Violent bond moves signal tectonic shifts in global markets

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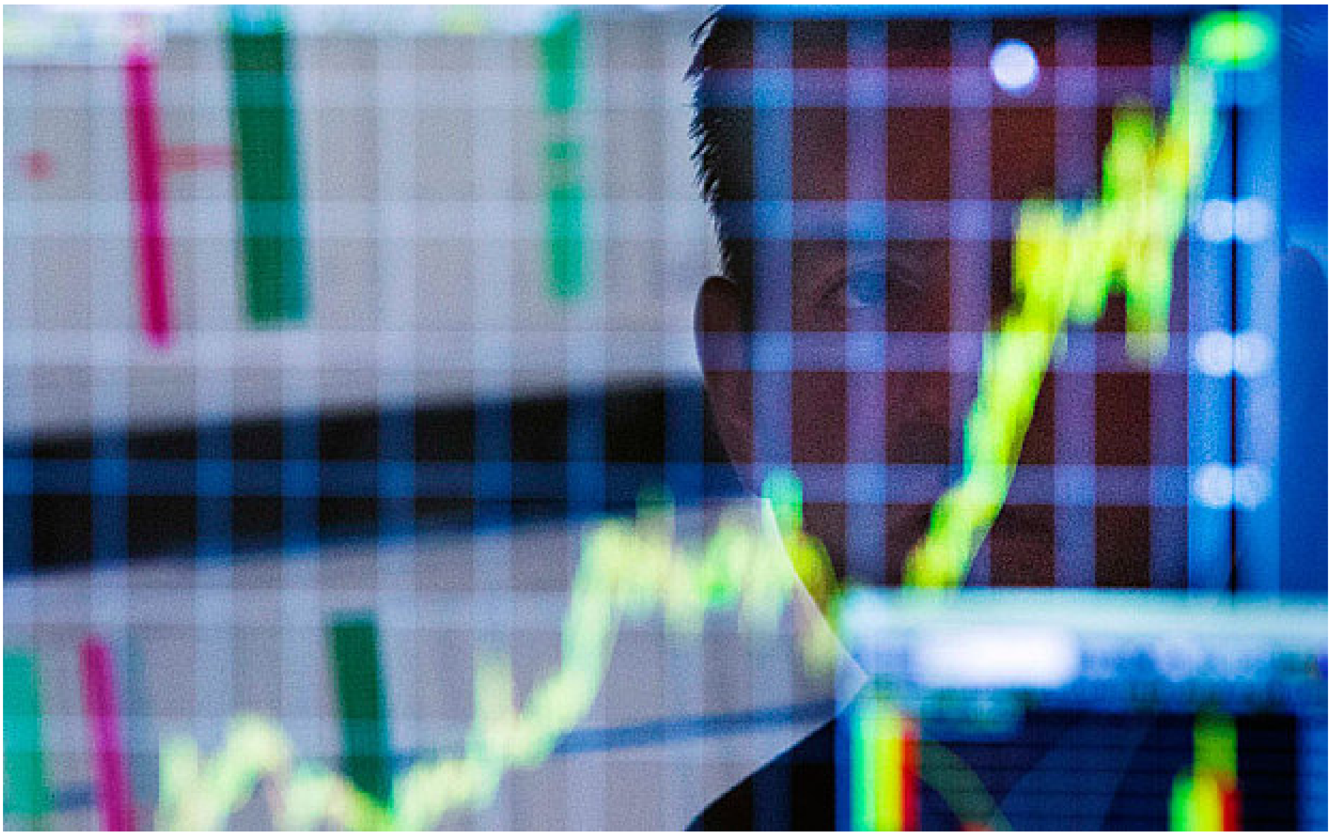

The sharp moves have been exacerbated by a lack of liquidity as traditional dealers withdraw from the market to comply with stricter rules Photo: Reuters

By Ambrose Evans-Pritchard

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A wave of turmoil is sweeping through sovereign bond markets, setting off the most dramatic gyrations seen in recent years and threatening to spill over into over-heated equity markets.

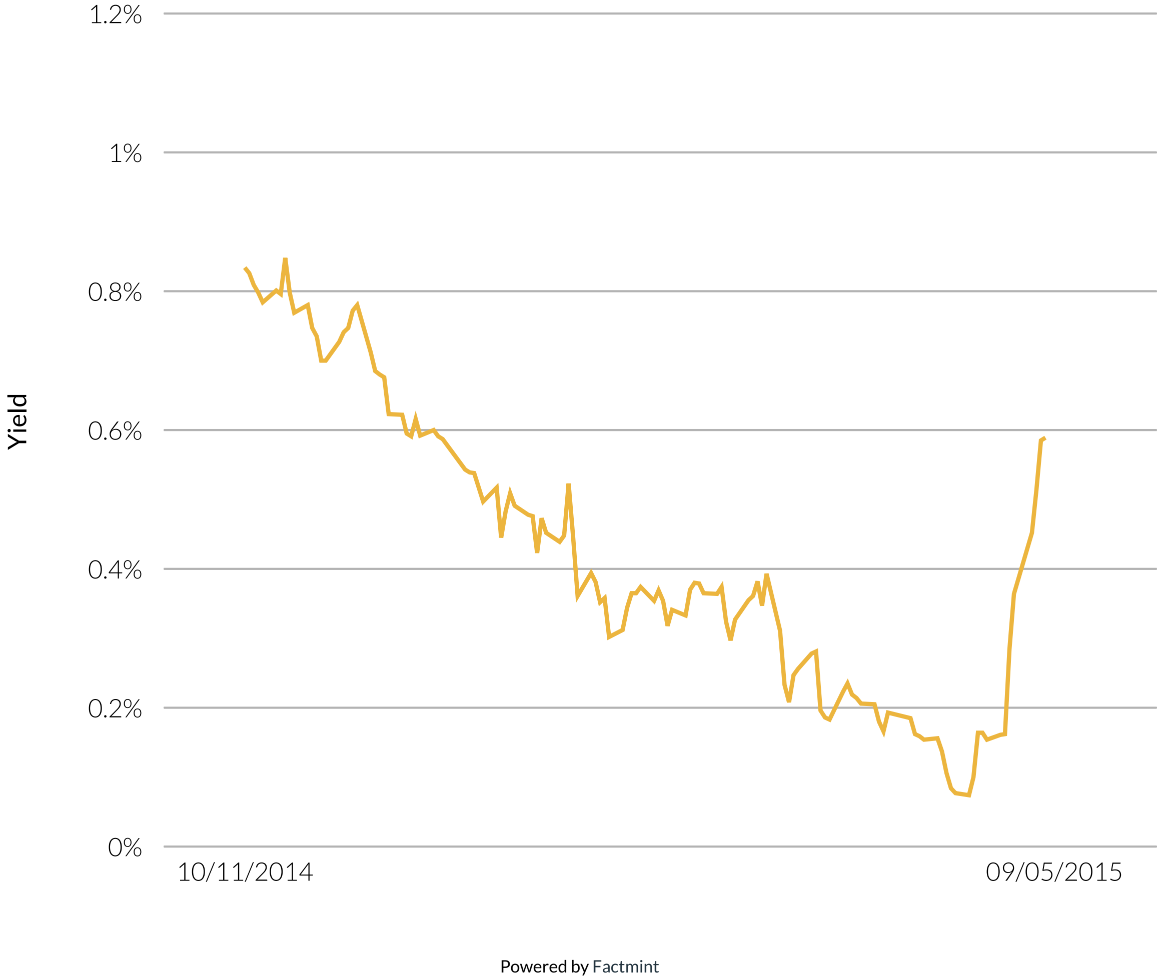
Yields on German 10-year Bunds spiked violently by almost 20 basis points to 0.78pc in early trading on Thursday as funds scrambled to unwind the so-called "QE trade" in Europe, with powerful ripple effects reaching Japan, Australia, Brazil and even US Treasuries.

"It is absolute pandemonium in the fixed income markets," said Andrew Roberts, head of European credit at RBS. "Everybody has been trying to get out of long-duration positions at the same time but the door is getting smaller."

German yields fell back just as fast to 0.58pc later, as bargain-hunters came back into the European debt markets, but are still unrecognisable from the historic lows of 0.07pc two weeks ago.

Ructions of this magnitude are extremely rare in government bond markets. Investors are nursing almost half a trillion dollars in paper losses in two weeks, a staggering sum in what is supposed to be a rock-solid repository for institutional investors.

The Great Bunds Sell-Off

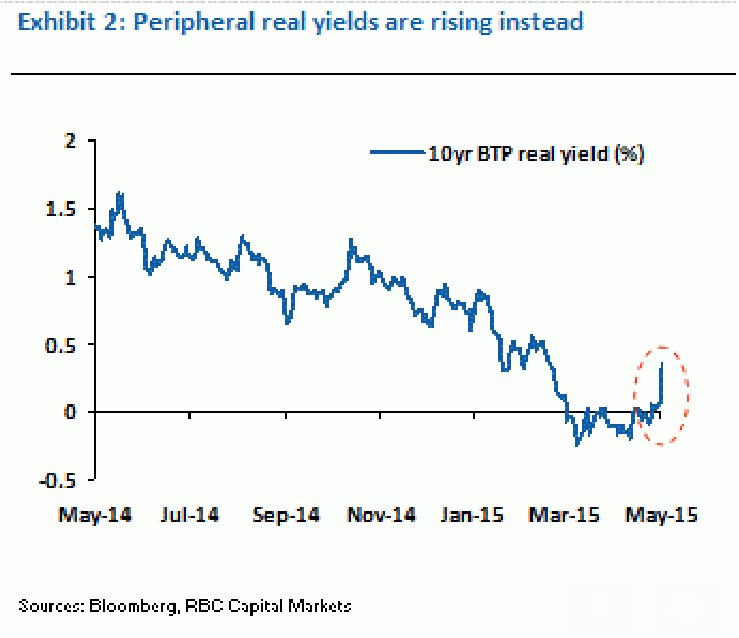


French, Italian, Spanish and Portuguese bonds have all been sold off sharply over the past two weeks, obliterating the gains in yield compression since the European Central Bank unveiled a bond purchase programme of €60bn a month in January.

“Anything over-populated is being cleared out. People got too exuberant and they’re coming back to reality,” said David Bloom, currency chief at HSBC.

Peter Schaffrik, at RBC Capital Markets, said rising yields can be a healthy development if the global economy is picking up speed. It is a different matter if they suddenly jump at a time of sluggish growth and disappointing figures in the US.

“It is potentially dangerous. What worries me is that we don’t have a good macro-economic back-drop driving yields higher. We don’t see a reflationary recovery,” he said.



Investors already face a changed world from early April, when deflation was still on everybody's lips and Mexico was able to sell €1.5bn of 100-year bonds at a rate of 4.2pc.

The worm turned two weeks later when bond king Bill Gross, at Janus Capital, declared that Bunds had become unhinged and were the "short of a lifetime", quickly followed by warnings from Berkshire Hathaway's Warren Buffett that bonds were "very overvalued".

The sharp moves have been exacerbated by a lack of liquidity as traditional dealers withdraw from the market to comply with stricter rules. The **Institute of International Finance** said this week that thin liquidity had become the top issue in talks with central banks and regulators. It said the new rules amounted to a "dramatic revolution" that had re-engineered the global financial system and pushed risk out into the shadows, storing up outcomes that are likely to be "pretty painful and certainly unknowable".

Global bourses have so far shrugged off the bond market crash but this may be untenable over time and there are already signs of jitters as the spring rally runs out of steam. Equity prices and bond yields tend to feed off each other, though the relationship is not always mechanical and there can be lags.

Janet Yellen, chair of the US Federal Reserve, issued an **implicit warning that Wall Street has got ahead of itself** and may be vulnerable to monetary tightening. Markets have priced in a far slower pace of rate rises over the next 18 months than the Fed itself.

"Equity market valuations at this point are generally quite high. They are not so high when you compare the returns on equities to the returns on safe assets like bonds, which are also very low. But the potential dangers are there," she said.

Confusion now reigns in financial markets. Brent oil prices have surged by more than 30pc since January to $67 a barrel and copper has risen in lockstep, normally a sign that the global economy is coming back to life and that inflation will follow in short order. The broad M3 money supply has been growing at a brisk rate on both sides of the Atlantic, reaching an annual rate of 7pc in the eurozone over the past six months.

Yet closely-tracked indicators for inflation expectations - such as the “5/year 5/year forward rate” - remain depressed, especially in Europe. “There is no global reflation story. If I were able to find it I’d be doing cartwheels down the dealing floor but it is not there,” said Mr Bloom at HSBC.

Investors piled into EMU sovereign debt late last year and in early 2015 in the belief that the ECB’s bond blitz would soak up the available supply, leading to a scarcity. Bunds became the favourite trade as the German government prepared a budget surplus of 0.5pc of GDP this year, eliminating roughly €18bn of existing bonds.

This degenerated into a momentum trade. German yields continued dropping below zero as far out as eight years maturity, even as the deflation scare abated and Europe began to eke out modest growth. “We are seeing the unwinding of an enormous bull rally in the bond markets,” said Anthony O’Brien, at Morgan Stanley.

“There was some complacency and a lot of lazy longs and bond prices have tumbled, but we don’t think this is enough to snuff out recovery."

Barclays said the moves in the Bund market threaten to repeat events in Japan in 2003, when 10-year Japanese yields rose 110 basis points in six months after touching unprecedented lows on deflation fears. Investors were left nursing paper losses of 8pc, but the shock was not enough to derail economic recovery.

Mr Roberts, at RBS, said the bond rout is likely to short-circuit once it becomes clear that the world economy is not out of the woods and that China’s leaders will continue to engineer a deliberate slowdown.

All the forces that combined to fuel the eurozone recovery are already slowing or in reverse. “Oil is up, the euro is up, rates are going up in Germany and the core, and spreads in the periphery are rising. This is absolutely terrible for the eurozone,” he said.

“There is going to be a monumental trade getting back into Bunds. All we are waiting for is a technical trigger,” he said.

How we moderate