International bond markets turn “surreal” as speculation grows

Nick Beams
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The value of negative-yielding bonds reached more than $13.4 trillion last week amid growing concerns that the actions of major central banks in pumping billions of dollars into the global financial system via various forms of “quantitative easing” are creating the conditions for a financial disaster.

According to figures compiled by Tradeweb for the *Financial Times*, the mass of bonds, corporate and government, with sub-zero yields rose by $300 billion in the course of the week. The escalation seems to have been sparked, at least in part, by the decision of the Bank of England to resume bond buying with purchases of £60 billion worth of government debt over the next six months in a bid to boost the markets following the Brexit vote to quit the European Union.

The decision sent yields plunging as bond prices rose—the two move in an inverse relationship to one another—with the yield on 30-year UK bonds now down to a record low of 1.3 percent, compared to 2.3 percent just three months ago.

The UK central bank was unable to find sufficient sellers for all the bonds it wished to purchase last Tuesday, indicating that bond market investors and speculators expect still further central bank action and even higher bond prices.

The international bond market is increasingly taking the form of a speculative bubble. A negative yield means that demand for a bond is so great and its purchase price so high that any purchaser would incur a loss if he held the bond to maturity. The investor is purchasing the bond in the expectation that its price will rise even further and he will be able to make a profit by selling it at a later date.

The demand for German government debt is so high that it now has on issue €160 billion of zero coupon bonds. These bring no interest and have been purchased solely in the expectation that their price will continue to rise.

Significant profits have already been made as the international bond market, once regarded as providing stability for the global financial system, increasingly resembles a multitrillion-dollar casino.

The soaring price of long-term British government debt means that the rate of return on 30-year bonds over the past 12 months is 31 percent. The rise in price of so-called “gilts” has been so rapid that the yield on the longest-dated bond, which matures in 2068, has almost halved since the day of the Brexit referendum, falling from 2 percent to 1.06 percent. The price of the bond has risen by 53 percent so far this year—the kind of rise normally associated with highly speculative stock, not long-term debt issued by the British government.

Mike Amey, the manager of sterling portfolios for the one of the world’s largest bond-trading companies, Pimco, described the speed of the move as “eye-popping.”

A senior investment officer at Prudential Fixed Income, Gregory Peters, told the *Financial Times* the situation had become “surreal.” He said, “It’s clear that central banks are dominating markets. There’s a race to the bottom.”

It appears that trading in bond markets has assumed the form of a mania, as everyone seeks to maximise immediate profits with no concern for what could be the consequences. “There’s too much acceptance of this,” Peters warned. “We’re talking about it in a cavalier way, but that’s not appropriate. It’s extremely distortive, and if we see a pick-up on the fiscal side, or inflation, it will look less comfortable sitting in this negative-yielding universe.”

The concern is that any action taken by governments to boost their economies through increased spending, or

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any unexpected spike in inflation, could send bond yields rising and prices falling. This would leave speculators who bought in at the top of the market, in the expectation that bond prices would climb still higher, with major losses.

The amounts involved are massive. Earlier this month, Fitch Ratings estimated that if yields went back to the levels of 2011, when they were already at historically low levels as a result of the quantitative easing programs following the 2008 financial crisis, total market losses could be as much as $3.8 trillion.

The official rationale for the quantitative easing policy was that lower interest rates were necessary to stimulate investment and consumer spending by lowering the cost of borrowing, thereby preventing the global economy from falling into a full-scale depression. But almost eight years of financial stimulus have failed to lift the real economy, with investment rates remaining well below where they were before the financial crisis. In the US, for example, the latest data on gross domestic product shows investment dropping by 9.7 percent in the second quarter.

In a comment published in the *Financial Times* on Friday, Eric Lonergan, the macro fund manager at M&G Investments, wrote that the policy of the central banks had been based on a false theory. There was, he noted, no empirical evidence to show that consumers tended to increase spending as a result of lower interest rates, and that when interest rates were very low, households tended to save more because of concerns about the future direction of the economy. Corporate investment was similarly unresponsive to lower rates.

"Investment decisions have financial consequences over many years, and are more influenced by beliefs about future growth and attitudes to risk than by overnight rates set by central banks," he wrote.

"Companies have in the past few years responded to very low borrowing costs by engaging in relatively low-risk financial engineering such as share buybacks, potentially crowding out productive risk-taking."

Lonergan did not say so openly, but his remarks pointed to the underlying cause of falling investment despite lowered borrowing costs—the persistent tendency of the rate of profit to fall. This decline was in evidence even before the crisis of 2008, and has increased since.

In the US, where the stock market has reached record highs because of low interest rates, profitability is worsening, with S&P 500 firms reporting weakening overall profits for four quarters in the row.

The only major area where falling interest rates have had a significant impact on the real economy is in housing, where ultra-low rates have fuelled the formation of housing bubbles in a number of leading economies, creating the risk of a new collapse in the housing mortgage market, as happened with the bursting of the subprime bubble eight years ago.

But the world's major central banks are now caught in a trap produced both by fundamental trends in the global capitalist system and the results of their own policies. The US Fed would like to bring about a return to a more normal interest rate regime, while in the UK, Bank of England Governor Mark Carney declared that he was "not a fan of negative interest rates," even as he introduced policies that sent British rates lower.

Such is the extent of speculation resulting from the quantitative easing regime that any return to even a semblance of normalcy threatens to set off a financial crisis that would go far beyond that of 2008.

Last week, the Swiss-based financial corporation UBS issued a research note citing several factors that could set off a major sell-off in the US Treasury market. Among the factors it listed were higher growth and inflationary expectations. But a return to these conditions is supposedly the aim of official policy.

As a comment in the *Financial Times* noted last month, any policy switch to loosen the austerity agenda that is devastating the lives of workers the world over would "herald a stampede" from the best performing sectors of global markets and prompt a rush for the exits, as investors moved to sell off their holdings.

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