The Bursting of the Bond Bubble

The thirst for yield has compressed spreads across high grade to high yield bonds, and bid up the prices of sovereigns and loans and just about any security that threatens to pay an income stream. Yield junkies a.k.a investors have even bought unrated, first loss securities, paying an uncertain coupon and with infinite duration, a.k.a equities, in their quest for yield. The usual intermediaries have of course been quick to meet this demand by offering all manner of income funds.

Given the state of the global economy, weak but for some pockets of strength such as the US, credit has become overpriced, particularly in investment grade but now including high yield as well. Even, or some would argue especially, emerging market bonds, are overvalued. Almost globally, credit is overvalued and the risk of the bubble bursting grows day by day. The market consensus, not bereft of moral hazard, believes that central banks will be able to sustain the credit bubble for longer if not indefinitely. What might confound this thesis?

Short term rates are mostly determined unilaterally and arbitrarily by central banks. It is hard to see the developed markets' central banks raising rates any time soon given their desperate efforts to suppress their respective term structures. Some emerging markets may already find themselves at the foot of stagflation as global growth slows while inflation rises. Control over the longer term interest rates is not so simple, generally involving intervening in otherwise free and open sovereign bond markets. The Bank of Japan's latest QE efforts are illuminating. Their stated objective of 2% inflation has had the unintended consequence of causing a selloff in JGBs.

Inflation has thus far been absent from the weak, developed markets, where demand is deficient. Instead it has manifested in emerging markets where growth has been robust. Now even emerging markets seem to be slowing. Yet inflation may be persistent, if sufficient money is printed globally. Witness Brazil's predicament of slowing growth and rising inflation. The situation that the major central banks have put us in is one perched between inflation and deflation, an unstable equilibrium.

If inflation should prevail, the ability of central banks to maintain flat term structures will be challenged. Given the low levels of interest rates, debt service is highly nonlinear in rates and could prove problematic. Also, the dependence on almost all asset markets on the level of interest rates in their derivation of value makes them vulnerable to a treasury selloff. Fixed income would be most sensitive, but so would highly geared investments such as real estate and REITs.

Deflation would allow rates to be held low but this would be a Phyrric victory since real rates would have risen.

It is academically appealing to seek causation in market moves but experience has shown that while causation matters, underlying fundamentals can be held back for long periods of time, all the while building unhealthy pressure. Catalysts are more difficult to identify. Often the catalysts lie in the same inscrutable animal spirits that policy has strived to revive. Pressures build in fundamental imbalances and in the collective psychology of the markets as well. Sometimes the catalyst for unwinding a fundamental imbalance or mispricing is purely a turn in the balance of sentiment. Aided by accumulations of gamma at key market levels, such reversals can be quite violent and mark the establishment of a protracted new trend.