THE LONG MARCH TO HIGHER INTEREST RATES

The bond bubble has burst, but it remains to be seen how quickly the fallout may spread. The first stage of the sell-off has taken many global core government bond yields up to 0.50% to 1.25% higher. Markets now await additional clarity around U.S. and Chinese policy actions before making the next move. Whatever the outcome, the rules of the game have changed and higher yields appear likely as this cycle unfolds.

Credit analysts often have the opportunity of meeting company CFOs and CEOs alongside their equity colleagues. Some companies find it challenging to simultaneously manage the message to both bond and equity holders. This wasn’t a problem for one CFO, however, who once greeted a credit analyst and proclaimed “When I look at you bondholders, all I see is a cheap source of capital.”

The U.S. executive branch will be populated by people who have built much of their careers around using leverage as a tool to enhance outcomes. Wilbur Ross, Steven Mnuchin, Gary Cohn and, of course, Donald Trump himself are no strangers to the wonders — and occasional perils — of debt as a cheap source of capital. Borrowing rates today are low, the new administration has made promises around spending and the public has expressed a strong desire for better economic growth. Creditors should be nervous.

We wrote last year in “Four Elements of a Bond Market Bubble” that the catalyst for higher bond yields would come from policy shifts rather than a sudden reassessment of economic growth. Two such policy shifts have dominated the landscape since. First was the Donald Trump victory and Republican clean sweep in November. The second important shift has been the reflationary policies implemented by China. The dominance of these key drivers will persist throughout 2017.

Growth will likely accelerate in 2017, but appears unlikely to break out of its post-crisis range. We are near speed limits in many economies, as productivity and labor force growth remain weak. Yet even in the absence of a resurgence in growth, the ground rules have irrevocably changed, and this is the important message for bond markets. ‘Monetary policy’ is yesterday’s game; fiscal policy is the way forward. Under the old stimulus rules, policy rates moved ever lower and QE-related bond purchases moved ever higher. Under the new rules, policy rates move higher, open market purchases trend lower, and inflationary expectations and deficits increase. The latter regime is clearly less positive for bonds. The key question facing markets today is, ‘to what degree?’
The 35-year-long bond bull market took yields to multi-century lows last summer. With more than $13 trillion of nominal bonds yielding less than zero, there was simply nowhere for yields to go but up. Real interest rates were negative in most developed markets, and term premia – the compensation for extending maturity – had collapsed. It is one thing to price in low growth and inflation. It was quite another to believe that high growth and inflation will never reappear. It was a bear market waiting for a catalyst. There is a high probability that developed bond markets have seen secular lows.

The sell-off to date can be viewed as an unwinding of 2016’s extreme overvaluations. Ten-year U.S. Treasury notes have corrected from a low of 1.35% in Q3 2016 to approximately 2.5%. Term premia, which appeared overvalued by 0.75% to 1.0%, largely readjusted as fears of deflation vanished. But with much of the overvaluation eradicated, we now find ourselves in the “wait and see” phase of the sell-off. Precise details and timing for much of the Trump plan remain incomplete making it difficult to assess implementation risks. Realization of all of Trump’s campaign promises will push yields to new cyclical highs. Missteps and delays may put the brakes on the sell-off and could even temporarily reverse it.

The new administration will not be able to quickly deliver on all of its promises. Momentum is faltering. Tax reform of the scale proposed has historically taken 6-12 months or more simply to bring to a vote. Trump’s spending plan is a budget-buster, and the proposed $1 trillion infrastructure figure has already been deemphasized. Moreover, the plan calls for public/private partnerships, which require time and effort to get off the ground. Finally, numerous Republican budget hawks will ask for expenditures to be deficit-neutral. There is more hope around the pillar of deregulation, but this too will become more contentious as the year progresses. In summary, the proposed Trump policies will not be able to do much direct heavy lifting in 2017, aiding U.S. growth by no more than 0.1%-0.2%.
This should not be construed as a bearish economic view. The global economy was trending higher even before the election. The deep inventory correction and profits recession that restrained growth in 2016 are receding quickly. The shift in consumer and business sentiment has been impressive and greater confidence is boosting investment and hiring plans. These factors alone should push growth higher this year by 0.3% to 0.5%, taking 2017 GDP to 2.0% to 2.5%. The risk of a material slowdown has diminished, providing the administration does not stumble.

Growth is important but has not been the key driver of rates for several years now. Macroeconomic volatility in the post-crisis era has, in fact, been among the lowest on record. As shown below, key measures of both growth and core inflation fail to explain rates’ behavior in recent years.

**Figure 3: U.S. real GDP growth and core PCE**

Macroeconomic volatility remains low; interest rate volatility remains high

Growth and inflation still matter, of course, but primarily through their impact on policy response. When weak nominal growth was assured of eliciting an emergency monetary reaction, bond markets responded accordingly, as it understood the QE policy reaction. But today, additional QE is off the table. Even with disappointment in the pace of Trump’s policies or in the absence of rapid growth, the prospect for yield declines on the heels of friendly monetary policy is limited.

Markets are correct in calling for a bit more clarity before taking yields another notch higher, and this extends across the globe. European bond markets have played catch-up this year and have underperformed the U.S. In this area too there is a need for more monetary and political policy clarity. This manifests itself in terms of the ECB’s intentions, the fallout from Brexit and in the upcoming electoral cycle in the eurozone.
NO U-TURN ALLOWED

The election of Donald Trump was a game changer. The reason is not Donald Trump himself; he is the vehicle by which the electorate is channeling their frustration. A single person cannot upend the entire political and economic establishment, and Trump will not immediately transform global economic growth. Rather, it is the electorates, both in the U.S. and abroad, that are the powerful forces upending the game.

Trump is also a game-changer because his election alters policy direction. Economic policy possesses inertia. Policymakers typically administer a small dose of medicine to the economy when appropriate. If that doesn’t work, policymakers usually prescribe a bit more of the same medicine. Breaks with these trends occur infrequently. Shifting policy reaction functions are almost always highly significant, but are usually deeply underappreciated at the time. Policy inertia will now move in a new direction. If a bit of fiscal expansion fails to cure the patient, there will be calls for more of the same. Western economies are opting for the fiscal policy fork in the road.

Brexit and the U.S. election shared a common bond. They marked the point at which the electorate rejected the status quo. Quantitative easing and low rates exacerbated income inequality and contributed to declining real standards of living. Too many had been left behind and the benefits of globalization, although positive, were unequally distributed. The public was not going to accept secular stagnation without protest.

THE CHINA WILDCARD

Although Brexit and the election grabbed the headlines last year, bond investors were also being buffeted by the rapidly-evolving policies of China and the rest of Asia. China has long been the key marginal buyer in developed market bonds. To understand this, we need to consider China’s excess savings and current account imbalances.

China has built its economy on a strategy of overinvesting, overproducing, and generally under-consuming. Savings greatly exceed investment, as they do in most exporting countries, forming a current account surplus. These surpluses are then used to fund other countries’ current account deficits. This symbiotic relationship tends to see savings flow into offshore products such as government bonds, keeping yields low.

China, after years of overinvesting in new capacity, has been reining in these excesses, denting growth. Commodities demand has suffered, and the combination of these factors pushed the country from producer price inflation to deflation. The yuan should have been softening, but with authorities reluctant to let it find an appropriate clearing level, capital outflows from China intensified. Investors, faced with excess capacity, a lack of profitable domestic investments and an overvalued currency, acted logically and moved money offshore. Massive amounts of savings struggled to find a home. Government bonds were the key beneficiary, and term premia in many core markets simply collapsed under the weight of these capital flows.
The slowdown in China explained more of the decline in U.S. rates throughout 2015-2016 than did the slowdown in U.S. growth. The combination of flows emanating from savings glut regions such as China, Europe and Japan, coupled with the powerful effects of domestic QE provided a turbocharged boost for bonds that will be hard to ever replicate. Foreign capital outflows peaked in the first half of 2016, not coincidentally about the same time bond yields bottomed. There are several ways a country can address an excess savings imbalance:

1. ‘Export’ excess savings overseas (as illustrated in the example above);
2. Retain the savings and invest them;
3. Save less by consuming more.

The problem with option #1 is that the current account surplus is already too large. The Trump administration wants a smaller Chinese surplus. Option #2 is a non-starter, as the Chinese have already invested too much, resulting in widespread overcapacity. That is in many ways the heart of their problem. Option #3, then, is the only viable choice. This is why China has started in earnest down this path.

This portends a significant shift in global capital flows. China now has a double incentive to rely less on the first two options and much more on the third. The third option is what the domestic economy needs to mature and restrain growing discontent. It is also the one that may draw less ire from protectionists. Pursuit of this strategy may be one of the few things that both the U.S. and China agree on.

With a more isolationist U.S., we should also expect China to resort to heavy stimulus, macro-prudential policies and currency depreciation to cure its imbalances. On balance, this should lead to a sharply-lowered level of capital flows and associated bond buying. The U.S. Treasury market has benefited most due to the dollar’s reserve currency status, but it may have the most to lose from this seismic and underappreciated shift.
A BEAR MARKET, BUT NO DISASTER

The bond bull market is over, exhausted by overvaluations and a realignment of policy expectations. But bear markets come in many sizes and shapes, and this does not necessarily mean that large losses now loom around each bend.

The upward pressure on rates will be tempered by many offsetting forces. Policy cannot easily erase globalization, income inequality, heavy debt loads, aging demographics and poor productivity. Each of these powerful secular forces has been pushing rates lower for decades and will not go away. These forces may limit rate rises to less than 0.75% in the near term, taking 10-year Treasuries to 3% or so. Investors need a cheat-sheet. Policy uncertainty makes it difficult to draw a road map for the next 12-24 months. Following are some key risks and signposts to watch out for:

Inflation
Recent history has taught us not to be worried about inflation. But longer-term history teaches us that the periods to be legitimately worried about inflation are those where the output gap has closed, the economy is growing above potential, and the labor market is at full employment. This is precisely the environment the U.S. faces today, so it is no time to be complacent. Attempts to boost growth when the economy is already at the speed limit will likely produce higher inflation but little incremental growth. Investors should keep an eye on wage pressures, diffusion indices and the global nature of price increases.

Trade and protectionism
A full-blown trade war would materially reduce global growth and boost inflation. We are hopeful that threats of steep tariffs are a negotiating tactic rather than an end-game. Countries such as China have made significant progress in recent years on permitting currency flexibility, clamping down on intellectual property theft and reducing import protection. A compromise is entirely plausible.

Tax reform
Tax code overhaul is a big job. Key issues here include the border adjustment tax and interest deductibility. Border taxes would be protectionist, boosting inflation and suppressing international capital flows, forcing both yields and the U.S. dollar higher.

A relapse in Chinese growth and inflation
This would lead to either a sharp devaluation in the currency or significantly higher capital outflows. It would further elevate global growth fears, sending global yields lower.

Exogenous geo-political shocks
We are in a bull market for geopolitical risk and some bond yields have risen to levels that would actually provide some portfolio diversification benefits in a flight-to-quality environment. Events in Europe, in particular, bear watching.

Stalled policy
Trump and team may fail, as internal crises prevent progress on key objectives. Although unlikely, both growth prospects and interest rates would fall. Delays in some key reforms might detract further from near-term growth if investment projects are postponed in anticipation of more favorable terms in 2018.
Most of these potential surprises are inflationary. With the U.S. output gap closed, above-trend growth will have a non-linear impact on inflation expectations. There is a paucity of evidence pointing towards a sustained acceleration in core prices, however, so investors should not be overly alarmed just yet. Pressures should emerge gradually, and markets have already repriced to reflect this development. Rising inflation expectations have provided the main thrust behind higher interest rates.

Figure 6: U.S. inflation expectations vs headline CPI

Expect some near-term stabilization in inflation measures but a subsequent reacceleration of core prices later in 2017. Deflation risks appear dead, even in disinflationary stalwarts such as Japan and Europe. Surprises in the inflationary landscape will be critical for assessing just how painful the bond sell-off might be.

BOND INVESTING IN 2017 – ANOTHER EXCITING YEAR IS IN STORE

It is important that one does not become anchored in periods of genuine uncertainty. Many of the outcomes we observe today do not conform to a normal distribution. Bi-modal and skewed outcomes are common. They rest on the ultimate details of legislation and policy action in the U.S., elections in the eurozone, Brexit negotiations in the U.K. and the ability to control rolling asset bubbles in China. Some depend equally on policy responses from others – the reaction to the policy action. Investors must be ready to amend their views as they receive new information.
The upward march in bond yields may require follow-through from global growth and inflation. This is likely to occur, pushing rates higher as the year unfolds. Expect a wild ride, but beware that a myopic focus on every wiggle in macro-economic data will prove frustrating. Much of the success of today’s policies will actually lie in what they portend for the economy and profits in 2018, rather than 2017. With a daily dose of tweets, policy pronouncements, news conferences and central bank meetings, it can be difficult for investors to stay focused on the longer-term.

If Trump unexpectedly delivers on nearly all of his campaign promises, the ‘bond vigilantes’ will step in and take yields much higher. This will likely create a boom-bust scenario that ends in recession, albeit one caused by much higher rates.

Risk assets will fare well if some key policy initiatives are slow to unfold, as we expect. Growth is already accelerating and the Federal Reserve has an itchy trigger finger. The best environment for corporate, emerging market and mortgage bonds will be one in which markets expect some fuel to be left in the tank for 2018. Certainty of outcome, but delay in implementation, will keep risk assets in the sweet spot and is far superior then the risk of a boom-bust type of environment.

The demise of quantitative easing will spread as the year unfolds. The Fed is already discussing means of shrinking its balance sheet. The ECB will face a critical tapering decision, and will likely curtail bond buying as it creates bond shortages, deeply distorted markets and escalating dislocations across the region (e.g., Target 2 balances). Japan and the U.K. will likely find their policies to be unsustainable. Amid uncertainty, scenario analysis can also be a useful tool. The following chart looks at total returns for different asset classes across three different economic scenarios for 2017.

The bond bubble may have burst, but the fallout from today’s levels needn’t be devastating. Much of the pain of the first phase has already been felt. Investors will need to look harder for attractive returns as rising yields will hamper returns in most sectors of the market. Corporate and emerging markets appear attractive, but one must be careful of the tail risks, as the spread rally has left little compensation for recessionary risks. Government bonds remain relatively unattractive.
As is often the case, markets appear to be overreacting to the immediate significance of the changes unfolding before us, but under-reacting to the long-term implications. There will be short-term noise around legislation, policy shifts and geopolitics. Markets will witness failures, successes and speed bumps. And given the lofty expectations now built into many markets, some setbacks may now be inevitable.

The real story, of course, is that these developments are occurring at all. In emerging economies, a long period of debt-fueled investment is fading. In developed markets, populism has been unleashed as a direct response to the failings of post-crisis economies. Bond markets will find themselves in the cross-hairs of the fight against declining standards of living, income inequality and sluggish productivity growth.
There are risks associated with fixed-income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities.

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