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U.S. Bond Sell-off Putting Pressure on Other Parts of the Economy

By Mohamed El-Erian
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Over the last few weeks, and especially last week, we have witnessed dramatic moves in a market that is central to many financial and economic activities around the world.

On Wednesday [May 27] alone, the yield on the 10-year bond surged by an unusual 19 basis points (to more than 3.7%), bringing the one-month move to almost 100 basis points. All this took place despite dramatic policy actions to keep interest rates low, not only by anchoring the overnight rate near 0% but also through direct purchases of securities by the Federal Reserve.

So, what is going on and why should investors and policymakers care? The answer is simple yet consequential: the bond market's gyrations are significant in terms of the causes and implications – the why and what now. On the why, four factors are currently in play:

First, the market is coming to grips with the U.S. Treasury's bond issuance plan which involves a massive jump on account of the country's stimulus package, the funding of multiple emergency facilities, and compensating for the recession's impact on tax collections.

The amounts involved are huge, whether you use absolute, relative or historical metrics. As an illustration, just look at the error term we attach to our 12-month issuance projection: +/- \$500 billion (£309 billion) around a central forecast of \$2 trillion. The error term is bigger than the largest 12-month issuance in history.

Second, the market is internalizing the Treasury's desire to reverse a trend that has seen the average life of its outstanding debt fall to just 48 months. Such a low level has not been recorded since the beginning of the 1980s. It is not a good position to be in on the eve of an era of major debt issuance. If the low average debt maturity is not addressed, look for an increase in the government's vulnerability to refinancing risks.

Third, there is concern about a potential deterioration in inflationary expectations notwithstanding the fact that the country is still mired in recession. This has technical, political and economic dimensions.

Markets have started to recognize that it will not be easy for any future government to drain the enormous amount of emergency liquidity that is being pumped into the system. History is full of examples where, facing various uncertainties and resistance, governments overstay their presence in the emergency mode.

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Technically, it is very difficult to determine with confidence whether the economy is ready for a withdrawal of emergency support. As a result, once committed to the task of stabilization, governments can end up doing too much rather than too little. Then there is the political angle. It is difficult to say "no more" to sectors that benefit from subsidized funds.

Markets are also starting to realize that the speed limit for sustainable U.S. economic growth is coming down as credit contracts, saving behavior changes, and regulation increases. Put all this together and you come to a simple conclusion: inflationary pressures will take hold well before what would be expected based on recent historical experience based on "output gap" analyses.

Finally, S&P's announcement earlier this month that put the U.K.'s AAA rating on negative outlook is a reminder that the sovereign risk of the U.S. could eventually also be in play. And this is more than a U.S. issue. It is an uncomfortable possibility for all those large holders of U.S. debt around the world that had been attracted by the U.S. dollar's role as the world's reserve currency, and by the depth and predictability of U.S. financial markets.

The Treasury bond sell-off is now putting pressures on other markets in the economy. We should worry most about housing where borrowing rates are rising notwithstanding the Federal Reserve purchase program. Indeed, according to data released on Thursday, already 12% of U.S. households are facing difficulties meeting their mortgage payments.

Housing is still central to the stabilization and eventual recovery of the U.S. and global economies. Any further decline in house prices will erode the collateral many Americans borrowed against, dampen their already-fragile consumption appetite, and increase the headwinds facing a banking system that is finally regaining its footing. The U.S. can ill-afford a further sell-off in U.S. bonds at this stage in the economy's rehabilitation process. Yet there is no easy way for policymakers to address this challenge.

As an illustration, consider the dilemma facing the Federal Reserve. Should the central bank step up its purchases of both Treasuries and mortgages in order to stabilize interest rates, but at the risk of adding to the distortions in these markets; or should it refrain from intervening further and risk a return of widespread economic and financial disruptions?

I suspect that, when push comes to shove, policymakers will opt for greater purchases of mortgages and Treasuries – not because they really want to, but because the alternative is viewed as worse.

Believe it or not, there is a silver lining in all this. As they contemplate this difficult situation, they can draw some comfort from one thing: with the anchoring of the short-term policy rate near 0%, the steepening of the yield curve is generating significant profits for banks.

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Remember, banking is fundamentally about mobilizing cheap deposits (at the short end of the curve) and, supported by deposit insurance and central bank liquidity windows, lending at the longer-end of the yield curve. Come to think of it, the smartest trade for investors today is to find a bank that, unencumbered by legacy issues, is able to take advantage of an enormously attractive environment for old-style banking.

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