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Ten-year yields: the end of an era?

Synopsis: Why ten-year yields have returned to the levels of long ago.

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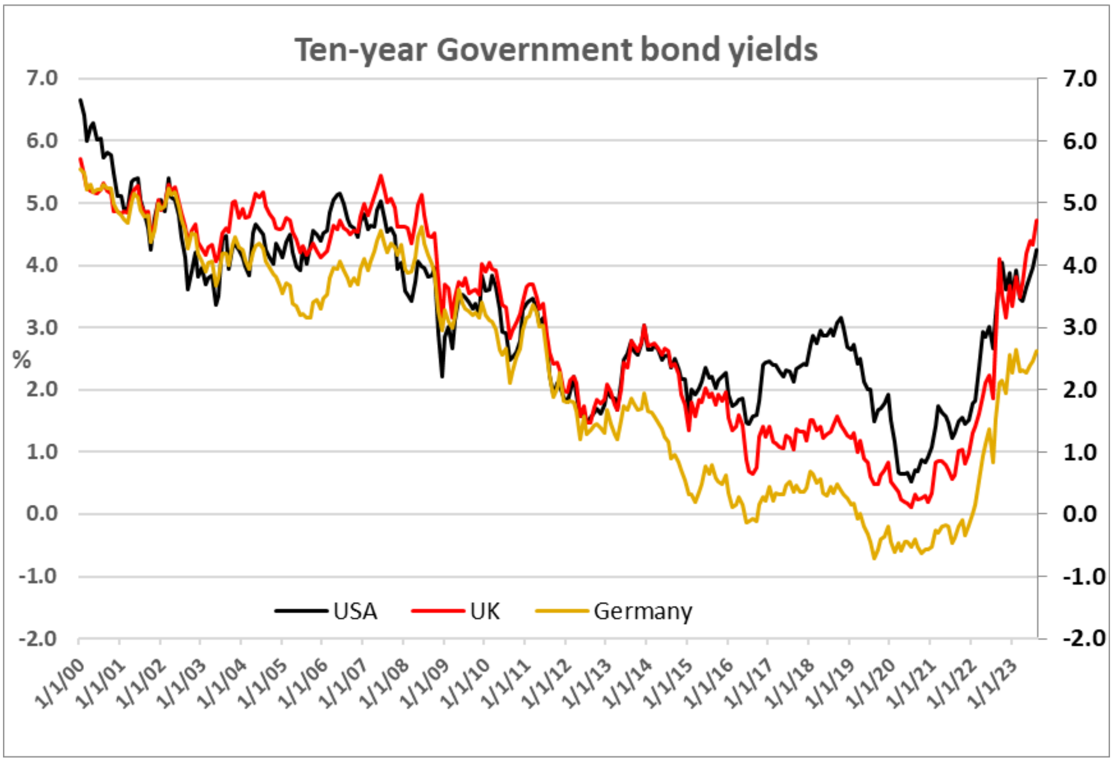

So far, August has not been a great month for Government bonds. From the start of the month to 18 August, ten-year yields rose by...

- 0.156% in Germany.
- 0.284% in the USA.
- 0.413% in the UK.

As the graph shows, that has taken yields back to levels not seen for 12 or more years. In the UK, that means a yield higher than in the wake of last year's kami-Kwasi mini-Budget. The days of flirting with negative yields now seem a distant memory, even though German ten-year bunds were still finding investors to lock in a decade of guaranteed losses as recently as December 2021.

At first sight, the rise in ten-year yields is puzzling because...

- Inflation, as measured by the CPI is well down from its peak in the Eurozone (5.3% from 10.6%), USA (3.2% from 9.1%) and the UK (6.8% from 11.1%).
- The broad consensus is that the ECB, Federal Reserve and Bank of England will not be raising short term rates much more, if at all.

Which begs the question of why ten-year yields are on the up. There are several possible answers…

- The markets may not be expecting much in the way of further central bank rate rises, but 'higher for longer' is becoming a theme. While headline CPI rates have dropped sharply, core inflation (which strips out energy and food) is coming down much more slowly due to wage pressures. The stickiness of core inflation will constrain central banks' ability to cut rates.

- There is plenty of new debt for the market to absorb. For example, at the end of July, the US Treasury issued an estimate that its July-September net borrowing would be $1,007bn. In the UK, the Debt Management Office needs to raise another £145bn before the end of the financial year. High supply puts pressure on price.

- Adding to the issuance are the central banks' sales that stem from quantitative tightening (QT). In theory as quantitative easing was meant to bring down longer term interest rates, reversing the process and selling bonds *to* the market should have the opposite effect. However, the impact of QT is so far unclear.

- Whisper it quietly, but maybe the world is reverting to a more 'normal' pattern of interest rates, such as the one which existed before the global financial crisis (please see graph).

Comment

If we are entering an era of higher long-term rates and higher real returns, the valuations of non-bond assets will come into closer focus.

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