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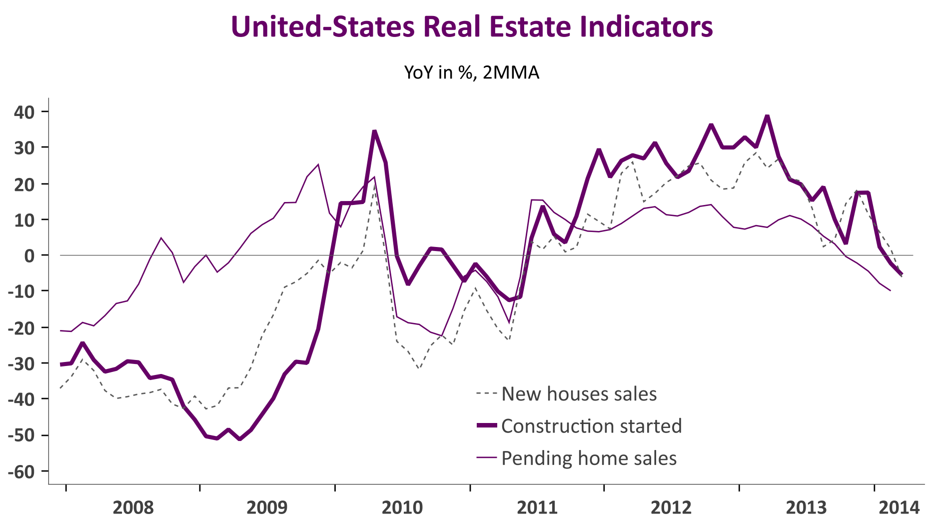
GLOBAL MACRO

Bonds Gone Wild

Will they rise or won't they? There is no end to the uncertainty on the future direction of long-term interest rates. Impatience is growing as well, with, however, this paradox: the fear of being surprised by a precipitous drop in prices on the bond markets (i.e. rocketing long rates) contrasts with the long-held desire to see long rates increase, which would be a clear signal that economic conditions have improved. For nearly one year (since the start of the "taper caper"), the US market has been on edge. Now, the Bank of Japan has said it is concerned that Japanese bond markets are not taking the country's new inflation context into account, worried about the effects should inflation finally wake up. These kinds of comments are surprising to say the least....

US market: the other possibility



Sources: RichesFlores Research, Macrobond

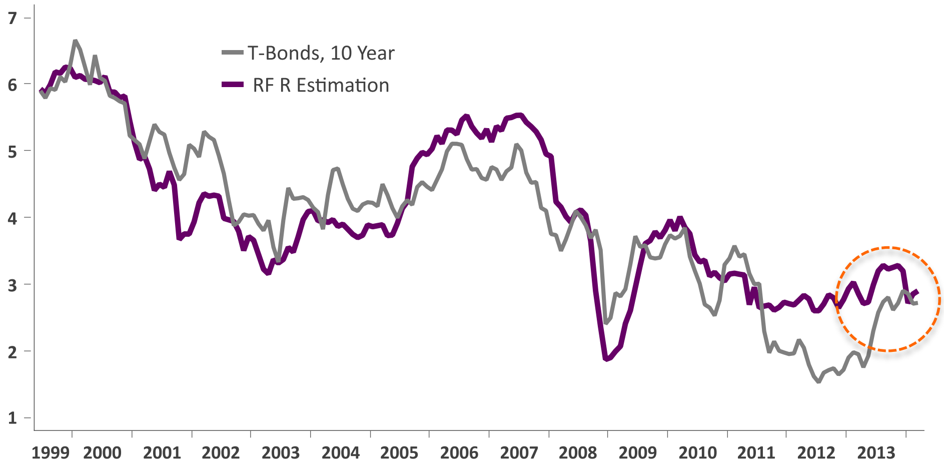
That the American market is hesitating is hardly surprising given the current taper context. It would be quite logical for long rates to increase, given that the Fed has reined in its stimulus and may cut it off entirely in a few months (a scenario the market is buying). Such a scenario would be justified by 1) technical effects linked to lower demand for securities and 2) the normalization of anticipations of short-term interest rates as the economic picture brightens. This may seem logical enough. However, it could be turned on its head in the event, notably, the second condition does not play out; in other words, if the end of QE is not followed by a rate hike by the Fed. There are many reasons justifying this scenario (our scenario in fact).

In fact, the current US cycle is on the cusp of celebrating its fifth birthday. This is beginning to be difficult to ignore for an economy whose productivity growth has struggled to improve. It is difficult to see how the cycle, which began in spring of 2009, will continue without productivity and investment improving. It is possible that we have already entered the second half of the cycle...

The real estate market has done nothing to dispel these premonitions. As we feared, the cold snap was not the only reason for the drop in the US housing market in recent months. All the latest data (housing starts, building permits, sales) continued to fall in March and April, continuing the slide begun in spring 2013 when mortgage rates started to rise.

This should suppress the urge for normalizing key rates and should influence the Fed's decision. The current level of the 10Y is not particularly undervalued (see chart), and it has no fundamental reason to increase if key rate anticipations do not budge. In the latter case, the 10Y could even decrease if expectations for profit growth are revised downward. At least this would put an end to the current state of uncertainty...

US T-Bonds



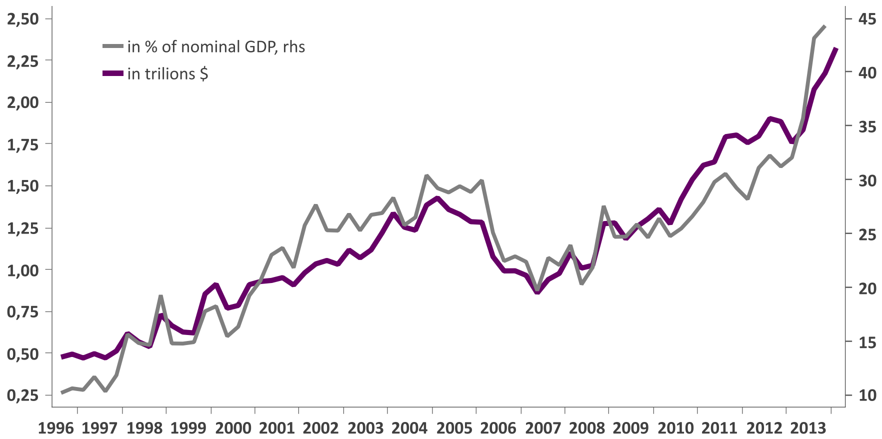
Sources: RichesFlores Research, Macrobond

Is the BoJ pretentious or just preparing a new offensive?

What is to be made of the BoJ's statements? Are they over-estimating the chances of Abenomics succeeding or are they justifying, albeit laboriously, fresh and large-scale stimulus measures? It stands to recall that the BoJ intervenes - massively - on the bond market, buying the annual equivalent of $550bn in JGB, with the very goal of lowering long-term interest rates. As such, its balance sheet has swelled by 11 GDP points since the start of the year. Under such conditions, it is difficult to imagine that investors will go out on a limb and bet that long rates will increase, especially since the success of Abenomics in staving off deflation remains to be seen. In fact, although trends from recent months have been mostly encouraging, they came at a time when the biggest of inflationary policies was being put in place. The hardest part will be to keep this up, which is no small task. Not only does the consumption tax increase weaken the domestic economy in the short run, which could wipe out the bulk of recent progress, but the regional impact of Abenomics has been considerable and could, in fact, squelch the pick-up in export activity. Although it is not entirely responsible for the deterioration in economic growth in southeast Asia, Japan's exchange rate policy has undoubtedly worsened the situation, which has led to lower growth and recurring trouble on the forex markets. The orchestrated depreciation of the yuan since early March is not entirely unrelated to this situation and could work against Tokyo's goals... This risk has perhaps fuelled BoJ concerns, and all signs point to a ramping up of quantitative measures.

It suffices to say that higher long-term interest rates are not a done deal.

BOJ Balance Sheet



Sources: RichesFlores Research, Macrobond

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