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OPINION

High rates might soon prove to be an aberration

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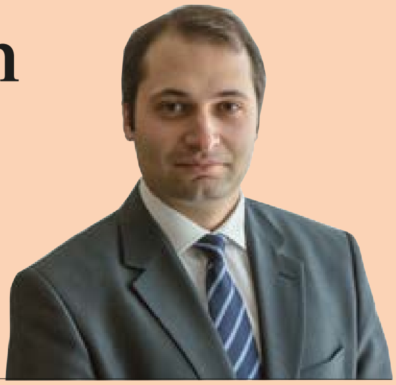

Shift in policymakers' priorities could come sooner than many investors think with a risk of debt crunch looming

Pity the poor bond investor. After suffering devastating double-digit losses in 2022, the fixed income market remains more fragile than at any point since the subprime mortgage crisis. The Move index — a closely tracked gauge of bonds' price volatility — recently hit its highest levels in almost 15 years.

More worrying still is that the instability has been especially pronounced in US Treasuries, the barometer for world debt markets.

In just one week in March this year, the yield on the two-year US government note saw both its steepest daily fall since the 1987 stock market slump and its sharpest one-day spike since 2009. This is not how a defensive asset class is supposed to behave.

True, bond markets were bound to hit turbulence given how aggressively central banks have battled to conquer inflation. In the US, borrowing costs have risen at their fastest rate since the 1980s, ratcheting up from near zero to a range of between 5 and 5.25 per cent in as little as 14 months.

Yet the violence of the market's recent moves suggests there is a new dynamic at play. We believe bondholders have become hostage to the growing conflict at the heart of central bank policymaking.

At issue is how much longer the US Federal Reserve and its peers can continue to place fighting the war against inflation over and above their other official mandate — preserving financial stability.

In our view, the shift in policymakers' priorities could come sooner than many investors think. Interest rates have already risen to a point where they threaten a debt crunch; it may not be too long before they are cut, triggering a rally in bond markets.

That's the picture that emerges from our analysis of public and private debt trends among each of the world's major economies. Although the post-Covid economic recovery helped reduce government debt as a proportion of gross domestic product last year, indebtedness relative to economic output remains well above the levels hit in 2020.

It is hovering at about 96 per cent of gross domestic product. More concerning, however, is that in many developed countries, the volume of public and private debt is growing at a pace that is unstainable over the long run.

To assess a country's vulnerability to a debt crunch, we compare the current rate of increase in a country's public and private borrowing as a share of GDP to the long-term historical trend. The greater the upward deviation from the average, the more susceptible a nation is to a debt reckoning.

The analysis reveals that the US and eurozone are among the economies that find themselves in a potentially treacherous territory with credit-to-GDP ratios of 268.2 per cent and 254.2 per cent respectively at the end of 2022.

According to our calculations, for the US to be able to sustain its debt burden over the long run, borrowing costs would need to decline by some 1.50 percentage points. For the euro zone, the reduction required is even steeper, largely because of Italy's precarious public finances. We find that interest rates across the single currency bloc are running almost 3 percentage points above where they need to be to avert a credit crunch.

Surprisingly, perhaps, Switzerland is also close to the danger threshold with a credit-to-GDP ratio of 315.1 per cent. There, our model shows that it would take only two more modest interest hikes to threaten the country's debt position over the longer term.

None of this suggests central banks are about to suddenly reverse course and begin cutting borrowing costs.

But with the world a far more indebted place than it was before the Covid outbreak, policymakers will be more attuned to the risks of increasing rates any further.

The European Central Bank admitted as much in its recent bi-annual Financial Stability Review.

In the report, the bank warned that the recent tightening in monetary policy had laid bare "faultlines and fragilities" throughout the financial system. It said higher interest rates were beginning to cause strains for governments, businesses and households throughout the region, with property markets looking particularly exposed.

The upshot for bond investors, then, is that this period of higher interest rates may not turn out to be the new normal they were bracing for after all. It might soon prove to be an aberration.

The writer is senior economist at Pictet Asset Management