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R&R Weekly Column
By Brunello Rosa

Will Inflation And Higher Yields Mark The End of The Secular Bond Bull Market?

Government bonds have been among the most successful asset classes available to investors in the last few years, together with equities. Central banks brought their policy rates down to zero in response to the dot.com bubble in early 2000s, and in response to the global financial crisis of 2008-09 central banks started to conduct large scale asset purchases (LSAPs), in what has been called Quantitative Easing. All these policies, together with *forward guidance*, have brought market rates to historically low levels, in some cases into negative territory in economies such as the Eurozone and Japan.

But the beginning of the secular bull market in sovereign bonds (and, by extension, corporate bonds) dates back to the 1980s. After Paul Volcker raised the Federal Reserve's policy rates into double digit territory in order to defeat the persistent inflation that had originated from the two oil shocks of the 1970s as well as from the rupture of the Bretton Woods agreement, the subsequent secular decline in policy and market rates began a bull market that still persists today, almost half a century later.

In 2021, however, inflation has raised its ugly head after many years, a result of the pandemic. Bottlenecks in global supply chains, base effects, higher energy prices, and the re-opening of the economy following pandemic restrictions have all helped lead to a rise in inflation around the globe, especially in the US, where the rate of inflation has reached almost 7% y/y, and in the Eurozone, where it is already above 5% y/y.

Central banks have reacted by turning hawkish, as we discussed in several columns recently. This *volte-face* has surprised the market; there is a possibility that central banks will continue to tighten their policy stances more quickly than anticipated. Several central banks, in both DMs and EMs, have already increased their policy rates in the last few weeks.

Sovereign and corporate bonds have severely underperformed recently as a result of all of this. According to a recent article by the Financial Times, "the Barclays global aggregate bond index — a broad benchmark of $68tn of sovereign and corporate debt — has delivered a negative return of 4.8 per cent so far in 2021." This negative performance could spill into 2022 if inflation proves to be more persistent, and if central banks prove to be more proactive in trying to tame inflation than they are currently expected to be.

Other asset classes sensitive to inflation and higher yields, such as equities and real estate, may suffer as well, but the greatest impact would be felt by sovereign and corporate bonds. That being said, this may not yet be the end of the story. As we discussed last week, central banks do not seem to have wholly factored in the impact that Omicron (and the restrictions enacted in response to it) will have on economic activity. The combination of new restrictions and tighter monetary policy may result in such a dramatic halt in economic activity that inflation will eventually fade, and central banks may therefore need to undo some of the policy tightening they have thus far introduced. This may lead to a renewed phase of bullishness in bond markets in the earlier part of 2022.

In conclusion, while the prospects for bond markets do not seem particularly encouraging at this stage, we think it is still a bit too early to write off this asset class for 2022.

Our Recent Publications

- Major G10 Central Banks Turn Hawkish As Inflation Rises and Omicron Spreads, *by Brunello Rosa, 17 December 2021*
- Preview: ECB To Launch Its Post-Pandemic Policy Package, *by Brunello Rosa and Nouriel Roubini, 13 December 2021*

Looking Ahead

The Week Ahead: EZ M3 Money Supply To Slightly Fall; Unemployment Rate In To Remain Japan Unchanged

In the EZ, the November M3 money supply is expected to slightly fall to 7.6% y-o-y, from previous 7.7%.

In Japan, the unemployment rate for November is expected to remain unchanged (*c*: 2.7%; *p*: 2.7%).

The Quarter Ahead: Saving Scheme For Turkish Lira; Russian Proposal To NATO; New Leader Of the CDU Appointed

Turkey's lira surged sharply after President Erdogan disclosed a new scheme to safeguard deposits from FX volatility. The intense volatility of the Turkish currency may be interrupted by an interest rate hike. The scheme and higher rates may lure back investors, which have lost confidence in Erdogan's ability to manage the economy.

President Putin warns NATO of "appropriate military-technical measures" in response to NATO's expansion towards Russian borders. Russia has published a draft of security proposals demanding a retreat of NATO's and US troops in eastern Europe. Authorities are now preparing talks with Putin over the security proposal, nonetheless it is likely that the implementation of the proposal would reshape the post-cold war European security order.

People's Bank of China has cut lending rates as one of the measures adopted to counter the loss of economic momentum. The Chinese economy has recently come under pressure due to energy shortages, weakening consumer spending and property prices slowdown. Experts say that more cuts might be implemented in the first half of 2022.

The successor to Angela Merkel has been appointed. The conservative member of Parliament Friedrich Merz is to become the leader of Germany's centre-right CDU after winning a short contest among the party's members. Merz's responsibility is to boost the party's morale, which has been dented by the result of the recent Bundestag election.

Brexit negotiations to avoid a trade war are still ongoing. Brussels is hoping that the new chief negotiator, Liz Truss, will be more of a partner than an enemy, and it is not changing the UK's position on the post-Brexit trade deal. Despite the fact that Truss seems to be more prone to negotiations, Prime Minister Boris Johnson will still have the last say on the future of trade between EU-UK.

Last Week's Review

Real Economy: US PCE Deflator Rises; Loss In Consumer Confidence in EZ

In the US, the PCE deflator increased to 5.7% in November, with core PCE deflator reaching 4.5% y-o-y, as gasoline and vehicle prices continued to rise.

In the EZ, consumer confidence indicator fell to -8.3 points in December, due to mounting concerns over the Covid-19 Omicron variant.

In Turkey, the Turkish lira was trading around 11.5 to USD, recovering from previous 18.4 after President Erdogan announced a new scheme to safeguard bank deposits from currency depreciation.

Financial Markets: Global Equities and Gold Prices Ending the Year Higher

Market drivers: Last week's main market movers were: *i)* evidence that the Omicron variant might not be as disruptive as feared; *ii)* announcements of policy shift by the Fed, BoE and some other central banks in Eastern Europe and Latin America; *iii)* volatility in technology stock prices.

Global equities increased w-o-w (MSCI ACWI, +0.03%, to 749). In the *US*, the S&P 500 ended higher (+0.62% w-o-w to 4,726). In the *EZ*, shares rose (Eurostoxx 50, +1.16% w-o-w, to 4,266). In *EMs*, equities increased (MSCI EMs, -0.08%, to 1,221), while the Chinese stock prices dropped (Shanghai Comp., -0.69%, to 3,618). *Volatility* remained unchanged (VIX S&P 500, almost unchanged at 18, *52w range.:* 14.1-37.51).

Fixed Income: US 10-year bond yield remained almost unchanged at 1.50%, while Germany's 10-year bond yield dropped, remaining in negative territory (-0.2bp, to -0.25%). The EMTX 7-10 RT decreased by -1.12pts, to 281.

FX: w-o-w, the US Dollar Index fell (DXY, -0.02%, to 96.035 pts; EUR/USD fell by -0.07%, to 1.320). In *EMs*, currencies strengthened against the USD (MSCI EM Currency Index, +0.15% w-o-w, to 1,733 pts).

Commodities: Oil prices fell (Brent, -0.1% w-o-w, to 76.52 USD/b). Gold futures slightly rose (+0.01% w-o-w, to 1,810 USD/Oz).

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The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	thousand	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*