Selloff in global bond markets

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Global bond markets experienced a significant selloff last week, sparking fears that something much more serious could be developing.

German bonds experienced their worst month since 2013. Yields on the country's 10-year securities, regarded as the benchmark for European financial markets, rose to their highest levels for six months. In the US, the 10-year treasury bond yield climbed to its highest level since June. (The yield on a bond moves in an inverse relationship to its price.)

The biggest selloff and rise in yields was in Britain where the return on a 10-year bond rose to a post-Brexit referendum high. Gilts, as they are called, have recorded their largest loss since the turmoil of the global financial crisis in January 2009.

The yield on these British bonds has risen from an historic low of 0.51 percent in the middle of August to 1.28 percent. This means that an investor who purchased bonds at the end of August has suffered a paper loss of £91,000 on every £1 million outlaid, or just over 9 percent, in the space of less than two months.

There are two main reasons for the bond sell-off. The first is the expectation of a December interest rise by the US Federal Reserve, coupled with uncertainty over the future of the European Central Bank's (ECB) quantitative easing (QE) program of bond purchases. The second is signs that inflation may be moving upward, which tends to depress bond prices. This is because bonds pay a fixed income and rising prices reduce the income stream and lower the value of the principal in real terms in the future.

Peter Chatwell, head of rates strategy at Mizuho International in London, told Bloomberg: "The premise of the selloff so far was higher inflation and uncertainty on what the ECB is going to do next and particularly about how the next leg of quantitative easing would look."

The ECB has said it will announce the future of its QE program, under which it purchases €80 billion worth of bonds per month, at the next meeting of its governing council in December. At present the program is due to end in March 2017. While an immediate cut-off appears unlikely, the ECB may decide to "taper" its purchases in the same way that the Fed did when it withdrew from bond purchases. Any move to extend the program without any indication of when it would start to be wound back would increase opposition from German financial authorities, who have been critical of the policy from the outset.

There is a general mood in financial markets that central banks may start to ease back on QE measures. One of the reasons for the sharp movement in Britain is that the economy expanded by 0.5 percent in the September quarter—a better result than expected in the immediate aftermath of the Brexit vote—and so Bank of England governor Mark Carney will be less inclined to further loosen monetary policy.

According to a report in the *Financial Times*, "investors are now broadly reassessing the willingness of the European Central Bank and the Bank of Japan to maintain their aggressive unconventional measures" as the Fed "prepares markets for another US interest rate increase in December."

As one fund manager told the newspaper, the bond market was at an "inflection point" as a result. "We're seeing a general attitude shift. It's subtle, but it's there."

While the movements thus far are relatively small, they can have large consequences. The reason is that the policies of the world's major central banks in pumping trillions of dollars into financial markets have created a bond market bubble. At one point, the price of bonds rose so high that some $10 trillion worth were trading at negative yields. That is, if an investor purchased these bonds and held them to maturity, they

would suffer an overall loss.

The reason such purchases were made, however, was not to hold the bonds but to sell them for a capital gain when their price rose even further.

As the *Wall Street Journal* noted, the "weak point" for bonds is that their "previous superstrong performance … makes them unusually vulnerable."

This means that relatively small movements can have a large effect. A rise in the rate of inflation, for example, from 1 percent to 2 percent would not have major consequences in the real economy. But it would have a significant impact on financial markets if it were matched by the same rise in yields.

According to an article published by Dow Jones, it has been estimated that such an increase would reduce the value of Bank of America Merrill Lynch's Global Broad Market Index, which measures global bond prices, by 6.9 percent, that is, a loss of about $3.36 trillion.

Such calculations throw a spotlight on the explosive contradictions at the very centre of the monetary policies pursued by the major central banks in the eight years since the financial crisis.

The stated aim of their agenda has been to lift the real economy. However, rather than produce any tangible boost—investment, for example, remains well below pre-2008 trends in all the major economies—the most significant effect has been to create a bubble in both equity and bond markets. Consequently, if interest rates do start to rise, either because of an increase in inflation or an uptick in economic growth—the stated aim of QE measures—there is the risk of a major crisis as a result of massive losses incurred in finance markets.

Moreover, there is a significant difference between the situation today and that of eight years ago. In 2008 the central banks stood outside the financial markets. Today they are major players and would therefore be directly involved in any market meltdown.