Heartwood Investment Management

02 February 2018

Investment Insight

Weekly Insight

January's bond blues

With US ten-year treasuries testing three-year highs, do January's 'bond blues' herald the start of a bond bear market or the return to a more 'normal' cycle of higher yields and higher interest rates?

The ten-year US treasury yield rose 30 basis points over January, testing a three-year high of 2.70%. To some extent, longer-dated US treasury bond yields have been playing catch up with the front-end of the US treasury curve, as shorter-dated yields had already risen meaningfully in the fourth quarter of 2017. Growing confidence in the current synchronised global economic expansion, further fuelled by US stimulus expectations, has contributed to investors' reassessing central bank policies and longer-term inflation expectations.

January's sharp rise in the ten-year yield, though, came at a time when US economic data releases were more mixed. US economic fundamentals remain firm, but momentum has cooled slightly across business surveys (albeit from peak levels), as well as in housing and real consumer spending data.

Closer analysis of the recent upward move in ten-year nominal bond yields shows that they have moved higher than the equivalent maturity treasury inflation-protected securities. In other words, breakeven rates (i.e. the difference between the inflation-protected bond and the nominal bond) are rising. At the same time, as ten-year breakeven rates are rising, so are oil prices (please see chart below). Oil prices have risen more than 40% since June 2017, with the trend gathering momentum since November when OPEC and Russia agreed to extend production cuts. While perhaps not the overriding factor, the oil price will be worth monitoring to see if any significant correction precipitates a halt to the current bond market sell-off.

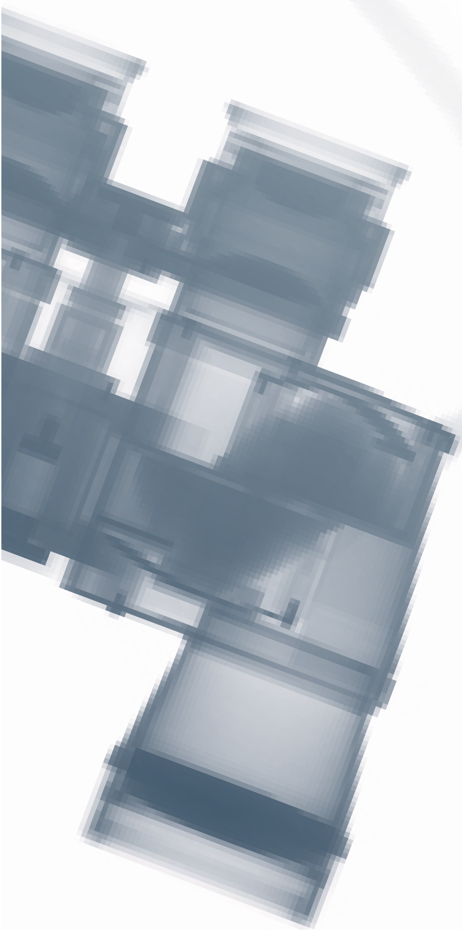
10 year breakeven rates moving in step with oil prices

Source: FactSet

Past performance is not a reliable indicator of future results.

What do higher yields and higher oil prices mean?

As the global synchronised expansion takes hold, we may assume that higher yields and higher oil prices reflect increasing investor confidence in the reflationary outlook. Of course, other factors reinforce the reflationary theme, including expectations of higher wages, a weaker US dollar and US fiscal stimulus (and the associated questions around how this is funded). ▶



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Furthermore, other major developed sovereign bond markets are also seeing higher yields, which again express investor confidence in the global economic environment. Notably, five-year German government bond yields entered positive territory for the first time since 2015.

Do January's woes indicate the start of a bond bear market? Irrespective of short-term market movements, we believe that we are returning to a more 'normal' cycle of higher yields and higher interest rates. The real question is whether this process will be orderly or disorderly. For now, our core view is it will be an orderly transition, as equity markets remain underpinned by solid global growth and strong corporate earnings.

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