

Global Macro Strategy

Will a Bond Sell-off Derail Global Markets?

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Why Are Bond Markets Selling off Now?

Three major developments have shaken bond markets over the past few weeks (10-year govt bonds for Japan +27bps since late July, and for Germany and the US +13bps in just the last two days). First, in Japan [the policy set-up is starting to change](#) with the government emphasizing fiscal stimulus and the central bank signalling the desire for a steeper curve. Second, in the US, following the Jackson Hole symposium, [the Fed has attempted to maintain the optionality](#) for a hike sometime in 2016. Lastly, [yesterday's ECB meeting](#) confirmed once again the notion that European bond yields are so suppressed that the ECB need only be marginally less dovish to disappoint expectations for excessive easing.

Can the Sell-off Extend?

We think it can, primarily driven from Europe and potentially from Japan (not from the US). 1) From a valuation and a macro standpoint, [Euro-area yields look 70bps too low](#). Against excessively dovish pricing, the ECB need only ease less aggressively than discounted, for bonds to sell-off and curves to steepen. 2) Japanese bond market dynamics will largely depend on the course of action that the comprehensive assessment of monetary policy will signal. As we have discussed, under certain macro policy choices there is room for steeper curves and higher real rates there; at most, a full return to pre-NIRP levels would lead JGBs 30bps higher. 3) In contrast, we see much [less reason or room for curve steepening](#) driven by US bond market and macro dynamics. Amid softening growth and inflation, the US bond sell-off seems mostly driven [by international spill-overs](#).

Will it Derail Global Markets?

Unlikely, but it can give markets a short-term shake. [In our estimates](#), a full back-up of EUR yields towards fair value and a coincident spike of Japanese yields towards early January levels, would push 10y US yields towards the 1.90-1.95 region (from 1.67% currently). These potential moves are substantial but they should not be seen as a regime change for markets. From a macro standpoint, the global environment remains one of [low inflation](#), [low trend growth](#) and accommodative monetary policy. A wobble of 20-30bps in bond markets can also weigh on global equities at this stage, as low yields have been [the predominant driver of equity market resilience](#). However, the deeper the equity damage, the more short-lived the bond sell-off would likely be.

Where are Markets Likely to Settle?

As these moves take place, positioning unwinds, squeezes and dislocations will likely dominate near-term price action. But when the dust settles, we would anticipate the following underlying macro trends to manifest: a) towards year-end bund yields are likely to equilibrate at around 0.15%, b) UST yields are unlikely to end up much higher from current levels (and there is a cyclical drift for a move towards 1.35 in our forecasts), c) the narrowing gap between US and EUR rates will likely support the EUR towards 1.16, d) a dip in equity markets could provide a buying opportunity, e) JPY would experience further appreciation pressures towards and below 100 until the BOJ signals dovishly in a genuine fashion and lastly f) the rush into EM assets is likely to moderate significantly [following a shift in Japan and European yields into positive levels](#).

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