Bonds in Neverland

See the collection of the individual charts linked below.

(1) Unconventional monetary policies become conventional. (2) From the Old Normal to the New Normal to the New Abnormal. (3) Fed aborts normalization. (4) ECB reverses course. (5) BOJ never even considered leaving Neverland. (6) PBOC continues to inflate greatest credit bubble in history. (7) Negative mortgage rates in Denmark. (8) The tether gets tighter in global bond market. (9) TIPS on the verge of going negative? (10) Negative real rates may have more to do with geriatric demographic outlook than with productivity.

**Credit I: Monetary Policies for the New Abnormal.** The major central banks adopted unconventional monetary policies following the Great Recession and the Great Financial Crisis. They were supposed to be temporary responses to the “New Normal,” i.e., slower global growth with subdued inflation. These ultra-easy policies have become conventional and permanent. They increasingly seem like abnormal reactions by the central banks to problems that can’t be fixed with monetary policy. Instead of boosting economic growth and lifting inflation rates closer to zero, they are inflating asset prices. Here is a brief update of the latest developments:

(1) **Fed.** The Federal Reserve started down the path to normalizing US monetary policy on 10/1/14, when it terminated QE3 (Fig. 1). The Fed started raising the federal funds rate at the end of 2015, moving it that first time from 0.00%-0.25% to 0.25%-0.50% (Fig. 2). The rate was subsequently raised to 2.25%-2.50% at the end of 2018.

But the Fed was back in easing mode by last month, when it lowered the fed funds rate to 2.00%-2.25% on 7/31 (Fig. 3). More rate cuts are widely expected. In the federal funds futures market, the 12-month forward yield fell to 1.19% on Monday (Fig. 4). QT (i.e., quantitative tightening), which began on 10/1/17, was terminated on 7/31/19.

(2) **ECB.** Meanwhile, the European Central Bank (ECB) never got started on the path to monetary normalization. Instead, the ECB adopted its negative interest-rate policy (NIRP) on 6/11/14, when its official deposit rate was lowered to -0.10%; three months later, the rate was dropped again, to -0.20% on 9/10/14 (Fig. 5). There were two more cuts in this rate at the end of 2015 and during early 2016, to -0.40%.

Last year, ECB officials suggested that the process of normalizing this rate would start sometime in 2019; but in recent months, they’ve reversed course and prepared the financial markets for another cut at the 9/12 meeting of the ECB’s Governing Council. They’ve also suggested that they will resume their QE program, which had been terminated at the end of 2018 (Fig. 6).
The Bank of Japan (BOJ) never even considered leaving Neverland. In his opening remarks at a conference in Tokyo on 6/4/15, BOJ Governor Haruhiko Kuroda said: “I trust that many of you are familiar with the story of Peter Pan, in which it says, ’The moment you doubt whether you can fly, you cease forever to be able to do it.’” The Wall Street Journal (6/4/15) observed: “Japan’s central bank chief invoked the boy who can fly to emphasize the need for global central bankers to believe in their ability to solve a range of vexing issues, whether stubbornly sluggish growth or entrenched expectations of price declines.” Kuroda added, “Yes, what we need is a positive attitude and conviction.”

On 1/29/16, the BOJ surprised everyone by adopting NIRP, lowering its official rate on new bank reserve deposits to -0.10%. It remains at that level. The BOJ’s QE program, which started during April 2013, continues with no end in sight. As a result, bank reserve balances at the BOJ have increased 738% from 42 trillion yen to 352 trillion yen during July (Fig. 7).

The People’s Bank of China (PBOC) seems like an outlier. It still has normal interest rates. The prime lending rate in China was set slightly lower yesterday to 4.25%. However, China’s central bank has fueled the greatest credit binge in world history over the past 10 years. Since late 2008, bank loans have soared 386%, from $4.4 trillion during December 2008 to $21.4 trillion during July of this year (Fig. 8). They are up a staggering $2.4 trillion in just the past 12 months.

CNN reported on Monday: “On Saturday, the People’s Bank of China launched a long-awaited reform to the way it manages money in the world’s second biggest economy to support growth and employment. Its aim is to make it cheaper and easier for companies to borrow. The central bank is gradually replacing its existing fixed benchmark lending rate, with a new Loan Prime Rate, starting Tuesday. ... The PBOC’s benchmark one-year lending rate stands at 4.35%, and it hasn’t changed since October 2015. The new LPR will be set Tuesday, and subsequently on the 20th of each month. It will become the benchmark for banks to price new loans.” This amounts to a rate cut.

Here are the growth rates of the assets of the four major central banks since the start of 2008 through July of this year in their local currencies: Fed (338%), ECB (234), BOJ (411), and PBOC (112) (Fig. 9). Here are the values of their assets in dollars at the end of July: Fed ($3.7 trillion), ECB ($5.3 trillion), BOJ ($5.2 trillion), and PBOC ($5.2 trillion) (Fig. 10). The sum of their assets rose 208% from $6.3 trillion at the start of 2008 to $19.4 trillion during July (Fig. 11). Here are the latest quarterly data on the assets of each of the four central banks as a percentage of their respective country’s nominal GDP: BOJ (101%), ECB (40), PBOC (37), and Fed (18) (Fig. 12).

The NIRPs of the ECB and BOJ have created a Neverland in the global fixed-income markets. An 8/18 Bloomberg story reported: “The world’s headlong dash to zero or negative interest rates just passed another milestone: Homebuyers in Denmark effectively are being paid to take out 10-year mortgages. Jyske Bank A/S, Denmark’s third-largest lender, announced in early August a mortgage rate of -0.5%, before fees. Nordea Bank Abp, meanwhile, is offering 30-year mortgages at annual interest of 0.5%, and 20-year loans at...
A 7/29 story in *The Washington Times* reported: “The latest estimates are that approximately 30 percent of the global government bond issues are now trading in negative territory. Last week, Swiss 50-year borrowing costs fell below zero percent, which means that Switzerland’s entire government bond market now trades with negative yields. Earlier in the month, Denmark became the country to have its entire yield curve turn negative.”

During 2018, when the 10-year US Treasury bond yield was rising toward last year’s high of 3.24% on 11/8, there was much chatter about its going to 4%-5%. For example, on 8/4 at the Aspen Institute’s 25th Annual Summer Celebration Gala, JP Morgan Chase Chief Jamie Dimon warned that the 10-year US Treasury bond yield could go much higher: “I think rates should be 4% today. You better be prepared to deal with rates 5% or higher—it’s a higher probability than most people think.”

At the time, the bears worried about mounting federal deficits, resulting from the tax cuts at the beginning of the year, at the same time that the Fed was on track for more QT. In addition, there was mounting evidence that inflationary pressures were building, with some related to Trump’s tariffs.

In the 8/8/18 *Morning Briefing*, I wrote: “So why isn’t the US bond yield soaring? The bulls respond that trying to forecast the bond market using flow-of-funds supply-vs-demand analysis has never worked. It’s fairly obvious that US bond yields are tethered to comparable German and Japanese yields, which are near zero, and are likely to remain there given the stated policies of both the ECB and BOJ to keep their official rates near zero for the foreseeable future.”

The tether has gotten tighter since last year’s peak in the US bond yield on 11/8. Since then, the US bond yield has dropped 164bps to 1.60% on Monday, while the comparable German and Japanese yields are down 111bps to -0.65% and 36bps to -0.23%, respectively (*Fig. 13*).

Now consider the following related developments in the US bond market:

1. **Tipping into negative territory.** The 10-year TIPS yield dropped to zero on Monday, suggesting that the nominal yield reflects only inflation expectations with no real yield (*Fig. 14* and *Fig. 15*). The TIPS yield could be about to turn negative, as it did in 2012.

2. **Real rates and productivity.** Why should the real bond yield be negative or even zero? The most widely accepted notion is that the real bond yield should be related to the growth rate in productivity, which is the economy’s real return, arguably. The correlation between the two—using averages over five-year time periods—is not compelling, though (*Fig. 16*).

In any event, as we showed in yesterday’s *Morning Briefing*, productivity growth has been turning up over the past few years. Productivity has been growing faster in the US than in the other G7 economies (*Fig. 17*).
(3) Demography is destiny. The geriatric trend in global demographic profiles does support a case for negative nominal and real interest rates if the trend leads to a combination of slow growth and deflation. That’s if deflation reduces the value of assets purchased today with debt. Negative interest rates on that debt might reflect the voluntary self-extinction of the human race attributable to the collapse of fertility rates around the world. Dwindling populations, particularly of younger people, will put downward pressure on real asset prices, because there will be less demand for the goods and services they provide in the future.

Credit III: Jackson Hole. Central bankers, policymakers, and academics will head to Jackson Hole, Wyoming from 8/22 to 8/24 for the annual economic policy symposium hosted by the Federal Reserve Bank of Kansas City (FRB-KC). According to the FRB-KC’s website, the central topic this year is appropriately “Challenges for Monetary Policy.” Investors will be scrutinizing the speeches and discussions for clues on the direction of monetary policy. So will Melissa and I.

While former Fed Chair Janet Yellen geared her Jackson Hole speeches toward an audience with advanced degrees in economics, that’s not current Chair Jerome Powell’s style. We expect from Powell a speech that’s easier to decode but light on specifics. We’ll be listening for terms—such as “cross currents” and “uncertainties,” especially related to trade—that underpinned the Fed’s decision to reverse course and cut interest rates 25 bps at its 7/30-31 meeting. With the Federal Open Market Committee (FOMC) not meeting next until 9/17-18, Powell’s Jackson Hole speech will be important for feeling out the Fed’s policy leanings—especially since President Trump’s announcement of new tariffs to be imposed on China came on 8/1, a day after the last FOMC meeting.

The question is: How much more of a “midcycle adjustment,” as Powell put it during his last press conference, is expected? Markets did not react kindly to that phrase, as it suggested a possible one-and-done rate adjustment. Our hunch is that the Fed chair will leave the door open for maybe one more 25bps rate cut at the next FOMC meeting. We don’t expect a big rate cut signaled, like the 100bps cut Trump wants. Nor do we expect any hints about a renewed QE, as Trump also has called for.

When we last did a roundup of FOMC voters ahead of the July meeting in our 7/29 Morning Briefing, we noted that “the doves clearly outweigh the hawks at the Fed.” The two officials we expected to dissent—FRB-KC’s President Esther George and FRB-Boston President Eric Rosengren—indeed did so.

Lately, Rosengren has become more vocal on his position. Following his July dissent, he issued a statement saying that he did not see a “compelling case” to cut rates and cited concerns that further cuts could compromise financial stability. On Monday, he told Bloomberg Television: “We’re likely to have a second half of the year that’s much closer to 2% growth … I just want to see evidence we are going into something that is more [of] a slowdown.”

Nevertheless, Rosengren noted that he is mindful of global risks including the situation in Hong Kong. As we’ve discussed previously, the outcome in Hong Kong has implications for the US-China trade deal. We will be interested to see if Powell adds Hong Kong to his list of global
“cross currents.”

Interestingly, Rosengren also said: “Just because other countries are weak, if we’re strong, it doesn’t necessarily mean we should be easing as well … It’s much more efficient for China and Europe to expand their own economies” through their own policy actions. He added that he isn’t focused on the recent inversion in the yield curve as the Fed’s goal is to get inflation and employment right.

Whether Rosengren’s arguments sway other Fed officials remains to be seen. But regardless, we expect Powell’s monetary policy stance to remain on the easing side for now.

**CALENDARS**

**US. Wed:** Existing Home Sales 5.40mu, MBA Mortgage Applications, DOE Crude Oil Inventories, FOMC Meeting Minutes (7/31). **Thurs:** Leading Indicators 0.2%, Jobless Claims 218k, M-PMI & NM-PMI Flash Estimates 50.5/52.8, Kansas City Fed Manufacturing Activity Index 2, EIA Natural Gas Storage. (DailyFX estimates)

**Global. Wed:** Canada Headline & Core CPI 1.7%/1.8% y/y. **Thurs:** Eurozone, Germany, and France C-PMI Flash Estimates 51.2/50.6/51.9, Eurozone, Germany, and France M-PMI Flash Estimates 46.2/43.0/49.5, Eurozone, Germany, and France NM-PMI Flash Estimates 53.0/54.0/52.5, Eurozone Consumer Confidence -7, Japan Headline, Core, and Core-Core CPI 0.5%/0.6%/0.5% y/y, Japan Machine Tool Orders, ECB Publishes Account of July Policy Meeting. (DailyFX estimates)