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HOW DANGEROUS IS THE BOND MARKET CORRECTION?

Berenberg Macro View

Reflation hopes and concerns that central banks may turn off the liquidity taps early are driving a sell-off in bond markets. Does the rise in yields pose a serious risk to our above-consensus outlook for economic growth and for risk markets? Not really, in our view. We see a return of bond yields from ultra-low to still low levels as a consequence of rather than an obstacle to a strong economic rebound and solid gains in corporate earnings in most of the world. Seen from a fundamental angle, the ultra-low yields of 2020 made much less sense than the less depressed yields to which markets are heading now.

In line with our calls for strong economic growth and a trend rebound in underlying inflation towards central bank targets around 2%, we look for 10-year yields to rise to 2.0% for US Treasuries and 0.0% for German Bunds by the end of 2021, with risks tilted to the upside. Starting at 1.0% for Treasuries and -0.5% for Bunds in early 2021, markets have now delivered roughly half that rebound within just two months. As usual, necessary and ultimately welcome adjustments in markets are rarely smooth. Trying to find a new post-Covid equilibrium, markets are prone to sudden spikes and volatility. Technical factors such as convexity hedging in US mortgage-backed security (MBS) markets can contribute to short-term volatility. Fortunately, such short-term volatility rarely hits business sentiment and overall economic performance.

Economic impact: Financing costs matter. If yields were to rise much faster and by much more than we anticipate anyway, we may have to finetune the outlook for interest-sensitive sectors such real estate markets in the US and the UK. But the huge fiscal stimulus in the US and the less headline-grabbing but still significant fiscal expansion in Europe, the combination of pent-up demand for consumer services with huge excess savings of households on both sides of the Atlantic, the need to replenish inventories and the positive outlook for global trade are an exceptionally potent mix. Some normalisation in bond markets will not retard or even derail the strong economic expansion we project.

Inflation outlook: Inflation is making headlines. Special factors such as oil price base effects and transport costs will raise headline inflation significantly in coming months. A strong cyclical rebound and a likely spring and summer hump in prices upon the reopening of pubs, restaurants and theatres as well as the return of long-distance tourism will also feed inflation worries. But modest inflation greases the wheels of commerce. It will take time for underlying inflation excluding such special and temporary factors to re-accelerate to such an extent that central banks would have to do something about it – see [After Covid: the great inflation reset](#).

Central bank reaction: Central banks are watching. But financial markets are not their prime concern. They care about the economic outlook and the potential consequences of market moves for their inflation and explicit or implicit employment mandates. If a tightening of financing costs – which includes bond, credit as well as equity financing – and/or excess volatility in markets



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were to jeopardise the strong economic rebound which they desire after the mega-recession of 2020, they would try to do something about it. In the same vein, they would intervene if market dislocations were to impede the transmission of their economic stimulus to the real economy. Central banks are well aware of the special and temporary effects that will lift inflation in 2021. We expect them to look through such effects and not be pushed into a premature discussion of scaling back their stimulus. The Fed has already reminded us that they do not intend to taper their asset purchases anytime soon. In line with comments from various ECB board members, the ECB may step up its purchases within its ultra-flexible Pandemic Emergency Purchase Programme (PEPP). To which extent that will soothe current market concerns remains to be seen. But in the – rather unlikely – case that overall financing costs were to tighten to such an extent that central banks would perceive it as a serious risk to the economic outlook, they could intervene more forcefully. Remember: don't fight the Fed. As long as the Fed is far away from tapering, it is too early to throw a serious taper tantrum. After some ten years of overpredicting inflation, central banks will want to be sure that the economic rebound is well entrenched and that underlying inflation is moving towards their targets for good, underpinned for instance by stronger wage gains, before they reduce their stimulus.

For an in-depth discussion of the US outlook, see Mickey D. Levy [Strong US growth, inflation, and the Fed's challenges \(11 February 2021\)](#).

Berenberg webinar with ECB Vice President Luis de Guindos on 3 March

To discuss the outlook for growth, inflation and the central bank reaction to it as well as financial stability issues, Berenberg invites you to a webinar on the “Evolving Role of Monetary Policy” with ECB Vice President Luis de Guindos on Wednesday, 3 March, at 15h GMT, 10:00h EST, 16:00h CET. The event is the third of a series of Berenberg webinars on the future interplay of monetary and fiscal policy and pro-growth reforms in Europe. In the 45-minute webinar, a conversation between de Guindos and me will be followed by a Q&A session for the audience.

Click here for the [invitation](#). To register please contact [Charlotte David](#).



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