Bond yields fall as fears rise over global economic growth

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Amid rising concerns over global economic growth, global bond prices surged to a record high on Friday in a "flight to safety" as equity markets in Japan and Europe experienced their worst day since the turbulence at the start of the year.

Yields on German, UK and Japanese government bonds, which move in an inverse relationship to their price, all reached new depths, with the yield on the German 10-year Bund, regarded as a benchmark for the euro zone, going as low as 0.01 percent.

The head of sovereign capital markets at Citigroup, Philip Brown, said to see the yield on the Bund so low was "shocking." "Equities are falling and fixed income is rallying in a flight to quality—there are real fears in markets about global growth."

The surge in government bond prices came as the European Central Bank began buying corporate bonds in addition to its purchases of government debt of €80 billion a month. The extension of debt purchases, the result of an ECB decision last March to step up its quantitative easing program aimed at pumping trillions of euros into the financial system, has been accompanied by deepening criticism from Germany.

The bond-buying program, which started on Wednesday, had been expected to only involve high-grade bonds. While the ECB has not disclosed which corporate bonds are being purchased, market analysts quickly discerned those involved. Contrary to expectations some of them are of "speculative grade" status.

One of the most prominent was Telecom Italia Spa, whose bonds are listed as below investment grade status by two of the major credit rating agencies and only qualified because of the higher grade status afforded them by the Fitch rating agency.

The new phase of ECB action was greeted with a 12-page report by Deutsche Bank chief economist David Folkerts-Landau denouncing the central bank's program. The criticisms have been voiced before but the latest report is the most strident yet.

Folkerts-Landau said the ECB had "lost the plot" and its desperate actions—bond purchasing programs and the establishment of negative interest rates—raised the risk of a "catastrophic" mistake.

"ECB policy is threatening the European project as a whole for the sake of short-term financial stability," he wrote.

"The benefits from ever-looser policy are diminishing while the litany of distortions, perversions and disincentives grows by the day. Savers are punished and speculators rewarded. Bad companies survive while good companies are too scared to invest."

The report compared the ECB's mistakes to the German Reichsbank in the 1920s which printed money, leading to hyperinflation and economic collapse. "That was a hundred years ago but mistakes keep happening despite all the supposed improvement in central banking."

Tracing out the evolution of the ECB policy, he said that after the failure of the lowest interest rates in 20 generations to boost investment, the central bank embarked on a massive program of purchasing euro zone member government debt. But the sellers of that debt did not use the money to invest but just placed their money at the central bank, after which the ECB went to the "next logical extreme" by imposing negative interest rates on deposits. He noted that almost half of euro zone sovereign debt was trading with a negative yield, meaning that a bond purchaser who held it to termination would make a loss on the investment.

Folkerts-Landau also bought into a political row that erupted in April. At that time, German Finance Minister Wolfgang Schäuble said the impact of the negative interest rate regime on small savers was at least 50 percent responsible for the rise of the right-wing German populist party, AfD, which made considerable gains in recent regional elections.

"The longer policy prevents the necessary catharsis," Folkerts-Landau wrote, "the more it contributes to the growth of populist or extremist policies."

These comments point to the underlying reasons for the strident opposition within the German financial system to the ECB policies. A large portion of the German financial system consists of smaller regional banks whose business model, based on investment in secure government debt, is being hammered by negative rates. The operations of these regional banks form a part of the social base of the ruling party, the CDU.

The criticism of the ECB goes beyond Deutsche Bank. This week Commerzbank, which is partly government-owned and second only to Deutsche Bank, indicated it was looking at the possibility of hoarding its cash rather than placing its funds with the ECB where it is charged at a negative interest rate of minus 0.4 percent. As one commentator noted, such an action "would be the most flagrant bank protest against central bank policy yet seen."

The policy agenda of Deutsche Bank and much of the German financial establishment was indicated in Folkerts-Landau's indictment. Despite its "good intentions," he wrote, the ECB had removed the incentive for euro zone government to revamp their policies through "structural reform." Together with the reference to a "necessary catharsis," this points to the growing clamour in financial circles for the initiation of further sweeping attacks on the social and employment conditions of the working class across Europe—a deepening of the measures which the French government is seeking to implement through its new labour laws.

The official rationale for the actions of the ECB and other central banks is that lower interest rates are needed to boost inflation and investment. But the euro zone remains in the grip of deflation and the ECB has lowered its own 2018 forecasts for growth in the region.

Opposition to present policies is not confined to criticism of the ECB. This week the Fitch rating agency reported that negative yielding government debt globally had now risen to more than $10 trillion following a 5 percent increase in bonds with a sub-zero yield. This means that the price of the underlying bond is rising, as yields and the price move in an inverse relationship.

Initially negative yields only affected the shortest-term bonds but the phenomenon is spreading and now encompasses seven-year German Bunds and 10-year Japanese government bonds. This is impacting heavily on insurance companies and pension funds which rely heavily on positive rates on government bonds to finance their operations.

Commenting on the $10 trillion mass of negative yielding sovereign debt, Bill Gross, the former head of the world's largest bond trading firm, tweeted: "Global yields lowest in 500 years of recorded history … This is a supernova that will explode one day." This refers to a situation in which interest rates begin to rise, leading to a fall in the price of bonds, thereby creating massive losses for investors who have purchased them at inflated prices.

Gross is by no means the only one warning of a possible financial catastrophe. Capital Group, which manages about $1.4 trillion in funds, has warned that negative interest rates are distorting financial markets and might lead to "potentially dangerous consequences."

The head of the Los Angeles-based bond house DoubleLine, Jeffrey Gunlach, recently described negative interest rates as "the stupidest idea I have ever heard of" and warned that the "next major event" for financial markets could be when the ECB and the Bank of Japan cancel the experiment.

Larry Fink, the head of BlackRock, one of the world's biggest hedge funds, recently wrote in a note to investors, that there had been plenty of discussion about how low interest rates had contributed to the inflation in asset prices. But, he continued, "not nearly enough attention has been paid to the toll these low rates—and now negative rates—are taking on the ability of investors to save and plan for the future."

In other words, out of the horse's mouth so to speak, comes the warning that the parasitic policies which have proved so beneficial to the hedge funds and other multi-billion dollar financial speculators are undermining the central foundations on which the financial system has rested for decades.