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A Roundabout Path in the "Snapback" of Long-term Bond Yields

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Executive Summary

- BIS's Shin noted that the "snapback" in long-term interest rates represents the biggest risk in the global economy
- A decade of policy-induced yield-chasing not only directly lowered long-term rates but also begot further demand
- As term premium decompress amid waning policy support, higher long-term bond yields will induce further selling
- The rise in long-term real interest rates (the discount rate that affects all risk assets) would threaten risk sentiment
- Higher long-term rates first triggered a de-leveraging wave, but flight-to-quality flows subsequently eased the rout
- Bond yields will "snapback" under a roundabout path as stabilizing risk sentiment leads to further sell-off in bonds

Mechanisms behind "snapback" in bond yields

In his September 2017 speech "Is There a Risk of Snapback in Long-dated Yields," BIS Head of Research Hyun Song Shin highlighted that policy-induced yield-chasing not only directly lowered long-term bond yields but also begot further demand by liability-driven investors (LDIs), because it would take increasingly greater stock of fixed income holdings to meet future liabilities under declining yields; consistent with this framework, broader asset markets now face the risk of a "snapback" in sovereign bond yields, where higher yields would erode bond demand as yield targets would be met with a smaller stocks of long-dated bonds with higher returns.

During a Bloomberg interview on the sidelines of the annual IMF and World Bank meeting, BIS' Shin further elaborated his macro framework:

- Global investors have a large footprint in local currency bond markets, and they are responsive to changing global financial conditions by changing their risk appetite
- Local authorities and issuers need to have a certain amount of self-awareness; easy local funding conditions is not simply a vote of confidence on local policy but a reflection of global financial conditions – a cautionary tale to "not drink too much from the fountain of global liquidity" when "the going is good"
- The bond market has undergone some changes recently; the backdrop being the exit from an extraordinary period when the term premium was negative and long yields kept low through central bank policies
- As central banks "lift their fingers off the scales," term premium would undergo decompression to lift real yields; this shift is not extraordinary but a return to normal
- The biggest risk in global economy is snapback risk (in long term interest rates), as the rise in long-term real interest rates (the discount rate that affects all the risk assets) under the backdrop of interconnected global financial markets would trigger declines in asset prices
- Leverage in the banking sector has declined following the post-crisis deleveraging, and new weak-points would likely emerge elsewhere

Unfortunately, many market participants and policymakers continue to view level of real interest rates as pure reflection of economic conditions unaffected by policy. In his thesis "The Future Fortunes of R-star: Are They Really Rising," then-San Francisco Fed President Williams argued that estimate of equilibrium real interest rate (r*) "is a result of longer-term economic factors beyond the influence of central banks and monetary policy." Thus, prospects of real yields rising as a result of QE-taper as well as balance sheet unwind would ironically shift policymakers' goalpost.

Under this framework, broader market participants and policymakers may incorrectly attribute the rise in real yields to economic strength rather than waning policy support, which would warrant additional duration shedding. This further reinforces Shin's framework where higher term premium would beget further rises in bond yields and ultimately weaken risk sentiment.

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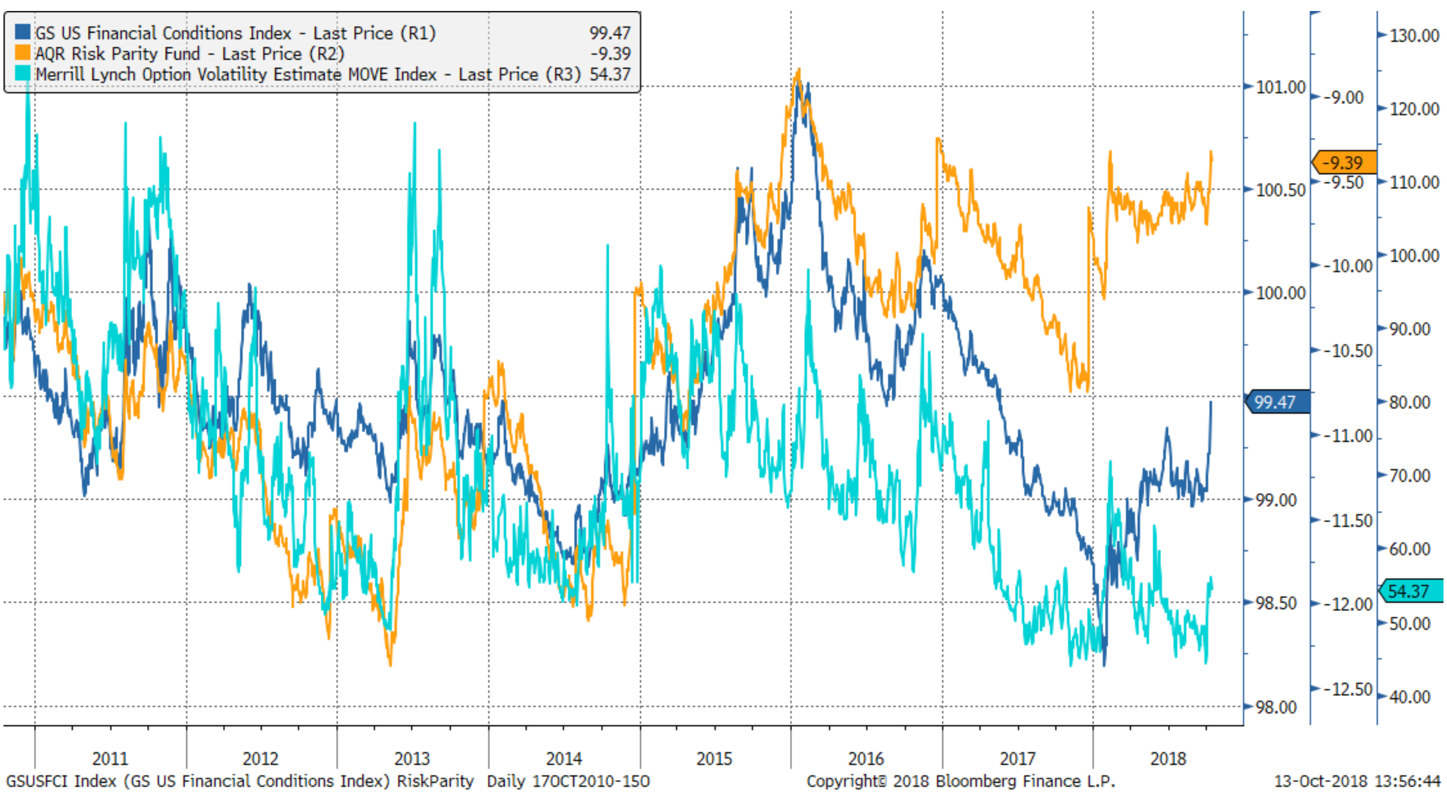
It is worth noting that global risk assets are becoming more vulnerable to the rise in long-maturity bond yields, for the September 2018 BIS Quarterly Review noted the outstanding (dollar denominated) debt securities have eclipsed bank loans to cement the post-crisis shift in funding preferences from banks to non-bank financial institutions (such as mutual funds, hedge funds, pensions – buyers of corporate debt).

A "roundabout" path to higher long-term interest rates

Rather than bond yields persistently "snap" higher amid rising U.S. fiscal deficit, global monetary authorities' retreat from extraordinary easing, and the prevalence of bearish volatility and bullish risk-parity strategies, the "snapback" will likely undergo a "roundabout" path thanks to the effects from a multi-body problem between high-quality sovereign bond yields and risk assets:

- Long-maturity Bunds, Gilts, JGBs, and Treasuries would exhibit co-movement based on Fed Governor Brainard's thesis that balance sheet expansion would lower term premiums across the globe, especially in economies "whose bonds were perceived as close substitutes"
- As global term premia rise in tandem, risk assets across multiple markets would weaken, and flight-to-quality flows would subsequently re-strengthen high quality sovereign bonds
- As risk sentiment stabilize, the retreat in safe haven bids would again allow bond yields to "snap higher" and renew the bearish risk-parity cycle

Unfortunately, some market participants prematurely concluded that the October 2018 bond rout was a transient event rather than secular shift away from past decade's status quo in term premium and volatility suppression; at the same time, some investors continue to place overt focus on Fed's rate path despite the rise in aggregate interest rate volatility (as seen in the MOVE index below) is largely driven by the rise in longer-maturity tenors, which have reliably triggered past episodes of financial conditions tightening and risk-parity unwind:



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