How worried is the bond market?

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A flat yield curve, and very low absolute yields on sovereign debt, are classic signs of economic fear and loathing in the bond market. Flat, and particularly inverted yield curves, have been reliable harbingers of recession, or at least as reliable as any other signal, including the consensus of economists.

But the recession warning is typically generated in an environment in which rising short rates have eclipsed long rates, with the market betting that the tightening has been excessive. That's hardly the story today, after one meagre Fed hike and rate cuts elsewhere. Today's yield curve has been distorted by central bank purchases aimed precisely at lowering long-term rates, a policy necessitated by the lack of room for action at the front end.

There's another bond market fear indicator that seems, on the surface at least, to be shouting an all-clear-ahead view of the world. What's rallied even more than Treasuries since earlier in the year has been corporate debt, including high yield bonds. Spreads that had been blowing out returned sharply to earth, and are close to historical averages.

That's a remarkable achievement since, given how low government yields sit, corporates are raising capital in the bond market at very slim absolute yields. Such yields are typically a sign that other than for a handful of special cases, investors don't see soft economic data deteriorating to the point at which defaults climb.

Or is this simply a case of closing your eyes and hoping for the best? Rather than improving sentiment on risk, investors may be responding to the abysmal (and even negative) yields on sovereign debt, and the impact of QE on the availability of such issues, by moving out the credit curve. Just as duration risks have been put aside in an effort to avoid the lack of return in short dated bonds, investors are taking on spread product to get closer to the yields they "need" to meet their target returns. There could still be room for further spread compression given that QE is alive and well in so many countries.

For now, the carry in spread product remains attractive, and an overweight in corporate debt could also be a safer bet for yield enhancement than duration. But given that this spread narrowing has been divorced from its usual link to falling economic risks, signs of economic improvement in the US in the latter part of the year could fail to have their typical impact on spreads.

Instead of rallying on dampened default risks, spreads could actually see a modest widening if government yields start to move higher, making it less urgent for investors to buy lesser credits to reach a given yield. That might be a slow process in euro-denominated debt, since sovereign debt is starting from outright negative rates, but could emerge a bit earlier in North America if long government debt at least provides a positive real yield.

If so, for corporates looking to tap the bond markets, there's no time like the present.