

Global Debt Levels, Central Bank Policy, Implications for Interest Rates and Bonds. Nov 2016

We have had central banks telegraph their intentions to us for years now, and mostly those signals have been dovish. Recently, however, there has been a backup in bond yields and some uncertainty around what central banks want and what they can achieve.

Is the current correction in bonds similar to the taper tantrum of 2013 when the Fed signalled an end to quantitative easing, or is it a shorter, shallower correction, or is it a more durable reversal in the one way market for bonds since the crisis of 2008?

Let's explore a slightly cynical view of the world, that central banks are in fact not independent of their political masters and that the government uses all the apparatus at its disposal in the management of the economy.

Global debt levels have risen from 87 trillion USD (246% of GDP) in 2000 to 142 trillion USD in 2007 (269% of GDP) and to 199 trillion USD (286% of GDP) in 2014. Despite deleveraging of particular sectors in the aftermath of 2008, aggregate debt levels did not drop but instead accelerated.

A plausible strategy for dealing with excessive debt would run as follows:

1. The first order of business is to ensure that the holders of the debt are strong and do not attempt a market sale which would bring about price discovery.

2. Market rates of interest need to be contained to facilitate the refinancing of existing debt towards longer maturities. This involves suppressing two elements, the first is the underlying government bond curve, and the second, the credit spread.

3. A strong holder of debt is the government since it pursues objectives beyond economic and commercial ones.

4. The government needs to finance debt purchases with the issue of government debt. This will lead to an increase in the national debt, from in most cases already elevated levels. A strategy needs to be found to reduce the cost of government debt.

5. Central bank purchases of government bonds are an efficient means of financing the government's debt purchases and moderating financing costs. In the case of more determined programs, central banks may buy corporate debt to suppress the credit spread as well as the base interest rates.

6. A pool of investment capital sufficient to finance and refinance the debt needs to be maintained and developed.

7. Excessive savings are to be encouraged as they are another source of cheap funding. Inequality of wealth supports excessive savings and may therefore be tolerated.

8. To channel savings to fund government debt, banks need to be encouraged to buy government bonds. Under Basel III, government bonds have a risk weight of zero, making them highly capital efficient investments despite their low yield. The zero capital consumption of government bonds makes banks demand highly inelastic. In the US, in the 12 months to Oct 2016 the holdings of US treasuries and agency MBS by banks has risen from 2.16 trillion USD to 2.43 trillion USD. Western and Southern European banks' holdings of government securities has more than doubled from 627

billion EUR in Sep 2008 to 1,422 billion EUR in mid-2016. This has been aided by credit lines (LTRO) for which government securities are eligible collateral.

9. The slower is economic growth and corporate profit growth, the lower must financing costs be maintained in order to prevent the excessive growth of the total debt. Ideally, the objective is to at least attain steady state if not shrink the stock of debt.

If the above conjecture is true, then interest rates will be capped over the long run. The current rise in interest rates would be a short term (3 to 6 months) phenomenon.

On this basis, while we would be tactically short the 10Y UST at 1.8, we would be long the 10Y UST between 2.0 – 2.3, and the 30Y UST between 2.84 – 3.06.