Heartwood Investment Management

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Investment Insight

Weekly Insight

The bond market sell-off at the heart of recent volatility

Since October began, the market spotlight has been shifting from ongoing trade disputes to a different kind of turbulence. This week, investors have witnessed the most significant market volatility since February's surprise sell-off, with a combination of factors ranging from a broad investor switch into less expensive 'value' stocks, to fears about the outlook for global growth (currently being driven almost exclusively by the US).

However, the starting pistol for this period of volatility unquestionably came in the form of a bond market sell-off, beginning in the opening days of the month. The sell-off has driven yields on Treasuries (US government bonds) to multi-year highs,[1] fuelled by fears of rising interest rates amid stronger-than-expected US economic data. The situation has been further exacerbated by a rapidly expanding US budget deficit, funded through additional Treasury issuance and pushing yields higher (particularly on shorter-dated bonds).

The current sell-off may even have been significant enough to break US 30-year Treasury yields out of their long-run trading range – previously an apparently well-entrenched downward trend. 30-year Treasury yields reached almost 3.4% at the end of last week (5 October).

US 30-year Treasury yields may have broken out of their long-run trading range

US Generic Govt. 30-year yield

Past performance is not a reliable indicator of future results.

Source: Bloomberg

Could the bond market sell-off create wider problems?

Sharp rises in bond yields can cause market dislocations, and if the current bond market sell-off becomes more aggressive, it could begin to create genuine problems for equity markets.

There are two reasons for this. First, investors would be less willing to take on equity risk if they could receive a similar return on US government debt whilst taking minimal risk. Second, an effective rise in the long-term cost of money would lower equity valuations today, as perhaps the most widely used method of

Clear Thinking

[1] Bond yields move inversely to bond prices.

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calculating the present value of an equity involves using a risk-adjusted interest rate to work out future expectations for its cashflows.

If yields in the US continue to rise significantly, this could also begin to impact the wider economy through higher debt refinancing costs, as well as impacting the housing market (banks charge higher interest rates for mortgages when Treasury yields rise).

For now, though, higher yields are a sign of economic strength in the US and should therefore be viewed in a positive light. We are positioned for rising yields so are comfortable with developments but, as ever, we will be listening closely should the mood music change.

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