaks the golden rule of forecasters by giving both a forecast *and* a date. In fact, it only just manages to claw back some ambiguity (which we all normally hide behind) by adding "Do not rule out..." which essentially means that anything *can* happen, but if it does do this, then "...I told you so!". Clever, but not smug.

Dizard notes that there is a scramble for short-dated T-bills in the US which has caused their yields to drop. Dizard perhaps overdoes the scale of the decline - we are talking a few basis points in reality, though this is admittedly a large percentage of the yield which is practically zero anyway. But the message is not diminished by this, and is essentially the following "If large financial institutions are taking precautions against a market crash, then perhaps we ought to do likewise..." There is also a good refresher on convexity trading, which always gives me a bit of a headache, like cross-currency basis, but is put in such a way that even I can understand it.

So much for the plug, and I agree, the probability of some market sell-off is increasing with rising yields. But here's the thing, what we now seem to be witnessing, as much as a rise in inflation expectations, is a rise in real yields. To put this in primary school language, the rise in "bad" yields is being offset by a rise in "good" yields. That leaves the net effect a bit ambiguous - at least until I do some number crunching and see what is winning this battle - more on that later in the week if I have time.

We also have to acknowledge that although we are all aware that headline inflation is picking up and that even the run rate of monthly inflation numbers has picked up a bit, no one really expects inflation to push up and stay at levels that will require central bank tightening anytime soon, especially not the Fed or the ECB. And that means no mirroring movements here in Asia by our central banks. Moreover, let's just try to remember a little further back than 12 months. In December 2019, just a few weeks before Covid changed all our lives, 10Y US Treasuries happily yielded about 1.9%. And no one thought this was unreasonably high. Indeed, the equity market back then was powering higher.

And much as the financial media tends to focus on the impact of higher yields on equities and other risk assets, large parts of the real economy will benefit from higher yields. Ever wonder why there isn't much feedthrough from low rates to bank lending in many of our economies in the region? Well with economic activity weak, banks will be setting aside capital for potential default charges, and frankly, the price of money which they borrow short-term isn't much of an incentive when the long-term rates are barely any higher. This is still a maturity transformation business, and a steeper yield curve and recovering economy will help banks to lend more.

Higher yields are also an indication of expectations of a stronger macroeconomy, where it makes sense to lend to profitable companies, and where it is possible to make a return from doing so. And don't get me started on the large portion of many populations that is currently panic-saving to offset the anticipated shortfall in income in retirement from woeful returns on fixed-income investments. Some of them might be able to spend a little more freely in a higher yield environment.

In short, while there is every chance that we will see some fairly choppy market action if, as we suspect is the case, bond yields rise much further (that will be convexity at work), let's not get overly worked up about this. The economies of the world are still in a very early cycle upturn. There is still plentiful economic slack in most economies, and central banks really will be *very* slow to start taking away their stimulus. So any pullback may be more of a correction in a market that is still trending higher, and not necessarily the end of the bull-run. Bleeding out some air from over-inflated risk assets may be no bad thing if it breathes some life into the real economy.

The Wall St vs Main St argument is playing out in front of us as the adjustment from emergency policies unfolds, and there will undoubtedly be some unwelcome jolts along the way, but it isn't all bad.

Calendar

It is very quiet in both the G-7 and Asia today. There is lots of Fed speaker action over the course of the week. This includes Fed Chair Powell's semi-annual testimony. No one should imagine that he will be anything except very dovish.

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