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Vigilantes and Opportunities in Bond Markets

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For the past three decades, worrying about the US budget deficit, rising bond yields (lower prices) and "bond vigilantes" has been a sure-fire way to lose money in financial markets. But, recently, the bond vigilantes have started to stir again.

The phrase "bond vigilantes" was coined by economist Edward Yardeni in 1983. Yardeni was referring to bond market investors acting as vigilantes by demanding higher interest rates (selling bonds) in response to concerns about elevated levels of government spending, with the goal of enforcing fiscal discipline.

Writing in the Financial Times recently, Yardeni warns that bond vigilantes are back: "The bond vigilantes' heyday was the Clinton years, from 1993 to 2001. Placating them [by tightly controlling government spending] was front and centre on the administration's policy agenda. Now they are back."

Since the lows in August 2020, the US 10-year bond yield has risen 420 basis points to 4.7%. The past two years have been a torrid time for bond investors with economic historian Niall Ferguson recently noting "in terms of total returns, this is the biggest bond market rout in 150 years".

However, determining exactly why bond yields are going up is more art than science. Bond yields can go up (prices down) for good reasons and bad. The economic recovery from the depths of the Covid crisis has been remarkably powerful, so this has been a significant (positive) driver of higher bond yields. Furthermore, many forecasters expected the US to fall into a recession this year and this has not happened.

Interestingly, the recent sell off in bonds has been led by longer dated yields, rather than shorter dated yields. This is unusual and would not normally happen towards the end of a business cycle.

One of the reasons bond vigilante concerns have gained traction is that the timing of the bond market selloff this summer coincided with the announcement that government borrowing was going to be higher than expected. Fitch downgraded the US credit rating from AAA to AA+ due to fiscal deterioration and erosion of governance.

Recent years have seen a significant expansion of government spending. Tax cuts for corporates and individuals in 2018 were followed by an enormous response to the pandemic. The CHIPS and Science Act, infrastructure bill and Inflation Reduction Act have come on top of elevated spending on social security, healthcare and defense. Higher interest rates are also sending the debt interest bill higher.

While this sounds concerning, there are signs that strong growth is the primary driver of yields rather than deficit worries. The US dollar has appreciated and inflation breakevens in bond markets are not signalling an inflation problem. The credibility of the Federal Reserve is an important factor here. After falling behind the curve on inflation they have acted aggressively and been prepared to impose pain so as not to be undermined on inflation credibility.

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One question that has come into focus has been who will buy the newly issued government bonds. This is something that has not been relevant for decades as demand for bonds has been strong and consistent. But the world has changed.

The Federal Reserve is engaged in Quantitative Tightening (reducing bonds held on their balance sheet) rather than Quantitative Easing (buying bonds). Banks have been large buyers of bonds but that is no longer the case. Global savings gluts, where foreign countries with a surplus buy bonds, have historically been supportive but for various reasons, including geopolitics, it is now less of a factor.

The US private sector has therefore been an important source of demand for bonds. Goldman Sachs estimates that households are on track to purchase $1.3 trillion of treasuries this year. However, investors have demanded a higher yield so this has been necessary to balance supply and demand.

While the awakening of the bond vigilantes is a little disconcerting, the bond market offers better value for investors than it has done for many years. Short dated treasuries yield over 5% and five-year inflation protected securities offer a very attractive real (after inflation) yield of 2.4%. Volatility in long dated treasuries has been higher than the equity markets, but with yields at these levels the risk/reward profile is favourable with perhaps significant upside in a recession and downside protection from the coupon income. There are also other interesting opportunities in bonds, such as mortgage backed securities.

Rather than something to worry about, rising bond yields may simply be recognition that we have moved away from the emergency setting of zero interest rates. Finally escaping “secular stagnation” is something to celebrate.

A productivity boom, perhaps from Artificial Intelligence, would help slay the stirring bond vigilantes, but this may take a bit more time. In the meantime, policymakers need to respect markets. But for investors, it is a time of opportunity in fixed income as long as risk is managed appropriately.

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