Just how dumb are the bond markets?

Tim Farrelly | farrelly's Investment Strategy | 03 August 2018

As QE turns to QT, central banks are going to be effectively selling bonds instead of buying them. On top of this, we have the US tax cuts dramatically increasing the size of the US budget deficit - meaning that the US Treasury will also be selling a lot more bonds to finance that deficit. All that selling must push prices lower and bond yields higher.

The big question is - when? Most pundits suggest that 'when' is in the future. Effectively, this narrative says that financial markets are really, really dumb. None of this information is a secret, so, unless all bond traders are monumentally stupid, the move should largely have already occurred.

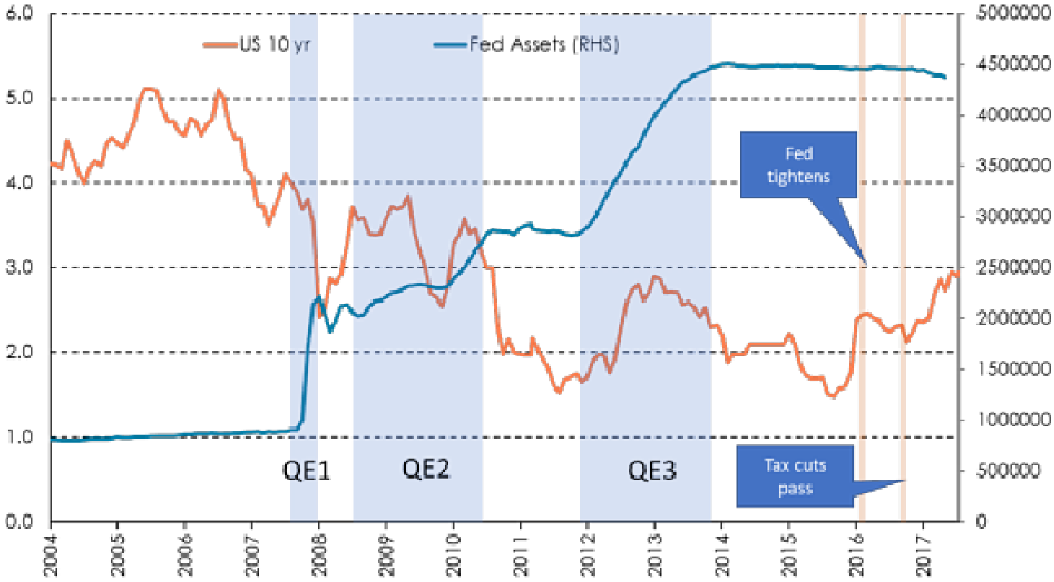
Let's look at some facts – as shown on Figure 1, highlighting US bond rates and the size of the Fed's balance sheet. If the "markets are really dumb" crew are correct, then periods when QE was on (the blue panels) should have coincided with falling bond yields and vice versa. What we see is quite different. During QE1 – in the middle of the GFC – bond yields did fall. However, as those with good memories will recall, there was rather a lot going on in the world at that time. During QE2, yields largely went sideways. Between QE2 and QE3 bond rates fell when the dumb market theorists felt they should have risen. And, during QE3, bond rates rose rather than fell. When QE3 ended, bond rates fell for some time rather than rose as the dumb market crowd would have expected.

In recent times, US bond yields have had two major jumps – in October 2015, when the Fed announced that they would start increasing cash rates, and again in October 2017, when the US tax cuts and associated deficits became a reality.

In other words, all the evidence suggests that the dumb market theory is, well, really dumb!

If US bond rates go higher from here, it is likely to be in response to something we don't yet know, rather than what is already out there. Markets are not perfectly efficient – but they are not nearly as dumb as many would suggest.

Figure 1: QE and US 10 yr bond yields



Source: US Federal Reserve

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