A Farewell to Bonds

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The title may be a tad dramatic, but who can resist a Hemingway reference in a week that saw some very real market drama? Government bonds globally seized the limelight, with yields further aggressively backing up and sending shivers through broad swathes of equity markets. Conditions settled somewhat after the Thursday afternoon blow-off, when 10-year Treasuries spiked above 1.6% on a weak 7-year auction. Still, they were hovering close to 1.5% by noon Friday, almost 40 bps north of where they started the month. Among the many moving parts of the latest bond sell-off, two items stand out in particular—it's been driven by a back-up in real yields (i.e., not inflation expectations), and it's begun driving up the middle part of the curve (i.e., around the five-year area). And one of the biggest near-term casualties was the highest-flying stocks, as the Nasdaq retreated 5½% in the first four days of the week, before rebounding on Friday.

To give a sense of just how violent some of the market moves have been in recent weeks, a variety of financial variables have already reached our targets for **year-end**... that is, the **end of 2022!** Briefly, we had been looking for 10-year Treasuries to grind higher over the next two years to 1.50% (check), WTI oil prices to reach US$55 (check), and the Canadian dollar to nudge up to 80 cents (check). We believe that in some cases, the market has moved **too far, too soon**, and—as signaled by what we are seeing on Friday—there could be a partial near-term reversal of the extreme moves so far in 2021. Even so, in sync with our upgraded U.S. growth outlook of 6% for this year, we have also moderately lifted our view on 10-year yields to 1.70% for the end of this year, and 1.75% for end-2022.

One of the more notable features of the recent bond sell-off is that it was focused on **real yields**. After barely moving in the first six weeks of the year, the real 10-year yield rose 44 bps in the past two weeks (albeit still -66 bps versus a small positive at the start of 2020). In sharp contrast, almost the entire back-up in Treasury yields from last summer's lows was driven by the **inflation expectations** component. Breaking it down a bit more precisely, 10-year yields bottomed in the first week of August at an average of 0.55%, with real yields at -1.05% and the breakeven inflation rate thus 1.60%. In the next six months, nominal yields jumped more than 60 bps, with almost no move in real yields and the breakeven inflation rate surging above 2.20%.

The sudden rise in real bond yields can be interpreted as the market gaining much **more confidence in the global growth outlook**. That is being loudly echoed in the broad-based strength in commodities, which is seeing record highs in lumber and decade-highs for copper. The Bank of Canada's commodity price index for non-energy goods has rocketed 26% y/y to an all-time high. It has also been reflected in the recent strength in the most cyclical components of the equity market, as well as the sudden outperformance of commodity currencies. Both the Australian and Canadian dollars took a brief peek above the 80-cent (US) level during Thursday's wildness, before

receding. Even with a late-week pullback, we remain constructive on these currencies, which will so clearly benefit from a solid global recovery.

It is no coincidence that some of the hardest-hit bond markets this week were found in those very commodity-driven economies. In fact, Australia's sharp sell-off played a significant role in aggravating the global back-up in yields. After starting the month right in line with Treasuries, 10-year Australian bonds have vaulted to nearly 1.9%, spiking 45 bps in this week alone. The RBA officially has yield curve controls in place, at least out to the three-year area, and stepped in to buy bonds this week. The fact that this did little to contain longer-term yields sent a warning shot to all others.

While Canada's yield back-up wasn't quite as intense as down under, it was among the most serious. At various stages this week, **the Canadian 10-year yield matched or even exceeded Treasury yields of the same maturity**. Aside from last spring's market turmoil, we haven't seen that in almost eight years. Notably, the **five-year bond was fully sucked into the mix**, with those yields surging more than 50 bps in the past two weeks alone to just above 1% at one point (i.e. doubling). Given the importance of 5-year rates in Canada's mortgage market, suffice it to say that this sudden sprint in the middle of the curve has important (and not positive) implications for the soaring housing market. While the bulk of this week's backup was concentrated in the 5-to-10-year area, **30-year yields** rose further to around 1.9%. While that's still a very low rate, we will point out that not only is that all the way back to above year-ago levels, it's the **highest since the spring of 2019**.

For policymakers, the broad-based jump in yields is a shot across the bows. For central banks, the sell-off is especially notable since it arrived despite **very dovish messages by both Fed Chair Powell and BoC Governor Macklem**. Both stressed that the job markets were a long, long way from normal, and that the recovery could prove protracted. (We agree that the labour market will ultimately be slower to recover than overall activity (GDP) or spending.) And, both also indicated that policy will thus remain highly supportive, and they're not even thinking about thinking about tightening. We would concur; yet, that didn't stop the market from bringing forward expectations of the first rate hikes. Clearly not helping were a few random comments by Fed officials that either downplayed the yield back-up, or even tacitly welcomed the rise as a sign of improving growth expectations. Given the intensity of the sell-off, **look for the messaging to shift significantly in coming days.**

The implications are equally serious for fiscal policy. Of course, much of this year's surge in yields has been driven by the prospects for much more U.S. stimulus spending than had been expected at the end of 2020. The massive US$1.9 trillion Biden proposal is working its way steadily through Congress and is a key reason why we cranked up our GDP call for the year. While the entirety of the President's measures may not survive—the $15 minimum wage for starters—it now looks like the vast majority will become law. And, as night follows day, this big spending spree will further drive up the budget deficit. The CBO estimates that the measures will boost this year's gap by $1.2 trillion to a massive, record $3.5 trillion (or 16% of GDP) after $3.1 trillion last year. Markets had initially been incredibly welcoming to this surge in borrowing, when the

economy was operating miles below capacity. But now that a robust recovery is on the near horizon, the appetite for such massive deficits is beginning to wane notably.

Arguably**, the market's loud message that there is no free fiscal lunch is even more important for Canadian policymakers**, especially with budget season now upon us. Leaders have relentlessly pointed to the historically low levels of interest rates as an offset to record levels of borrowing requirements. And, no doubt, negative real interest rates do indeed provide more borrowing room, compared with decades of yore (i.e., the 1990s, when real rates exceeded 5 percentage points). However, the sudden back-up in yields has brought many maturities back to pre-pandemic levels, suggesting that interest costs are: a) no longer extremely low, and b) could present more of a binding constraint on fiscal projections. We have long argued that with a large stock of excess household savings waiting on the sidelines, plus already highly supportive policy, governments do not need to spend much more to propel a strong economic recovery in the year ahead—an effective vaccine roll-out would be the single most important contributor to growth. It appears that the bond market is now loudly echoing our view that there are **clear limits to further stimulus spending**.

Economic data played second fiddle in the bond market symphony this week but added to the cacophony. **U.S. housing** was generally strong with prices now clocking in double-digit gains. **Consumer confidence** rose in February, no doubt supported by the $600 payments and a 10% leap in **personal income** the prior month. Some analysts downplayed the income surge, since outside of government support it was down. Well, yes, but of course employment struggled around the turn of the year amid the renewed second-wave restrictions biting. But with said second wave waning and vaccinations waxing, states are re-opening and jobs are poised to rebound notably in coming months, no doubt pulling incomes along. The week ahead is packed with key events (including an appearance by Fed Chair Powell) and reports, but the February payroll release Friday looms especially large, as a signal of that coming reopening rebound.

Canada's jobs report is a week later, but we will (finally) get the official read on Q4 and 2020 GDP, which is expected to reveal surprisingly perky growth at the end of the year (7.5% a.r.), but a full-year drop of 5.4%. While interesting, even more important for the near-term outlook will be the monthly estimate of GDP for January, which was in the middle of the second wave peak and tough lockdowns. Early indicators have been all over the map with housing and wholesale activity flaring higher, manufacturing posting a solid gain, but employment and retail spending falling heavily. We have been assuming GDP pulled back in January; if it manages to eke out some growth in the month, that will put a much rosier glow than expected not just for Q1, but for the year as a whole.

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