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One Hundred Years of Bond History Means Bears Fated to Lose

By Daniel Kruger and Liz Capo McCormick - Dec 8, 2014

If you're convinced the plummet in yields of U.S. government bonds is an aberration, it may be because you haven't been in the business long enough.

With the longest-dated Treasuries now yielding less than half the 6.8 percent average over the past five decades, it's not hard to see why forecasters say they're bound to rise as the Federal Reserve prepares to raise interest rates following the most aggressive stimulus measures in its 100-year history. Yet compared with levels that prevailed in the half-century before that, yields are in line with the norm.

For David Jones, the former vice chairman at Aubrey G. Lanston & Co. and a 51-year bond veteran, the notion that Treasury yields are too low is being shaped by traders, money managers and economists who began their careers in the wake of runaway inflation surpassing 10 percent in the 1970s and 1980s. With U.S. consumer prices rising at the slowest pace in five decades and economic growth weakening around the world, today's bond market may now be reverting back to form, he said.

"We have come full circle," Jones, 76, said by telephone on Dec. 1 from Denver. "Rather than decrying how low interest rates are and expecting them to shoot higher, it may be that we're in more normal territory than we thought we were."

Since the financial crisis, yields on Treasuries of all maturities have fallen as the Fed attempted to restore demand in the U.S. by dropping its overnight target rate close to zero and buying bonds to suppress long-term borrowing costs.

Bull Case

The 5.1 percent rally in U.S. government debt this year has pushed down yields even further, surprising everyone on Wall Street who anticipated the central bank's unprecedented stimulus would lead to stronger economic growth, faster inflation and ultimately higher borrowing costs.

Yields on 30-year bonds, the longest-term debt securities issued by the Treasury Department, have fallen a full percentage point this year to 2.95 percent as of 9:25 a.m. in New York today. At the start of 2014, forecasters said they would rise 0.28 percentage point to 4.25 percent.

Economists and strategists in a Bloomberg survey are sticking to their calls that yields will rise and predicting those on long-term Treasuries will reach 3.88 percent next year.

Lacy Hunt, the 72-year-old chief economist at Hoisington Investment Management, says lackluster demand and inflation will likely keep yields low for years to come as the U.S. contends with record debt levels.

Even though the Fed inundated the U.S. economy with almost $4 trillion of cheap cash with its bond buying, growth has averaged 1.8 percent a year since 2009. In the seven expansions dating back to the 1960s, growth averaged almost 4 percent.

History Lesson

Inflation, which erodes the value of fixed-income payments, has failed to reach the Fed's 2 percent target for 30 straight months based on its preferred measure. The U.S. consumer price index has risen an average 1.62 percent over the past five years, the least since the five-year period ended in 1965.

"Over time, what drives the bond yield is the inflationary expectations," Hunt said by telephone on Dec. 2. "If you wring all the inflationary expectations out, you are going down to 2 percent on the long bond over the next several years. That is the path that we are on."

Based on bond yields, inflation expectations over the next 30 years have fallen below 2 percent and reached a three-year low of 1.96 percent at the end of last month.

Those levels are more akin to inflation rates that were prevalent in the five decades after the Fed was established in 1913. Living costs rose an average 2.45 percent annually during that span, versus 4.3 percent in the half-century since, according to data compiled by the Labor Department.

Great Society

Long-term U.S. bond yields were also lower in the earlier period, averaging about 3.1 percent, according to more than 100 years of data provided by Austin, Texas-based Hoisington.

Forecasters have continued to anticipate higher borrowing costs partly because recent history has been marked by periods of elevated inflation, said Ray Stone, a Princeton, New Jersey-based managing director at Stone & McCarthy Research Associates.

"Those of us that grew up in the 1970s and when there were very high interest rates in the early 1980s might think that that is the norm," Stone, who began his career at the New York Fed in 1973, said by telephone Dec. 3. "But it's not. What prevailed before then is probably more indicative of the norm."

Yields on the longest-term U.S. government bonds started to rise to unprecedented levels in the 1960s as government spending increased with the Vietnam War and the social welfare programs of the Great Society under President Lyndon B. Johnson.

Oil Shock

In the 1970s, oil shocks stemming from the 1973 embargo by the Organization of Petroleum Exporting Countries and the Iranian revolution in 1979, as well as the easy-money policies by the Fed during the Nixon administration, caused annual consumer prices to soar as much as 14.8 percent in March 1980.

Yields on 30-year Treasuries followed, surging to a record 15 percent in October 1981.

While former Fed Chairman Paul Volcker was credited with finally breaking the inflationary cycle by raising interest rates to 20 percent that year, at least one bond veteran says the three-decade bull market in bonds that ensued may finally be over as the central bank tightens policy. His name? Bill Gross.

"Prepare for at least a halt of asset appreciation engineered upon a false central bank premise of artificial yields," Gross, 70, who left Pacific Investment Management Co. in September to join Janus Capital Group Inc., wrote in his investment outlook for December.

Less than two months earlier, billionaire hedge-fund manager Paul Tudor Jones said there's a bubble in debt globally that will burst and that "the piper will be paid one day."

Secular Bear

Signs that the trillions of dollars of stimulus by the Fed will lead to a pickup in inflation may already be emerging. Last month, the economy created more jobs than at any time in almost three years, helping trigger a 0.4 percent jump in average hourly wages that was the biggest in 17 months.

Before November, earnings remained flat or rose just 0.1 percent in five of the prior eight months. Economists also anticipate that 3 percent economic growth in the U.S. next year, which would be the fastest in a decade, will compel the Fed to raise rates in the second quarter of 2015.

"We're in a transition period between secular bull and bear markets in bonds," Stewart Taylor, a money manager at Boston-based Eaton Vance Management, which oversees $294 billion, said by telephone on Dec. 4.

Even as the U.S. economy gains momentum, a slowdown abroad may help keep Treasuries in demand as central banks in Europe and Japan step up their own stimulus measures.

No Return

With the inflation rate for the 18-nation euro area matching a five-year low in November and Japan falling into a recession, JPMorgan Chase & Co. estimates their central banks will buy $1.1 trillion of debt in 2015 to support demand.

That's already made Treasuries more attractive on a relative basis, with 10-year German bunds yielding 1.58 percentage points less than similar-maturity Treasuries today, the widest since 1999. The gap between the U.S. and Japan is even greater at 1.88 percentage points.

"It's more of a structural shift related to globally low yields," Jennifer Vail, the head of fixed income at U.S. Bank Wealth Management, which oversees $115 billion, said by telephone. "It's driving a lot of money into our market."

A price war between OPEC and U.S. shale oil drillers is also likely to keep inflationary pressures tied to energy from building. The price of the U.S. benchmark grade has plummeted 33 percent this year and reached a five-year low of $63.72 a barrel on Dec. 1. Since soaring to a record of $147.27 in July 2008, prices fallen by about half. During the oil shock in the late 1970s and early 1980s, crude prices more than tripled.

"Inflation is a non-story, and as long as inflation is a non-story, we're not going back to those elevated yield levels," David Robin, an interest-rate strategist at Newedge, an institutional brokerage firm, said in a Dec. 3 telephone interview in New York. "We're not going back there."

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