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Term premia rising: The financial market implications of higher interest rate risk

The large global bond market selloff of late has naturally elicited much commentary from investment strategists and the financial media. By some estimates as much as $1tn in bond value has been wiped out. That is a large number. But what is behind the selloff? Did expectations for Fed rate hikes suddenly surge? In fact, rate expectations have risen only modestly, perhaps in reaction to president-elect Trump's expected fiscal stimulus plans. More important has been a large expansion in so-called 'term-premia' for longer-dated bonds. Term premia represent the additional yield bondholders require for holding long-dated bonds as opposed to short-dated paper. When premia fall, so does the real cost of long-term borrowing and vice-versa. This is why recent developments are of such interest, as premia have remained structurally low for years. In this report, we explore the implications of a premia reversal on financial assets, the dollar and gold. In brief, gold is highly likely to outperform financial assets in this environment, although not necessarily the dollar itself. The key to the dollar is to understand the Fed's reaction function to the above.

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Although it may have coincided with president-elect Trump's surprisingly successful campaign, in fact the global bond markets have been indicating that a trend reversal might be underway for some time. On trend, yields have been declining for many years. However, in 2016, there had already been a notable loss of momentum. The great global bond market rally had, for the most part, ground to a halt. Central bank policy rates were already zero to negative in most of the developed world, and commodity and consumer price inflation had begun to trend higher again, if only gently in most economies; so it was understandable that the bond market rally was probably nearing exhaustion.

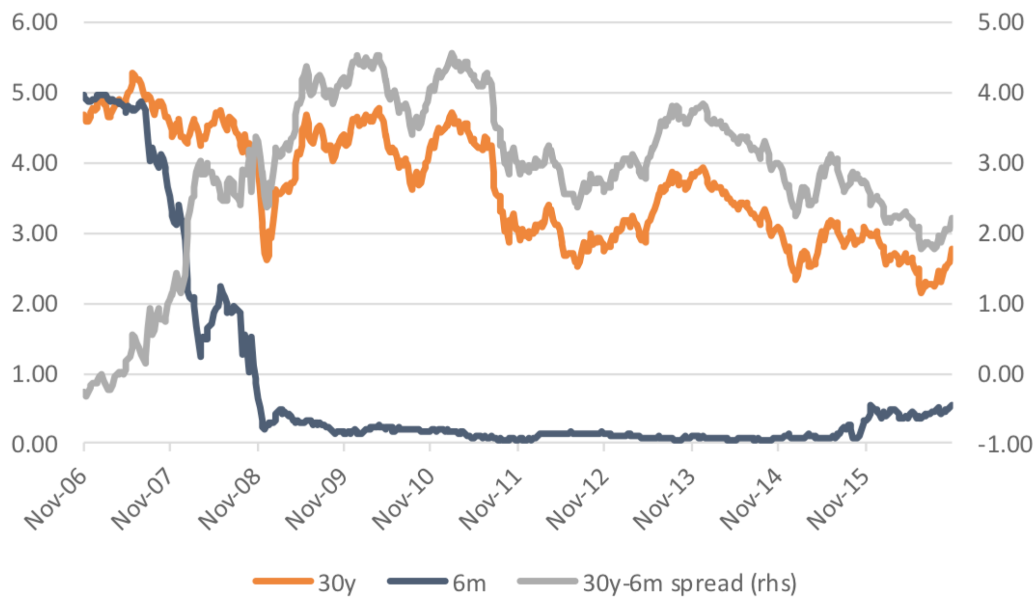
However, Trump's election appears to have awakened the so-called 'bond market vigilantes' from an unusually long slumber. Why? It is well-known that Trump has said he will cut taxes—most Republican presidential candidates have done so historically, especially amid a weak economy—but it is not at all clear how he plans to prevent this leading to a surge in the deficit. Hence there is a general expectation that some fiscal stimulus might be on the way under Trump's administration. That could be negative for bonds.

Regardless of the catalyst, the reality is that bond yields have soared of late. When looked at in risk-adjusted terms, the carnage has been historic. Many investors measure their returns in this way, that is, they place returns in the numerator and divide them by the volatility of that return stream. This risk-adjusted return concept, primarily associated with Nobel-prize-winning economist Robert Sharpe, can be applied to all assets in theory, but is most commonly applied to relatively liquid assets which can be liquidated at any time in large amounts without materially affecting the overall price in the market for the assets in question.

By way of example, imagine for a moment a bond yielding 5% losing 10% of its value. Using simple math—excluding compounding effects, etc—this selloff wipes out two years' worth of that bond's returns. Now imagine a bond yielding only 1% losing 10%. This results in that bond losing 10 years of returns. Presumably, given that investors, like all people, care about returns over time, the latter loss is more painful than the former. With bond yields currently so incredibly low in a historical comparison, yet with volatility now having surged and produced huge losses, the ratio of the numerator to denominator is thus at a historic low point, probably the lowest within the lifetime of anyone investing today and perhaps reaching back multiple generations. It is indeed historic.

Looking behind the sell-off, what we see is that it was primarily the result of a rise in so-called 'term-premia', which is the compensation that investors require to assume an exposure to unexpected future path of long-term interest rates. (It is important to distinguish carefully between actual rate expectations, and the uncertainty premium added on top. The latter can be derived by subtracting the forward short-term interest rate as visible in the futures markets from the long-term eg 30y interest rate.)

Figure 1: The yield curve has not only shifted upward but steepened of late. This is unusual and indicative of rising term premiums



Source: US Federal Reserve, Goldmoney Research

As with all things in investing, uncertainty requires compensation, or no one will accept exposure to the uncertainty in question. While ultimately all calculations of uncertainty are subjective, so is the determination of term-premia. There is no 'right' answer, just the market's determination of what constitutes fair compensation for risk at any given point in time. The market price is thus that which clears the market, in this case that for long-term interest rates.

When it comes to government bonds, there are multiple sources of uncertainty. The future price level is uncertain. The supply of bonds vis-à-vis other assets is uncertain. The underlying currency of the bond might swing around in value, something of particular concern to international investors. The bonds might, in extremis, be defaulted on, although this is exceedingly rare in the case of governments with access to a printing press, as most governments have, with the notable exception, at present, of euro-area member countries.

Regardless, uncertainty, and the volatility associated with it, is both the investor's friend and enemy. There is no return without risk and, to the intelligent investor at least, no risk will be taken without a sufficiently attractive potential return. The trade off in question may be relatively small in the case of government bonds given their perceived safety. But here, too, safety is in the eye of the beholder. Do governments always make good on their promises? Of course not. But unlike financial analysis, such as that which can normally be done with corporations and their balance sheets, income statements, cash flows, etc, government finances are so opaque and the political risks so qualitative in nature that they normally defy any robust quantification. Indeed, one could argue that many investors simply place their 'faith' in governments. However, history instructs that this can be a dangerous mindset at times.

Returning thus to the recent sell-off, there is simply no way to know what mix of the above risk factors is behind it. We can speculate, but not analyze in any detail. If we just accept rising uncertainty for what it is, however, we can derive certain implications for the financial markets, the dollar and gold.

The shift higher in uncertainty, should it continue, implies a higher cost of borrowing, other factors equal, such as the specific growth/inflation mix in the economy. In other words, growth may be weak, as we know, and inflation may be low (if rising), as we also know, but for whatever reason, if investors are now demanding more compensation for holding bonds, then borrowing costs can rise regardless. This additional compensation must come from somewhere in the economy, and so it leaves less on the table for those who would use that particular slice of available funds to spend instead. As such, it will reduce the potential growth rate of the economy. With global commodity prices probably having bottomed out at this point, the net result is likely to be one of 'stagflation'.

That, to put it plainly, is horrific news. For when an economy already struggling to grow is faced with a shift higher in term premia, it only makes whatever problems exist even worse. As I once explained to the Chief Economist of a bulge-bracket US investment bank, "Higher real bond yields aren't predicting a crisis; higher real bond yields ARE the crisis!"

Emerging market finance ministers that have faced funding crises in recent decades understand exactly what I mean by that statement. Beyond a certain, unknowable point, term premia rise to the extent that an event horizon is crossed and some combination of default and devaluation, almost always the latter if you own your own printing press, becomes unavoidable.

Hence a trade off approaches. Beyond a certain point, the Federal Reserve will need to decide whether to fight the reawakened bond-market vigilantes or not. If it doesn't fight and allows interest rates to rise as the markets desire, bonds will continue to lose value and the equity markets will almost certainly also underperform, as their valuations will begin to appear too expensive to bonds in relative terms. If the Fed does fight by engaging in, say, another round of QE, it will encourage the dollar to decline instead which, if persistent, could lead to the loss of the dollar's dominant international reserve status.

While not generally appreciated in significance, a loss of dominant reserve status is where the dollar as we know it ends. There is simply no way that the world's largest creditor nation—the US—can lose its dominant reserve position and still expect the dollar to be accepted internationally at anything close to its present value in real, purchasing power terms. But while that may seem obvious, the cognitive dissonance suffered by many is that there is no alternative to the dollar and, thus, the dollar will somehow hold on. After all, the euro has issues, the Chinese yuan has issues, the yen has issues, sterling has issues, etc.

But there is an alternative, just not the one mainstream economists might have in mind, namely, the only truly international currency, one that cannot be printed or otherwise manipulated by any one government to further its own national economic interest: gold. Whether gold is in any way officially re-monetized at the international level is, in a way, beside the point. Gold is highly liquid, accepted everywhere, and thus stands at the ready to serve as an international reserve asset. Exporting nations can, if desired, convert whatever portion of their dollar trade into reserves of gold instead. That would place downward pressure on the dollar and upward pressure on gold.

Combining the probable effects of structurally rising term premia on bonds, stocks and the dollar, the outlook for gold is becoming increasingly asymmetric to the upside, as we have observed in several previous Insights[1]. Yes, the Federal Reserve might allow bond yields to keep on rising, but that implies an outperformance of gold vis-à-vis financial assets, just as occured in the stagflationary 1970s. Or, the Fed will seek to halt the rise in yields with QE or some other unconventional policy, and the dollar will decline versus gold if not necessarily versus other currencies. In either case, gold is likely to outperform financial instruments generally as a store of value.

A final observation to make is that there is some evidence that president Trump is sympathetic to the idea that a gold-backed monetary system is superior to an unbacked

[1] Josh Crumb, Inverted Asymmetry, Goldmoney Insight, 20 September 2016. Link here.

one dependent on a central bank to maintain economic and price stability. Trump could, in theory at least, rescind president Nixon's executive order from August 1971 'temporarily' suspending the dollar's convertibility into gold. What this would do is awaken from their even longer slumber the 'gold vigilantes' who would seek to clear the market between the vast amounts of dollar reserves circulating around the world, and the market value of gold.

By implication, the price of gold would soar. While precise estimates are difficult to make, one approach would be to allow the ratio of the dollar money supply to the value of US official gold reserves to return to where it was, on average, under the Bretton Woods system, when the dollar was convertible into gold. Were that to be done today, depending on one's definition of the money supply, it would imply a dollar price well in excess of $10,000 and possibly more than $20,000[2].

Yes that might seem a huge rise, but all this would do would allow the price of gold to catch up with the exponential growth in the dollar money supply in recent decades. The supply of gold has risen only about 1-2%/yr during this period whereas the supply of dollars has risen by 5-10%/yr or so, again depending on the definition of the money supply. The cumulative effect of that is indeed massive, hence the perhaps surprisingly large revaluation of gold required to restore a credible degree of backing for the dollar.

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[2] *Alasdair Macleod, Fiat Money and Gold, Goldmoney Insights, 20 October 2016. Link here.*