Why Bond Yields Will Remain Low

Chairman Bernanke spent most of his congressional testimony this week explaining why US bond yields would remain low for quite some time. His first order of business was to refute the media hype that the sudden backup in Treasury yields somehow stemmed from misperceptions about his earlier revelation that the Fed inevitably would exit its current policy of quantitative easing (QE) perhaps sooner rather than later. In his view, the bond market's sudden response simply reflected the unwinding of leveraged positions, primarily by hedge funds that were up to their eyebrows in carry trades that were long and wrong-footed.[1] Misperceptions of the Fed's intentions had little to do with this swift deleveraging. Bond prices now are closer to underlying fundamentals, all of which still point to low yields - just not as absurdly low as they were this spring.

The case favoring low yields falls into four categories: 1) the US economy has a lot of slack and that keeps downward pressure on prices; 2) economic growth is not likely to re-employ all those idle resources anytime soon; 3) the rest of the world is not yet in a position to rejuvenate global demand; and 4) most major central banks including the Fed will be providing ample liquidity with generous monetary policies for years to come. Let's consider each piece of the argument in turn.

Idle resources. Mr. Bernanke expressed current conditions in terms even a Congressman can understand: "the jobs situation is far from satisfactory, as the unemployment rate remains well above the longer-run normal level, and rates of underemployment are still much too high." He went on to observe that even the decline in measured unemployment to date was deceiving: "For example, if a substantial part of the reductions in measured unemployment were judged to reflect cyclical declines in labor force participation rather than gains in employment, the Committee would be unlikely to view a decline in unemployment to 6-1/2 percent as a sufficient reason to raise its target for the federal funds rate." As is typical of a recession, a lot of Americans are forced to work part-time or simply drop out of the workforce and do not even attempt to search for a job when good opportunities are sparse. The under-employed now include 11.8 million unemployed persons, 8.2 million persons who are working pat-time but would rather have a full-time job and another 7.8 million have dropped out but would look for work if jobs were more plentiful.

A more comprehensive measure of an economy's underutilized resources is the output gap – the difference between actual real GDP and its theoretical noninflationary *potential.* The latter is an empirical construct subject to some uncertainty, especially during the recovery from a recession. Our estimate of the US output gap is shown in figure 1 on the next page.

[1] We have long characterized the bond selloff as an unwinding of leveraged positions, which invariably causes asset prices temporarily to overshoot on the downside. See "The Intended Consequences of Exiting QE: Re-pricing Credit Risk," Fenwick Advisers, 12 June 2013.

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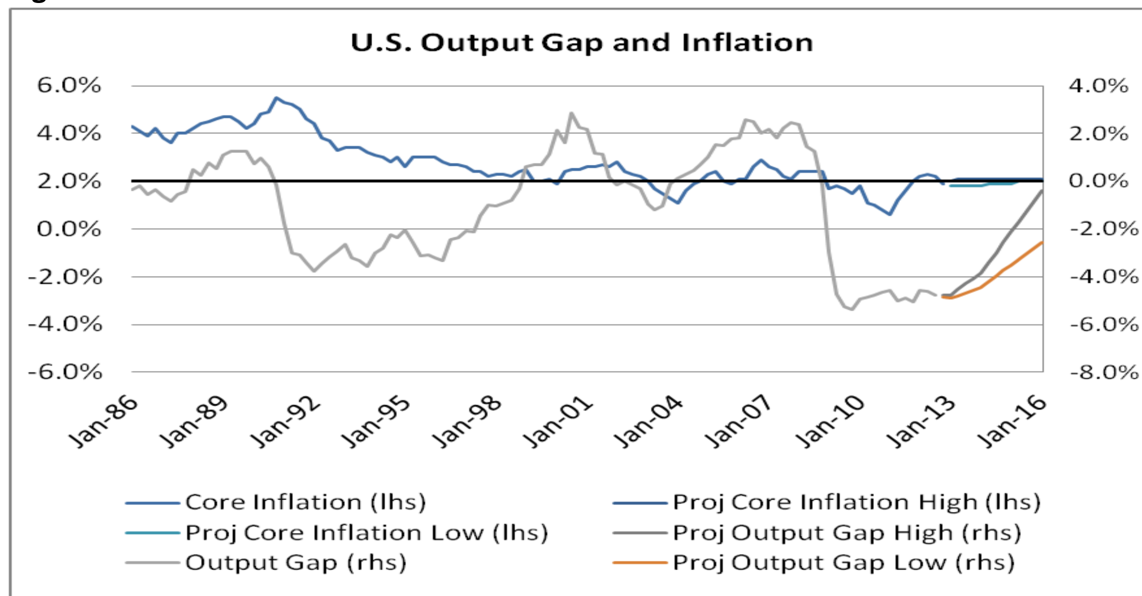
The figure uses an estimate of potential GDP growth of 2% since the apparent break in the productivity trend in 2003. Even using that conservation estimate, the output gap now is 4.6% of GDP – a substantial amount of slack by historical standards.

Figure 1



The unspoken empirical link is that an output gap of any size is associated with disinflation as can be seen from the blue line representing the 12-month change in core inflation as measured by the consumer price index less food and energy items. That measure already has slipped to 1.6% in June, well below the Fed's target, and is likely to decline further in 2014. Needless to say, few FOMC members are concerned about inflation and some including James Bullard are worried that inflation is to low and oppose any tapering of asset purchases until inflation stabilizes.

In this context, it is hard to explain why FOMC members have come to the conclusion that asset purchases should be wound down over the next year or so. Some members are concerned that zero funding costs coupled with the Fed's commitment to purchases of Treasury bonds in itself promotes excessive speculative behavior and leveraged trades that are unhealthy for financial markets and are unsustainable in any event. They have a good point in light of how the market has performed after the mere suggestion of tapering. Another unspoken perspective is that QE cannot go on forever. In the extreme, the Fed someday would become the sole financier of government debt – like the Reichsbank in 1923 or Banco Central do Brasil in the 1980s. Granted, the Fed's holdings are not remotely close to that level yet, but FOMC members should become uneasy about the size of the central portfolio at some point. A few fainthearted members already are calling it quits; the majority, though, seems comfortable up to $5 trillion, which is about the size the portfolio would be if the Fed began to taper purchases of Treasuries before yearend and ended them

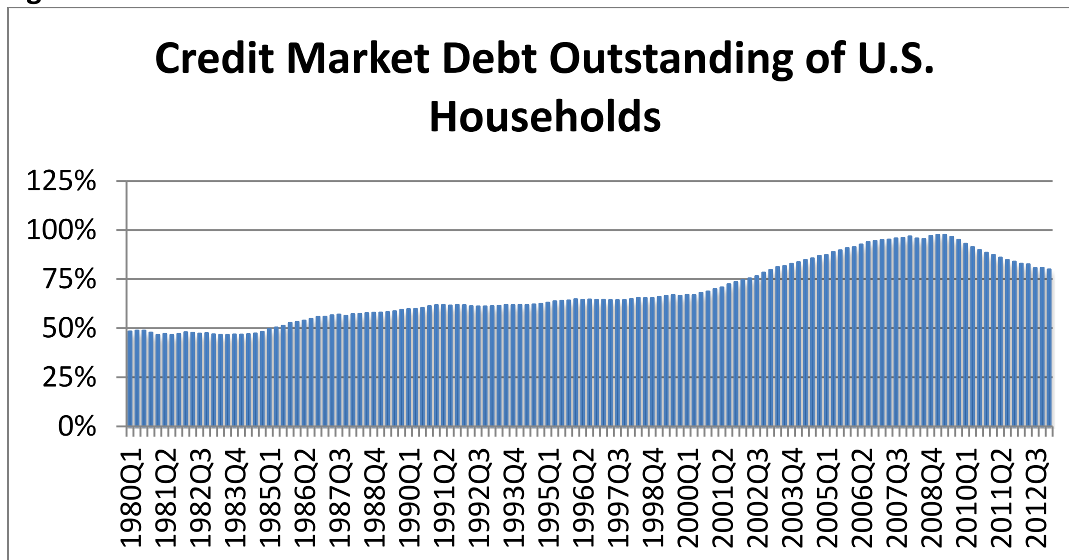
by mid-2014. There is less reluctance to buy mortgages, in part because those targeted purchases seem to be more effective and less disruptive to capital markets than their sovereign counterparts. Short of the US economy tipping into a recession, I believe a consensus among members already has been reached on something close to the aforementioned timetable for tapering Treasury purchases.

Growth and deleveraging. Notwithstanding this consensus on tapering, Chairman Bernanke was quick to qualify the timetable as conditional on the FOMC's explicit economic forecast coming to pass. It is best to ignore this inconsistency because the US economy and the job market are doing well enough to appear satisfactory this year. Granted, the Fed's forecast does become more aggressively optimistic in 2014 and especially so in 2015. By winding down asset purchases over the next 12 months or so, the Fed then simply could postpone the first adjustment to the fed funds rate if faced with disappointing economic results rather than having to prolong riskier asset purchases. This strategy makes good sense, especially given the diminishing returns and increasing risks associated with purchasing Treasuries. By getting out of the business of financing the government while the economy is improving, the Fed will reassert itself as an independent central bank yet it will retain the option to maintain a generous monetary policy for as long as it takes to get back to full employment. Moreover, the Fed will find its forward guidance on the timing of the first rate adjustment will be much more effective than its current forward guidance on tapering that is fraught with the inherent inconsistency of trying to explain what conditions are needed to warrant an exit for a policy that is unsustainable in the long term. This conundrum brings to mind Keynes' famous quip about the unintended short-term consequences of the interwar gold standard that was ultimately was unsustainable: "In the long run, we are all dead." QE has been a valuable stopgap policy but is not a viable long-term strategy.

Sometime in the near future the US economy is likely to fall short of the FOMC's lofty expectations because the deleveraging process is far from complete. At home, both households and government at all levels still have a lot of wood to chop. I judge that households are more than halfway toward normalcy. Figure 2 shows household debt as a percent of GDP. Note that this measure of household debt burdens has declined from almost 100% of GDP at its apex in 2009 to 80% in early 2013. A 'normal' level of household debt is a subjective issue, but somewhere in the neighborhood of 65%, i.e. the pre-housing bubble level of the late 1990s, seems to be a reasonable guess. If so, then households are more than halfway down the path of repairing their balance sheets. Until they reach that utopia, savings must improve further and spending will be subpar. And without euphoric US consumers, US economic growth is not likely to generate big surprises.

The other fly in the growth outlook is fiscal policy, which Mr. Bernanke saw fit to criticize Congress for their inconsistent and pro-cyclical tendencies. Another budget battle is brewing with the deadline on raising the debt ceiling approaching this fall. Another contentious debate and stalemate has the potential to be disruptive and Bernanke warned

Figure 2



that further fiscal restraint would be bad economics. In an ironic twist of fate, however, the shrinking US deficit gives FOMC members yet another reason to unwind its purchases of Treasuries. With sequestration of expenditures, better tax revenues and renewed solvency of Fannie Mae and Freddie Mac, the deficit is projected to drop sharply to $650 billion this fiscal year. That means the Fed is buying the lion's share of the new net issuance of Treasuries. Conversely, tapering purchases should be less detrimental to bond prices if done in an environment shrinking deficits than one of chronic deficits, as is the case in debtor countries.

Global demand. Domestic demand in the emerging world may someday rival that in western economies but cannot possibly make up for the shortfall during this business. In no other country is the transition to domestic-led growth more urgent than in China, yet despite the commitment and efforts of an authoritarian central government its transformation to more balanced is not progressing nearly fast enough to compensate for the shrinkage in exports. Global demand for exports from the emerging world has slowed to 5% this year as Europe's lingering recession and China's slowdown are taking a toll not only on commodity shipments and prices but also a wide range of inputs to manufacturing. Indeed, industrial production now is rising less than real GDP in every major country except China, where excess capacity has generated piles of unwanted inventories that in turn are being dumped at discounted prices at home and abroad. As global demand wanes, profit margins have been squeezed and emerging equity prices have collapsed, especially in China where profits heavily depend on sales volume.

In a way, the Great Recession belatedly is coming full circle. The first stage was the demise of global financial institutions that necessitated bailouts; the second phase was force

deleveraging and its attendant consequences for jobs and asset prices; and now we are grinding through the work out phase when debt and deleveraging weigh on growth as cash flow is diverted to paying down debt even as low interest rates prolong the process by offering hope of refinancing when default and devaluation might be the less painful routes. Emerging countries for once avoided the early phases of the Great Recession in part because the Fed initiated swap agreements with major emerging countries so that the illiquidity of US and European markets did not spread to dollar shortages for trade finance in the emerging world. China in a sense is doing the same thing today; as its economy struggles with a huge transition away for global exports to domestic services, the PBOC has initiated RMB swap agreements with 20 countries to insure liquidity in trade financing while it is clamping down on excess domestic liquidity flowing to the shadow banking sector. These sea changes in central bank policies rarely are graceful. Access to 'hard' currency alone cannot overcome anemic global demand. Only time and generous monetary policies can diffuse the pain of adjustment.

Central bank generosity. All western economies face headwinds on growth and risks of deflation and their central banks have turned the Fed-style forward guidance in the hopes of persuading investors that policy rates will stay low for a long time. The Fed's forward guidance on the first rate adjustment – namely, reduction in unemployment below 6.5% - was destined to run into controversy.[2] Mr. Bernanke has made it clear that this threshold is neither automatic nor fixed in stone, notably because too many Americans have dropped out of the labor force and may not return until the job market improves markedly. A better metric from fixing the first adjustment are real GDP growth relative to its potential and core inflation relative to its target – that is, the basic input to a so-called Taylor Rule. Figure 3 shows the empirical estimates from our Taylor model. Consistent with the Fed's current

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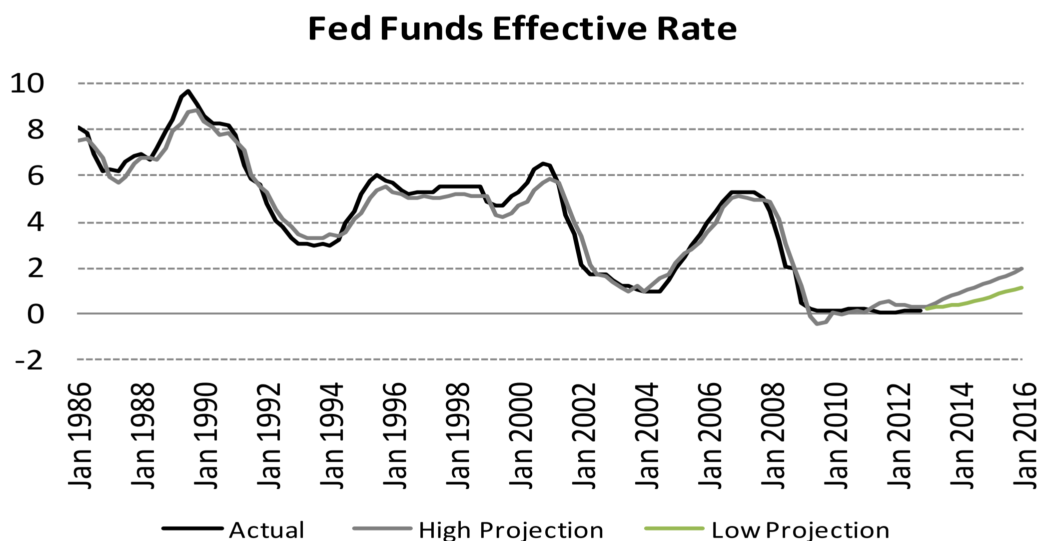

[2] See "The NAIRU, Okun's Law and Other Fed Esoterica", Fenwick Advisers, February 22, 2013.

guidance, the model predicts that the economy will be healthy enough to warrant a small rate adjustment around mid-2015 **on the critical condition that economic growth matches the optimistic Fed forecasts**.

In my opinion, the US economy is likely to disappoint beginning sometime in 2015 in part because both Europe and the emerging world are not pulling much weight. In some respects, that prospect is preferable to a quick recovery. The problems of the global economy are rooted not only in debt-laden balance sheets but also in low and declining potential growth rates almost everywhere. These issues take time, significant reforms and political leadership – all of which seem to be in short supply. None of the western central banks can resolve these flaws except those related to the financial system and the debt resolution process. Although some progress is evident, the political foot-dragging even on the financial reforms and tax havens along with the ECB's interminable timetable for effecting change assure that western central banks will be running accommodative monetary policies for a very long time. Indeed, the low policy rates themselves encourage procrastination in deleveraging Europe's financial system and further postpone the day when policy rates will return to normal.

That leaves plenty of time for central banks to rethink what neutral policy rates should be going forward. The historic norm of 4% for the major central banks (excluding the BOJ) from the past several decades no longer seems appropriate. Those nominal rates were high in order to get inflation down. Now that inflation is low, such high policy rates are not needed to maintain control. The real risk in this deleveraging environment is that the central banks fail to recognize the limitations of monetary policy in rectifying structural problems. Indeed, central banks in dealing with this lingering financial crisis run the risk of being 'enablers' of the next one.

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