GLOBAL MARKETS UPDATE

How the timing of rate cuts could affect bond yields

- **We think that sovereign bond yields in most major economies will generally reach their troughs around the same time over the next year or so. But with the Bank of Japan seemingly set to buck the trend once again, yields there may be an exception.**
- **The recent plunge in sovereign bond yields is a reflection of growing expectations that central banks are poised to cut interest rates aggressively.** (See Chart 1.) **A key question is whether any differences in the *timings* of the upcoming easing cycles will matter at all for those yields.** To answer this, we've looked at monetary cycles since the 1970s and how they've interacted with yields.
- **For a start, it's worth noting that sovereign bond yields in the major developed market economies have moved a bit less closely in the 2020s so far than they did over the preceding two decades. But they're still tightly correlated, especially when compared with the 1970s and 1980s.** (See Chart 2.)
- **In part, that's probably because monetary policy in the major economies was significantly out of sync for extended periods back then, in a way that's arguably happened less since.**
- The "Volcker shock" for example, – the rapid Fed tightening cycle that began in the late 1970s – started while short-term rates in Japan and West Germany were *falling*. (See Chart 3; admittedly, short-term policy rates haven't been central banks' preferred tools of monetary policy over the entire period shown, but we think they still provide a decent guide to whether policy is being tightened or loosened.) Perhaps as a consequence, although the 10-year Treasury yield started to rise around the start of 1977, 10-year yields in the latter two economies didn't increase in earnest until about two years later when local central banks started their own tightening cycles. (See Chart 4.) And the 10-year yield subsequently *peaked* much earlier in Japan than elsewhere, probably because that country's central bank began to cut much sooner.
- The mid-to-late 1980s was a similar picture. It's true that the Fed's modest monetary tightening in the middle of the decade, which occurred as other major central banks were still cutting, seems to have put some upward pressure on yields outside the US, especially in Germany. But yields in those other economies didn't really begin to rise significantly until their central banks began to tighten later that decade.
- Indeed, by the late-1980s/early-1990s, the picture on yields had reversed: they were rising much more sharply in Europe and the UK than in the US, partly because of the monetary tightening in Germany in response to that country's post-unification economic boom. (The UK and some other countries were forced to tighten as well, in part because their exchange rates were fixed to Germany's through the ERM. But the Fed, by that point, was *cutting* rates.) And while those hikes in Europe did seem to put some upward pressure on Treasury yields, the effect was only small. The result was that the late-1980s/early-1990s cycle peak in the 10-year Treasury yield occurred almost three years before the peak in the 10-year bund yield.
- **But monetary policy synchronisation – or lack thereof – probably isn't the whole story.** The Fed's mid-90s "opportunistic disinflation" hiking cycle began while other major central banks were *cutting* rates (although the Bank of England did belatedly join in the hiking cycle by late in 1994 when the Fed had almost finished hiking). But 10-year sovereign bond yields – especially outside of Japan – moved more or less in line with the 10-year US Treasury yield.
- There was also some variation in the timings of the tightening cycles of the mid-2000s, and yet the peaks and troughs in bond yields, even in Japan, lined up fairly closely with those of yields in the US.
- **It may be that financial globalisation – which has made investment flows more mobile over time – has forced bonds elsewhere to track Treasuries more closely. But regardless of the cause, the experience of recent cycles suggests to us that it would take a significant divergence in monetary policy to result in notably different cycles in sovereign bond yields. That's not, for the most part, what we expect.** We expect the Fed, the ECB and the BoE to start to cut next year, even if the BoE may be a bit later than the other two.
- **What does this mean for our forecasts?** Despite the fall in yields and policy rate expectations recently, we still think investors are underestimating how fast the Fed will cut rates over the next couple of years, which is why we think yields in the US have further to fall. By contrast, we think they are, if anything, a bit too

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dovish on the ECB (and, in the near term, the BoE) following the especially big falls in yields in Europe lately. But, as has been the case over the past three decades or so, we suspect the fall in the 10-year Treasury yield we project would be enough to drag down yields in Europe regardless, and yields in all three economies would reach their troughs around the same time.

- **Japan is the only developed market economy, in our view, that could still be an exception on this front.** Admittedly, we expect only a fairly token hike there at the start of next year, to bring the policy rate back above zero. And the 10-year JGB yield *has* broadly tracked cycles in other yields over the past couple of decades, even if its moves have been much more muted. That's partly why we don't expect a big rise in that yield next year. But we do think the difference in monetary policy with elsewhere will be enough at least to keep the 10-year JGB yield as high as it is now even if, as we expect, yields fall a bit further elsewhere. And it's possible, in our view, that Japan's first rate hike since the mid-2000s prompts a bit of a bigger reaction in the domestic bond market, helping the 10-year yield there *rise* a little, perhaps even surpassing its recent peak.
- **We'll publish a full set of updated forecasts for sovereign bond yields – and for other major global financial markets – in our *Global Markets Outlook* next week.**

Chart 1: OIS-Implied Federal Funds Rate Expectations & 10-Year Treasury Yield (%)

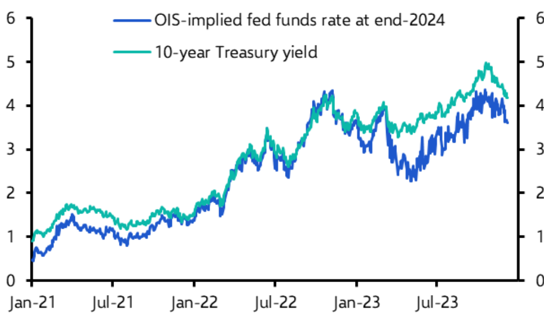


Chart 2: Correlations Between Monthly Changes In 10-Year Sovereign Bond Yields & 10-Year Treasury Yield

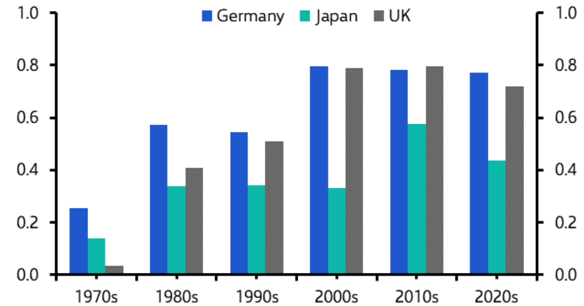


Chart 3: Central Bank Policy Rates (%)

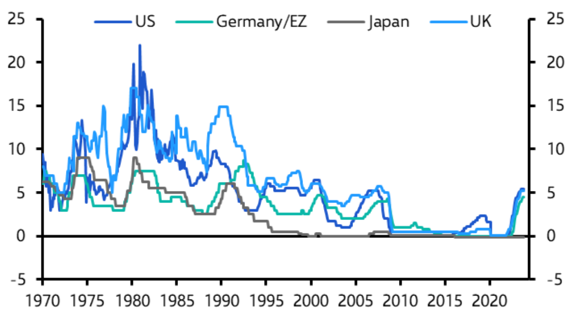
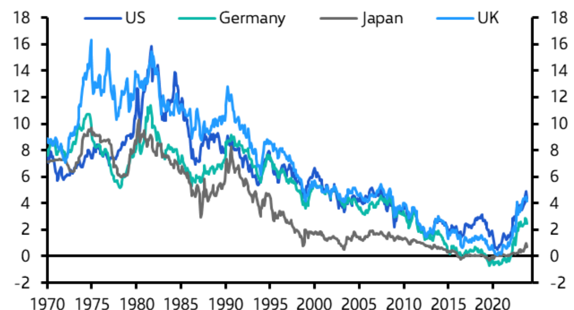


Chart 4: 10-Year Sovereign Bond Yields (%)



Sources: Bank of England, Refinitiv, Capital Economics

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