Are Rock-Bottom Bond Yields ‘Irrational’?

Dear Reader,

Happy Holidays from the Evergreen Gavekal team. We wish you and your loved ones all the best this holiday season. Stay safe, and may 2022 be a prosperous year for us all.

Sincerely,
The Team at Evergreen Gavekal

What has been the most surprising financial event of 2021? The 20% gain in equity prices, the 40% jump in oil prices and even the fivefold leap in US inflation may all have been bigger than expected, but they were at least directionally understandable consequences of the fastest growth in the world economy for 40 years. That explosive growth, in turn, was a predictable response to last year’s unprecedented monetary and fiscal stimuli, magnified by the end of Covid lockdowns. A more surprising event than the performance of equities or energy, or even inflation, was also arguably more important, not only for financial markets but for global economic prospects.

The 10-year US treasury yield, which was almost universally expected to rise back into the 2-3% range that it had inhabited before Covid, is ending 2021 well below 1.5%. And the 30-year bond yield, which had never in history plumbed levels below 2% prior to Covid, is trading today at 1.8%. That is exactly where it was back in January, when US inflation was running at 1.4% instead of 6.8% and when much of the world economy was still in lockdown.

The astonishing stability of long-term interest rates this year has attracted less comment than the gyrations of equities and energy prices, partly because it was a non-event, but mainly because the refusal of bond investors to push yields much higher seemed to defy all rational explanation, at least according to conventional theories of economics and finance. After all, bond yields are supposed to compensate long-term investors for the loss of purchasing power due to inflation, or to represent market expectations of short-term interest rates. Yet almost unprecedented inflation, explosive economic growth and steeply rising short-term interest rate expectations have had scant effect on bond markets this year. Last week bond investors defied expectations again, nudging bond yields down instead of up in response to hawkish surprises from the Federal Reserve, the Bank of England and to a lesser extent from the European Central Bank and even the Bank of Japan.

Many analysts have responded to the bond markets' refusal to budge out of their post-Covid trading ranges by dismissing investors as irrational, or by denouncing governments and central banks for "manipulating" bond yields to the point where they have become economically irrelevant. This is a big mistake. Bond yields are the single most important determinant of equity valuations and also a crucial influence on business investment decisions, which in turndetermine productivity and economic growth. If US 10-year bond yields remain in their 2021trading range of 1.25-1.75% for the next few months and then rise gradually into a range of 1.5-2% and then to 2-2.5% in 2023, the outlook for equity prices and global economic growth for thenext few years will remain very favorable, almost regardless of what happens to inflation, oilprices and short-term monetary policy.

This is roughly the outlook I suggested in February this year and continued to propound throughout 2021. It remains my view for the year ahead, which is why I continue to be bullish on equities and see setbacks, especially if they are triggered by interest rate fears, as opportunities to "buy the dip". If, on the other hand, bond yields explode upwards in the year ahead (say to 3.5% or higher for the US 10-year) then equities, property and other risk assets are likely to suffer more serious and protracted corrections—and the world economy could experience a crippling blow.

Therefore, blank incomprehension and moralizing are not good enough as a response to bond market pricing. Instead of assuming that bond investors are "irrational" or that long-term yields are somehow irrelevant because they are now "manipulated" by central banks, it is worth trying to understand why bond markets are behaving differently from the predictions of economics textbooks, and how long this behavior may last. If we accept that bond markets are inhabited by reasonably intelligent people who make rational decisions within their investment mandates, then two explanations of "surprisingly" low bond yields are possible, with diametrically opposite implications for equities and other assets.

The most common rationalization of bond market behavior, for which there has never been much evidence, is that bonds are "smarter" than equities— and that at present bond investors "know something" about the dismal long[1]term prospects for global growth and inflation that is not apparent to lesser mortals. Bond investors are therefore happy to buy low-yielding securities because these yields will move even lower, as they have in Japan.

The second explanation, which I find much more plausible, is that bond yields tell us almost nothing about the long-term prospects for growth or inflation. This is because the majority of investors who now dominate bond markets do not really care about what may happen to the US or world economies in 10 or even five years' time. The marginal players who determine market pricing in bond markets today do not buy 10-year or 30-year bonds in the hope of making a modest real return by holding them to maturity. Instead of the traditional buy-and-hold investors still assumed in economics and finance textbooks, bond markets today are dominated by four very different groups of market players:

- Short term players, such as hedge funds, primary dealers and algos, who make money by trading the yield curve and are mainly interested in the steepness of that curve, not the absolute level of interest rates.
- Official investors, who are motivated by macroeconomics, not investment returns. This group includes central banks buying bonds issued by their own governments for quantitative easing and foreign central banks, mandated to invest only in US or European

government bonds for purposes of currency stabilization and reserve management.
- Private investors who own bonds not to make money but to comply with regulations. These include pension funds and insurance companies forced to match liabilities with “risk-free” assets and banks required to own bonds for solvency buffers.
- Profit-oriented investors who buy bonds in the hope of stabilizing their equity portfolios, even though they expect to lose money on these bond hedges in the long term.

For these four groups of investors, there is nothing irrational about buying long-term bonds at negative real yields that are far below the “natural” or “equilibrium” levels assumed in textbooks of economics and finance. Since hedge funds, reserve managers and regulated investment institutions now far outweigh traditional buy-and-hold bond investors, governments and central banks should be able to keep long-term interest rates at very low levels for many years ahead, as long as inflation does not get completely out of hand.