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## The Bond Vigilantes

The Bond Vigilantes Model simply compares the bond yield to the growth rate in nominal GDP on a year-over-year basis (Fig. 7). Instead of spending lots of hours analyzing the ins and outs of the flow of funds, I do the best I can to forecast nominal GDP with the tools I discuss in Chapter 4 on predicting inflation and in Chapter 5 on predicting the business cycle.

This is a more straightforward approach but still requires plenty of work. My model shows that since 1953, the yield has fluctuated around the growth rate of nominal GDP. However, both the bond yield and nominal GDP growth tend to be volatile. While they usually are in the same ballpark, they rarely coincide. When their trajectories diverge, the model forces me to explain why this is happening. On occasions, doing so has sharpened my ability to see and understand important inflection points in the relationship.

Let's spend some time reviewing this relationship since the 1950s, and my ride with the Bond Vigilantes along the way:

- **1950s–1970s.** From the 1950s to the 1970s, the spread between the bond yield and nominal GDP growth was mostly negative (Fig. 8). Investors underestimated the growth rate of nominal GDP because they underestimated inflation. Bond yields rose during this period but remained consistently below nominal GDP growth.
- **1980s.** That changed during the 1980s, when investors belatedly turned much wavier of inflation just as it was heading downward. As a result, the yield tended to trade above the growth in nominal GDP during that decade. Furthermore, there were two discernable episodes at the beginning of the decade when rising bond yields slowed the economy, which allowed them to fall again. A third episode preceded the 1987 stock market crash.

I explained this phenomenon in the July 27, 1983 issue of my weekly commentary, which was titled "Bond Investors Are the Economy's Bond Vigilantes." I concluded: "So if the fiscal and monetary authorities won't regulate the economy, the bond investors will. The economy will be run by vigilantes in the credit markets." As the yield cycled in this vigilant fashion, the trend in nominal GDP growth moved downward along with inflation. Of course, bond investors don't have regulating the economy in mind but are simply acting in their perceived financial best interest—i.e., out of rising and falling concern that inflation might erode the effective purchasing power of their bond investment returns.

In addition to the Bond Vigilantes, there were other players and forces at work bringing inflation and bond yields down during the 1980s. At the start of the decade, there was a severe recession triggered by the spike in oil prices in 1979 and by Paul Volcker's aggressive monetary policy measures to contain that inflationary shock. The price of oil peaked during the summer and fell 71% through July 1986 (Fig. 9). That helped to moderate inflationary pressures. Economic growth was weighed down during the mid-1980s by the recession in the oil industry. During the second half of the 1980s, the mounting savings and loan (S&L) crisis depressed the housing market and raised fears of a financial contagion (Fig. 10).

The end of the Cold War in 1989 was widely expected to boost inflation because there would be more demand for goods and services from the millions of people who had been liberated from the Soviet system. Now they would want the same standard of living as Westerners enjoyed, the thinking went. Bond yields were expected to rise, as their credit needs would swell. None of that happened. Instead, over the next couple of decades, the end of the Cold War contributed to the forces of disinflation through more free trade that resulted in more global competition, as Chapter 3 discusses.

That latter disinflationary scenario was the one I thought would prevail, so I stayed bullish on bonds. In fact, in my June 20, 1988 *Topical Study*, "The Coming Shortage of Bonds," not long after the stock market crashed during October 1987, I predicted that the bond yield would fall to 5% by 1993 and that the Dow Jones Industrial Average (DJIA) would soar to 5000 by then. I revised that on January 6, 1994, when my new mantra became "5, 5 by '95." I predicted that the DJIA would rise to 5000 by 1995 and that the US Treasury 10-year bond yield would fall to 5% by then. At the time, the DJIA was 3803 and the yield was 5.84%. The yield fell to 5.00% on September 9, 1998 for the first time since June 13, 1967 (Fig. 11). That was well below most hat sizes. The DJIA hit a record high of 5000 for the first time on November 21, 1995 (Fig. 12).

• **1990s.** The Bond Vigilantes' heyday was the Clinton years, from 1993 through 2001. Placating them was front and center on the administration's policy agenda. Indeed, Clinton political adviser James Carville famously said at the time, "I used to think that if

there was reincarnation, I wanted to come back as the President or the Pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody.”

From October 15, 1993 to November 7, 1994, the 10-year yield climbed from 5.19% to 8.05%, fueled by concerns about federal government spending. With some guidance from Robert Rubin, who served in the White House as the President’s assistant for economic policy from January 1993 to January 1995, the Clinton administration and Congress tried to reduce the federal budget deficit. The yield dropped to 4.16% on October 5, 1998.

After the mid-1990s, the Bond Vigilantes seemed less active, because they no longer had to be as vigilant. As inflation fell, the spread between the bond yield and nominal GDP growth narrowed and fluctuated around zero.

- **2000s.** While today the US government faces the problem of persistently big federal budget deficits, it’s interesting to recall that at the start of 2001, a major topic of discussion was how big the coming *surplus* in the federal budget might get. It is truly remarkable to reread Fed Chairman Alan Greenspan’s congressional testimony of January 25 that year. He noted that the Office of Management and Budget projected that if current policies remained in place, the total unified surplus would reach \$800 billion in fiscal year 2011, including an on-budget surplus of \$500 billion. In his testimony, Greenspan added that the Congressional Budget Office was likely to report even larger surpluses. He concluded: “The most recent projections, granted their tentativeness, nonetheless make clear that the highly desirable goal of paying off the federal debt is in reach before the end of the decade.” He spent most of the rest of his testimony discussing whether the government might have to buy private assets with the surpluses.

During the 2000s, the Fed kept the federal funds rate too low for too long, mostly based on fears of deflation. According to both Alan Greenspan and Ben Bernanke, there was also a global savings glut back then. As a result, bond yields remained for the most part below nominal GDP growth. Mortgage rates and mortgage lending standards were too low. The result was a huge bubble in housing, which led to the Great Recession.

- **2010s.** From 2009 through late 2015, the Fed’s response to the anemic recovery following the Great Recession was to peg the federal funds rate near zero. The Fed also purchased bonds under various quantitative easing (QE) programs from November 25, 2008 through October 29, 2014, as Chapter 9 discusses. These ultra-easy monetary policies effectively buried the Bond Vigilantes, because the Fed was now the 800-pound gorilla calling the shots in the credit markets. Betting against the

Fed was likely to be a very bad bet since the “buyer of last resort” had opted to be the buyer of first resort in the bond market, scooping up large quantities of bonds on a predictable regular basis. The bond yield remained consistently below the growth in nominal GDP during this period.

My Bond Vigilantes concept was tested empirically by the Federal Reserve Bank of San Francisco, as detailed in its August 2015 working paper “Bond Vigilantes and Inflation.” The authors developed “a simple model where bond issuance may lead to political pressure on the government to choose a lower inflation rate.” Sure enough, they found that “inflation-targeting countries with bond markets experience inflation approximately three to four percentage points lower than those without.” The authors of this study explained: “Our model suggests that when a domestic bond market is created, the rich find themselves holding assets exposed to inflation, and respond by lobbying to lower inflation. Our model is stylized and not meant to be taken literally. Still, it formalizes our contention that domestic financial market developments can influence macroeconomic outcomes. By issuing debt that is not protected from inflation, the government creates a powerful political group opposed to inflation, and ends up choosing less inflation than it would otherwise.”

