FIXED INCOME

# BOND BEARS SCENT BLOOD AS BUNDS LEAD WAY DOWN

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Is this the big one? For those who have sat out the seemingly unending rally in sovereigns for the past four years, the sharp rise in bond yields raises the question of whether this is the moment the world ran out of greater fools.

'[This is the start of an] ultra-long-term grinding adjustment, with the odd sharp shock along the way,' predicted long-standing bond bear Ian Williams of Charteris. 'A proper long-term bear market in bonds.'

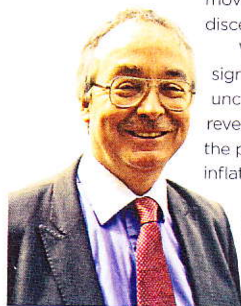
Bunds have led the way in the retracement since German CPI data surprised to the upside on 30 April, with 10-year bund yields since blowing out almost 60bps at the time of writing. The 30-year has also almost doubled from 0.75 bps to 1.3%. That is the largest two-week move since the late 1990s.

Europe and the rest of the G7 have since followed, with the US Treasury 10-year up 0.25 bps to 2.4% and the 30-year up 26 bps to 3.01%. Ten-year gilts have risen 19 bps to above 2%. Italian, French, Spanish and Portuguese sovereigns of the same maturity have moved between 34 bps and 47 bps over the period.

For the technically minded, bund yields have risen above both 50 and 200-day moving averages in a straight line with no discernible sign of resistance.

While economic data and official rate signalling have remained effectively unchanged, this has coincided with a sharp reversal of inflationary expectations. Over the past three months, German short-term inflation swap yields have risen 1.5%.

'Thirty-year bund yields in Germany that are less than 50% of the ECB's target inflation rate, do not make fundamental sense when the central bank is willing and able to deploy extraordinary policies to achieve that inflation,' noted Mark Holman, chief executive of TwentyFour Asset Management.



Ian Williams: This is the beginning of a long-term adjustment

'The market has now woken up to this. The rationale for those ultra-low yields has gone for now and the market is readjusting. Where they go to from here is hard to forecast...the shorter-term trend is higher and we do not want to stand in the way of that.'

## Inflows continue

Flow data suggests there may be a fairly substantial overhang of money to clear before fixed income can catch a bid. Broad bond market funds recorded 17 weeks of straight inflows over the 17 weeks to the end of April, including $5 billion (£3.2 billion) over the week to the first of May.

'Few positioned in April for US consumers to stay weak, or a German rates shock,' said Michael Hartnett, chief investment strategist at Bank of America Merrill Lynch. He was one of the few observers in recent months who warned that bunds appeared very tangibly mis-priced versus inflation. 'Correction risks [remain] elevated.'

'While the bank said that on a short-term trading basis, it believes it has seen most of the immediate move in bunds, it added that further volatility should now be felt in European equity, US fixed income and the EUR/USD exchange.

BoAML technical strategist MacNeil Curry added: 'Euro Stoxx 50 should also suffer further as bund yields rise, particularly following the completion of a five-week head-and-shoulders top.

'While most eyes are on the price action in European fixed income and EUR/USD, US fixed income volatility is [also] starting to look very ominous.'

That appears to have provided some underpinning to a sharp rally in the euro, up 8% versus the dollar since its low in mid-March or 4.5% on a trade-weighted basis.

Forward inflation expectations reflect both a remarkable rally in oil prices (up 41% since January) and some industrial commodities such as copper (up 18%).

It also suggests the anticipated effect of rebasing, once annualised CPI begins to reflect a big increase in 12-month inflation in the second half.

'These positive inputs into the CPI are huge and will have a huge effect on the inflation number in a few months' time,' said Williams.

'Oil is now back to $65 a barrel. And next January, when the fall drops out of the index, it will be replaced with a rise of +62%. Assuming it stays here, if it, say, goes up to $75 a barrel [the lowest price where new shale production can start], the input rise would be 88%.'

That escalated quickly: Bund sellers have found no resistance
Source: Reuters

The biggest two-week move since the 1990s for German yields
Source: Reuters