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Unstoppable \$100 Trillion Bond Market Renders Models Useless

By Susanne Walker and Liz Capo McCormick - Jun 2, 2014

If the insatiable demand for bonds has upended the models you use to value them, you're not alone.

Just last month, researchers at the [Federal Reserve Bank of New York](#) retooled a gauge of relative yields on Treasuries, casting aside three decades of data that incorporated estimates for market rates from professional forecasters. Priya Misra, the head of U.S. rates strategy at Bank of America Corp., says a risk metric she's relied on hasn't worked since March.

After unprecedented stimulus by the Fed and other central banks made many traditional models useless, investors and analysts alike are having to reshape their understanding of cheap and expensive as the global market for bonds balloons to \$100 trillion. With the world's biggest economies struggling to grow and inflation nowhere in sight, catchphrases such as "new neutral" and "no normal" are gaining currency to describe a reality where bonds are rallying the most in a decade.

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"The world's gotten more complicated and it's a little different," [James Evans](#), a New York-based money manager at Brown Brothers Harriman & Co., which oversees \$30 billion, said in a telephone interview on May 30. "As far as predicting direction up and down, I don't think they have much value," referring to bond-market models used by forecasters.

Flawed Consensus

With the Fed paring its \$85 billion-a-month bond buying program this year and economists calling for the five-year-long U.S. expansion to finally take off, Wall Street prognosticators said at the start

of the year that yields were bound to rise as central banks began employing tighter monetary policies.

Instead, investors poured into bonds of all types as global growth weakened, disinflation emerged in [Europe](#) and tensions between Ukraine and [Russia](#) intensified.

Globally, bonds have returned an average 3.89 percent this year for the biggest year-to-date gain since 2003, index data compiled by Bank of America Merrill Lynch show. The advance decreased yields on 10-year Treasuries by more than a half percentage point to 2.48 percent, the fastest pace over the same span since 1995, while borrowing costs for the riskiest U.S. companies tumbled to a record 5.94 percent last week.

Benchmark Treasury 10-year note yields rose six basis points, or 0.06 percentage point, to 2.53 percent as of 3:36 p.m. in [New York](#).

In developed countries, benchmark yields in 24 of 25 nations tracked by Bloomberg have fallen this year, with those in Italy and [Spain](#) closing below 3 percent for the first time.

‘How Wrong’

“I don’t expect the consensus to be right, I’m just surprised by how wrong it has been,” [Jim Bianco](#), president of Chicago-based Bianco Research LLC, said by telephone on May 28.

The seemingly unstoppable rally has caused bond-market professionals to reassess whether they’re using the right tools.

At the New York Fed, researchers Tobias Adrian, Richard Crump, Benjamin Mills and Emanuel Moench on May 12 released an updated methodology for a metric known as the term premium, which can be used to determine whether 10-year Treasuries are cheap or expensive relative to short-term rates.

After stripping out all human predictions and using only market prices to calculate future expectations, the researchers found the extra yield longer-term Treasuries offered has been “considerably higher since the onset of the financial crisis” than previous models, according to their blog post that included the data. That may be because the metric now suggests the Fed’s short-term interest rate may not rise as high as survey-based results predicted, wrote the economists.

Old Model

Based on the old model, last updated on March 31, the term premium on 10-year notes was 0.25 percentage point, versus 0.96 percentage point on the same day using the [current methodology](#). The reading was at 0.67 percentage point last week.

The researchers declined to comment beyond the blog post, according to Eric Pajonk, a spokesman at the New York Fed.

Bank of America's Misra says she stopped looking at the gap between the rate on 10-year [interest-rate swaps](#) and yields on benchmark government debt as a measure of risk.

The gauge, which usually widens as investors seek out haven assets in times of stress, is being distorted as those betting on losses in Treasuries have unwound their trades, she said.

[Hedge funds](#) and other large speculators cut their net short positions in 10-year note [futures](#) by the most since February as of May 27, according to data from the U.S. Commodity Futures Trading Commission. Primary dealers, which had [net short](#) positions in March for the first time since 2011, have since reversed those wagers, data compiled by Bloomberg show.

Forced Buying

"Everyone is short and they are forced to cover," Misra said by telephone on May 28.

While economists and strategists have reduced their yield forecasts, they're still sticking to the view borrowing costs will end the year higher as the economy gains momentum.

They now see yields on 10-year Treasuries rising to 3.25 percent by year-end as the economy accelerates 3.1 percent in 2015, estimates compiled by Bloomberg show. At the start of the year, the median yield forecast was 3.44 percent.

Investors risk becoming lulled into complacency by six years of near-zero U.S. [interest rates](#) at a time when yields are so low, according to Zach Pandl, the Minneapolis-based senior interest-rate strategist at Columbia Management Investment Advisers, which oversees \$340 billion.

Pandl, who developed his own version of the term premium, maintains that U.S. government bonds are too expensive.

"The Treasury market is overvalued," he said by telephone on May 28. "The funds rate has been at zero for so long so it becomes difficult to envision it being higher at all. [Monetary policy](#) is closer to exit."

Biggest Mistake

Traditional models are failing to explain the resilience of fixed-income assets as central banks led by the Fed pump [trillions](#) of dollars into their economies and suppress short-term rates at historical lows, according to Bianco.

The Fed, [Bank of Japan](#) and [Bank of England](#) all have quantitative-easing programs in place, while at least two dozen nations have dropped benchmark rates to 1 percent or less.

“The biggest mistake for people is they think interest rates are merely a projection of where the economy is supposed to go,” Bianco said. “It’s the Fed and the way they have changed the marketplace.” He foresees that yields on 10-year notes will end the year at 2 percent to 2.5 percent.

Fed Chair [Janet Yellen](#) said on May 7 there will be “considerable time” before the central bank raises its benchmark rate as slack in the jobs market keeps inflation below its 2 percent target.

Household spending declined in April, while the world’s largest economy contracted in the first quarter for the first time since 2011, government reports showed last week.

“Given the outlook for the global economy and inflation, bonds are not a bad place to be,” Gary Pollack, the New York-based head of fixed-income trading at Deutsche Bank AG’s private-wealth management unit, which oversees \$12 billion, said in a telephone interview on May 28.

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