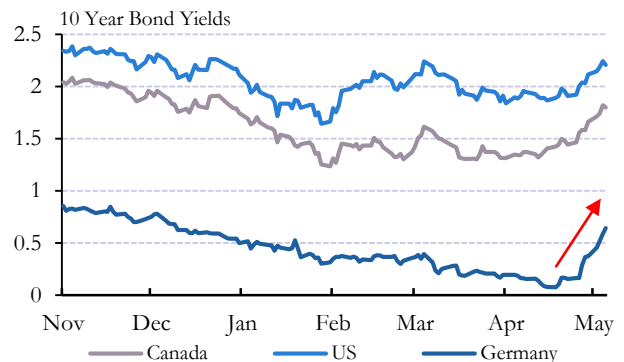


What Broke the Bond Market? | May 7, 2015

Financial headlines are usually the domain of stocks and currencies, but lately it has been the bond markets that are making the news.

On April 17th, German 10 year bond yields hit a record low of 5 bps. A mere 20 days later, they touched 75bps. I can't recall bond yields of any sort ever multiplying so rapidly. Over the same period, Canadian and U.S. 10yr bond yields have climbed 40bps.



Before panicking over the recent moves, one should consider the starting point. For the past six months, yields have trended lower as the bond market became enamoured with the idea that deflation was a significant risk. The herd managed to convince itself that lower oil prices would lead to negative CPI numbers, which would start a vicious cycle where consumers would stop buying things in hopes of lower prices in the future. The ECB poured fuel on the fire when they launched their quantitative easing program, confirming the existence of deflationary pressures.

This is where the 'greater patsy' trade erupted, as traders started buying bonds in order to sell them at much higher levels to the next 'patsy', namely the ECB. With a clearly identified buyer, investors even played the game in longer dated securities which have the greatest sensitivity to inflation. The whole purpose of QE is to raise inflation, so what in the world were 10 year German yields doing at 5 bps?

In the past few days, we saw positive inflation figures out of Europe which got people thinking that perhaps the ECB would stop QE early. With fears that the 'patsy' might leave the game, smart money started looking around for the next 'greater fool'. With no one stepping up to play that role, the rout was on. Canadian and U.S. yields, which were dragged lower by the game in Europe, naturally got side-swiped in the reversal.

I don't think this means we have started a meaningful move towards normal rates. The ECB for the time being remains committed to a €60 billion a month asset purchasing program through September 2016, which implies that the game of hot potato will at some point commence again. My guess is that point is close.

The take away from the recent move is that investors need to think carefully about the interest rate sensitivity in their portfolios. The volatility of the last 20 days hasn't been kind to traditional asset classes. Imagine what a sustained move to more normal interest rates would do to your portfolio.

Regards,

Brian