Global Demographics

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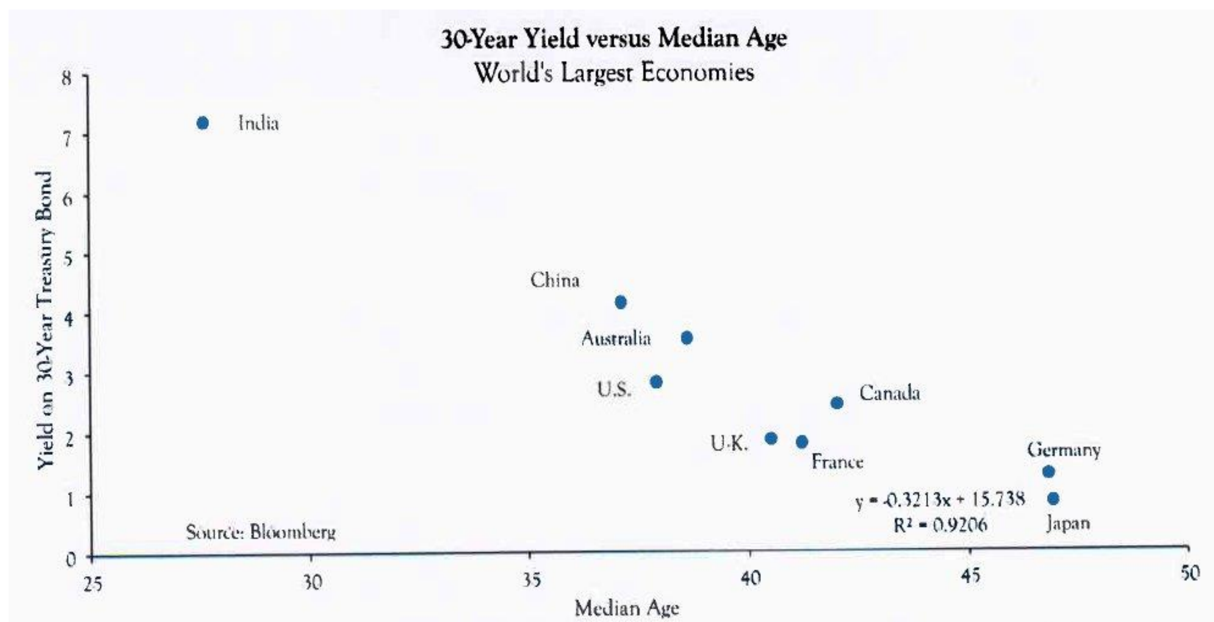
Will Bond Market Vigilantes Hijack the Recovery?

Are long-term interest rates low because of the expectation that the economic recovery will be lacklustre or are they low because the fixed income market expects inflation to remain subdued (structural disinflation resulting from an ageing planet)? Our position that it reflects the impact of an ageing population is bolstered by the relationship between interest rates and the median age of the World's largest economies (see Chart 1). It is not a view that is universally shared as there have been numerous articles that argue that inflation is only dormant and will reignite once the impact of Covid-19 dissipates. The surprise will be that any uptick in inflation will be a short-lived cyclical bounce that will dissipate to be followed by a continuation of structural disinflation.

Chart 1



The belief that resumption of stronger sustained economic growth will be inflationary is reminiscent of the experience of "bond market vigilantes" during the 1990s. During that decade, the fixed income market behaved as though they were suspicious that the Fed was abandoning the mandate of price stability. Signs of improved economic activity were almost immediately met by a steeper yield curve. The steeper yield curve had the obvious effect of reducing growth in the interest rate sensitive sectors of the economy, e.g. residential construction, consumer outlays for durable goods and capital spending. As growth slowed, the yield curve would become less steep. The net result was that the fixed income market did all the Fed's heavy lifting. The fact that inflation as measured by the core PCE deflator fell throughout the 1990s never deterred the belief of the bond market vigilantes (see Chart 2).

The bond market vigilantes also had an impact on the equity market. The increased volatility in the yield curve resulted in a substantial decline in the volatility of the real economy. This was less favorable for value investing as that thrived best when valuation parameters, e.g. interest rates are relatively stable and the volatility in the real economy provided opportunities for value investing.

My “Race to Zero” thesis that I formulated in 1992 resulted from seeing a chart displayed by Ed Hyman at a conference in Nashville, Tennessee. That led me to do a supply-side decomposition of nominal GDP in terms of population, labor force participation, productivity, wages and prices. In so doing, I ended up with the relationship that labor force causes nominal GDP (see Chart 3). I then compared that result with the nominal yield on long-term Treasuries (see Chart 4). At that time, my opinion was that the fixed income market was a backward flying goose, i.e. it reacted to inflation as opposed to anticipating inflation throughout the 1960s and 1970s

About 15 years ago, the relationship between yields and nominal GDP began to change. Instead of almost always perfectly tracking nominal GDP, yields drifted ever lower. There were occasional mini-spikes but they were mild and did not last long because the reality was that persistent inflation never materialized – inflation as measured by the core PCE deflator fell as the century aged (see Chart 5). We interpret the divergence between yields and nominal GDP as signalling the authenticity of structural disinflation which meant that the secular path was for ever lower long-term interest rates racing towards zero.

Investment Conclusion

As we noted above, the overwhelming consensus seems to be that inflation is lurking around the corner. That a consistent economic recovery will ignite it. Ignored is the experience of the last 50 years which has been characterized by ever lower rates of inflation. Also ignored is the fact that inflation did not become persistent until the baby boom generation reached adulthood, a theme that we have written about numerous times (see Chart 6). Inflation is principally driven by an over abundance of young persons. That is no longer the case which is why inflation and interest rates have trended lower. It is a global phenomenon.

There is however a risk that the fear of inflation will still take hold, that the yield curve will become much steeper. Such a development could greatly complicate the recovery, which could pressure the Fed to engage in yield curve management.

Chart 2

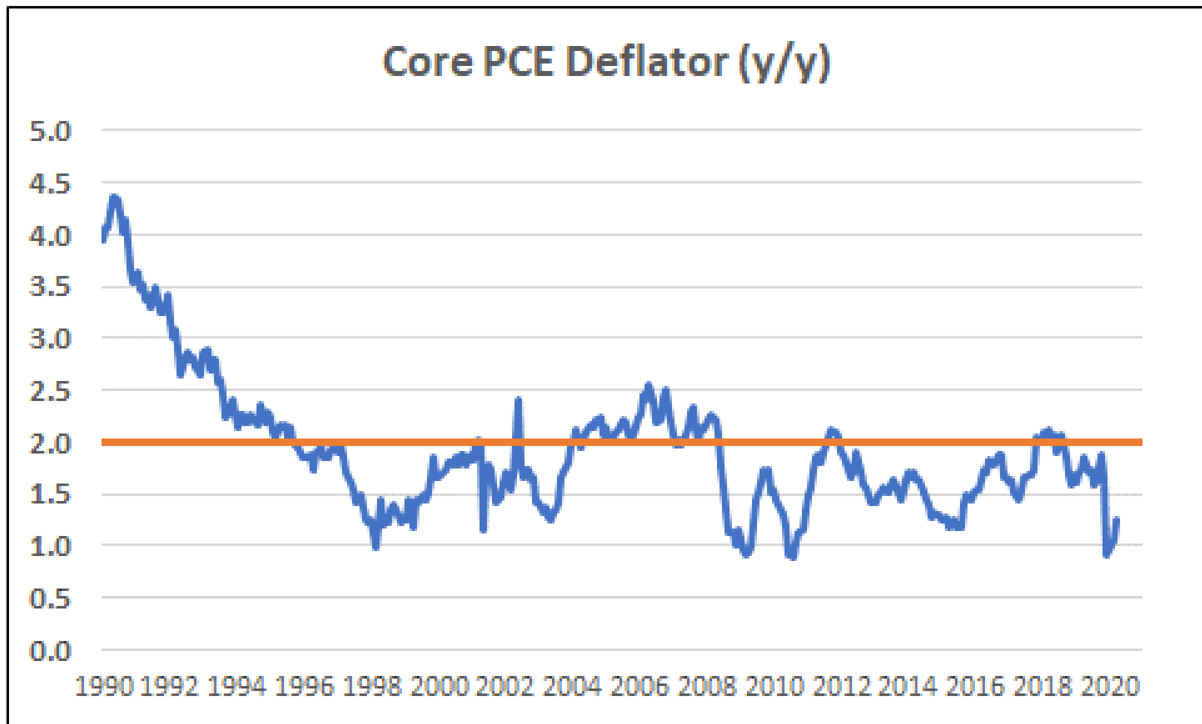


Chart 3

U.S. Smoothed Growth in Current Dollar GDP and the Labor Force
(Annual Rate of Change from same quarter 10 years ago)

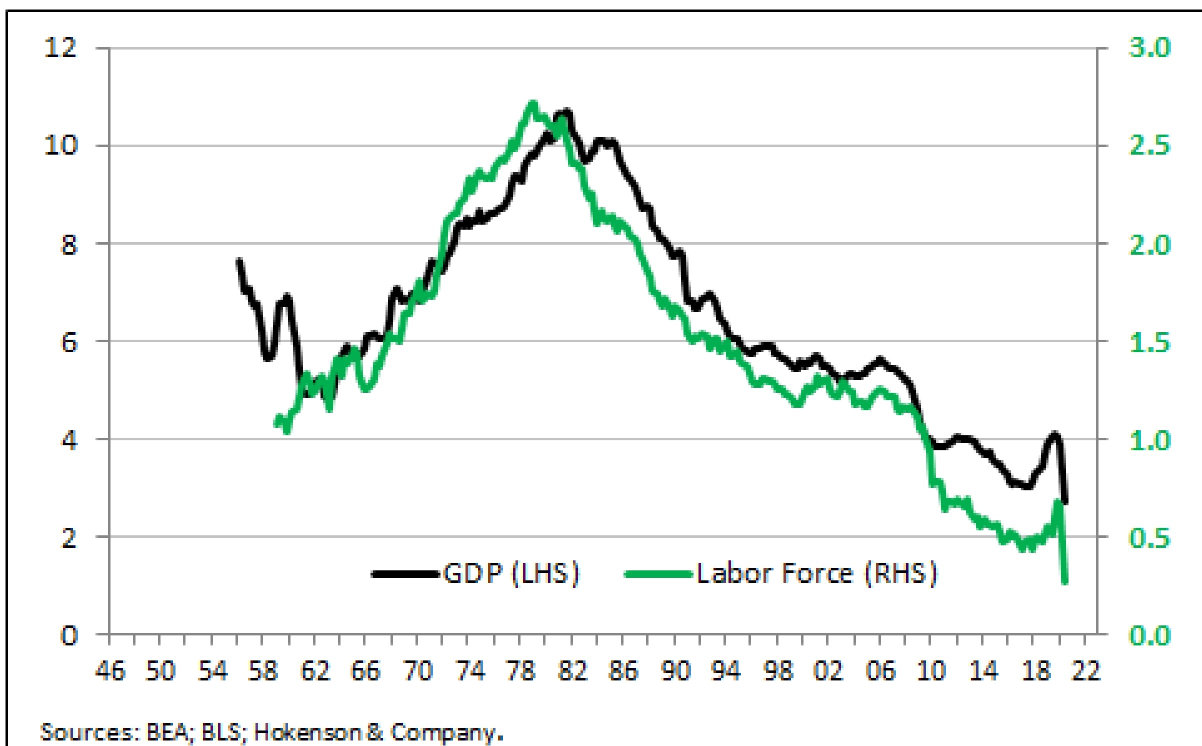


Chart 4

Nominal Yield on Long-Term Treasuries versus Smoothed Growth in Nominal GDP

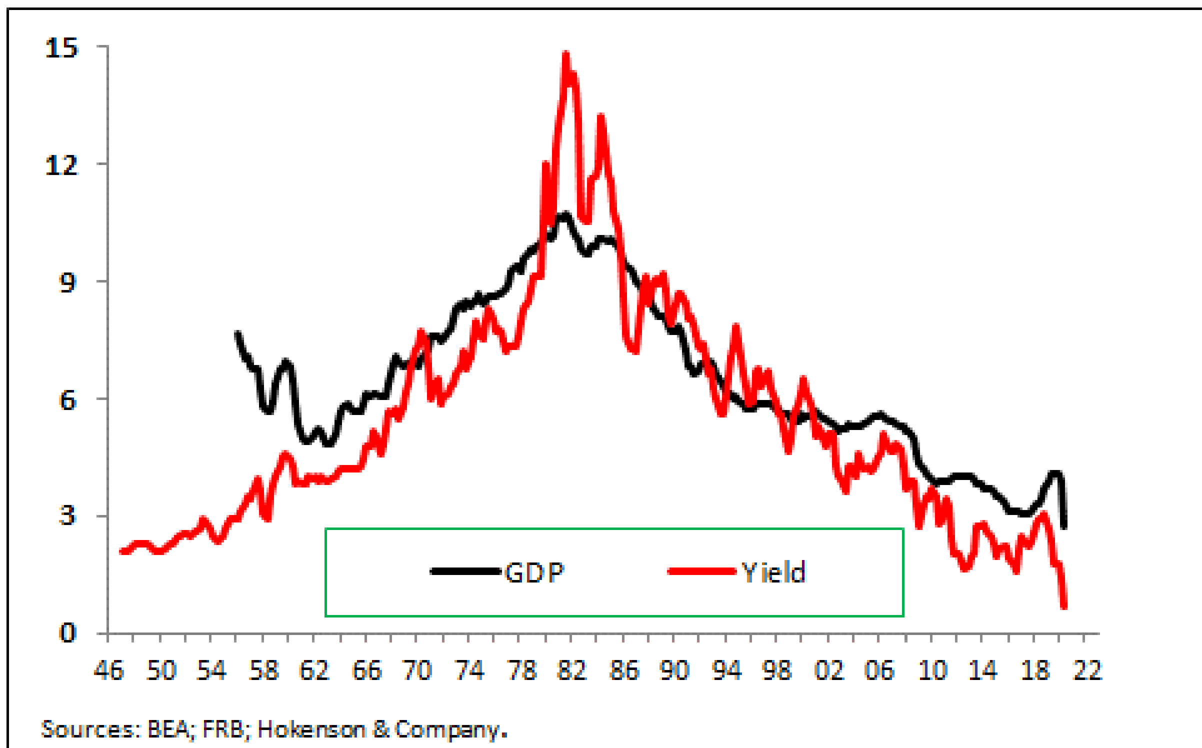


Chart 5

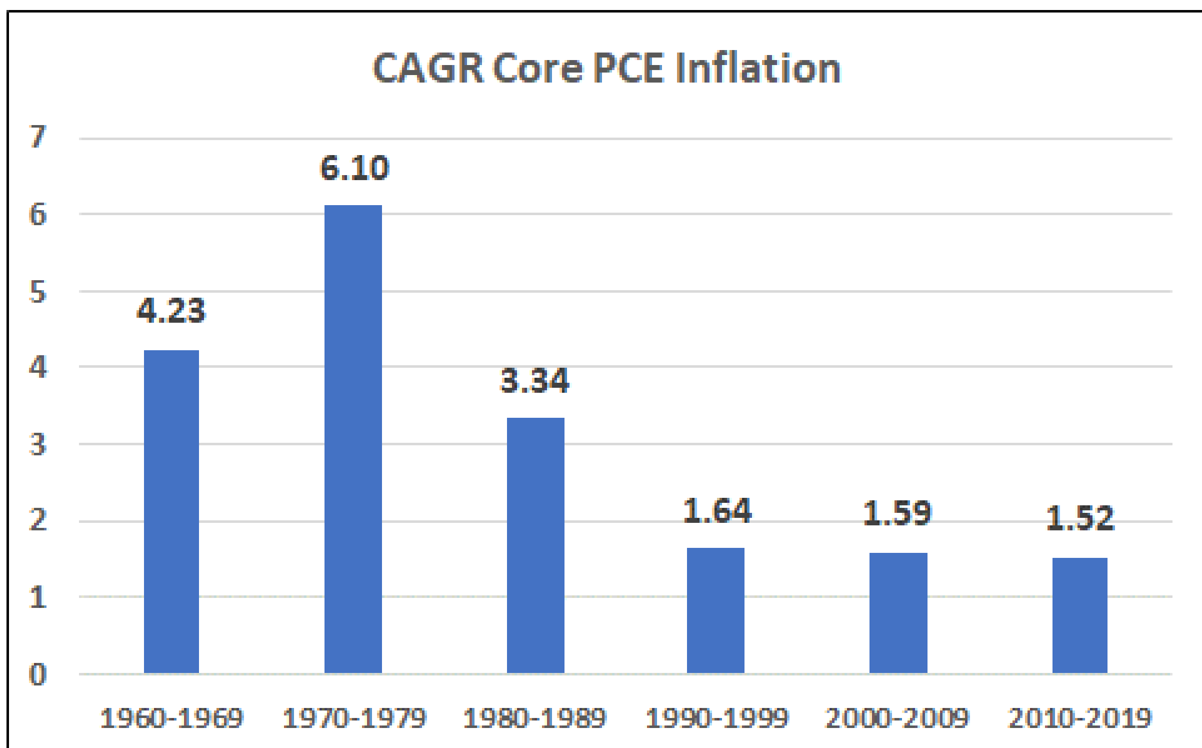


Chart 6