First Trust
Monday Morning OUTLOOK

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Bond Bull-Market Is Over

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Bonds have been in a "bull market" for the past thirty-seven years. Not every quarter, or every month, but bond yields have fallen consistently since Paul Volcker ended the inflation of the 1970s.

And just like any long-term bull market or bubble justifications proliferate. The current 10-year Treasury yield is 2.46%, which equates to a 40.7 price-earnings multiple. If the stock market had a P-E multiple anywhere near that, the nattering nabobs would be screaming from the mountaintops.

But the bond market has become the "knower of all things" – it's never wrong according to the bulls. Low yields are not only justified, they tell us the future.

There are three main bullish arguments.

1) The U.S. faces secular stagnation – permanently low growth and low inflation.
2) Foreign yields are lower than U.S. yields, so market arbitrage will keep U.S. yields from rising.
3) The Fed is raising short-term rates which will cause the yield curve to invert, leading to recession and lower yields over time.

But there are serious issues with all these arguments. First, it's not true the bond market is never wrong. In 1972, the 10-year U.S. Treasury yield averaged 6.2%, but inflation averaged 8.7% between 1972 and 1982. In 1981, the U.S. Treasury yield averaged 13.9%, but inflation averaged just 4.1% between 1981 and 1991. In other words, the bond market underestimated inflation in the 1970s and severely overestimated it in the 1980s.

The main reason was that the Fed artificially held down short-term interest rates in the 1970s, which pulled the entire yield curve too low. And in the 1980s, it did the reverse, and held short-term interest rates artificially high.

The past nine years are similar to the 1970s. The Fed has pulled the entire yield curve down, while big government (taxes, regulation, and spending) have held growth back. Now, growth and inflation are picking up, while the Fed lifts short-term rates. Just like in the 1980s, tax cuts, regulatory rollback, and contained government spending will disprove secular stagnation. Fed tightening will push the yield curve up and bond yields will rise.

We've never believed the low foreign bond yield story. Japanese bond yields have been near zero for at least two decades. If international arbitrage works to bring rates together, why aren't U.S. yields near zero (and why did Japanese bonds never move higher)? Isn't 20 years enough time for this arbitrage to take place? It comes down to fundamentals.

Every country has different growth rates, different currencies and inflation, different trade flows, credit ratings, tax rates, and banking rules. Every country is unique; why should bond yields be the same? The currency futures market signals that investors expect the Euro and Yen to appreciate versus the Dollar, which helps offset different interest rates. As we said earlier, bubbles twist logic to support the bubble, but that twisted logic doesn't hold up under intellectual scrutiny.

This year, the Fed is on track to ratchet the federal funds rate higher in three, possibly four, quarter point moves. With real GDP growth picking up to roughly 3%, and inflation moving toward 2.5%, or higher, nominal GDP will grow at roughly a 5.5% rate. That's the fastest top-line growth the U.S. has experienced since 2006. And in 2006, the 10-year Treasury yield averaged 4.8%.

We don't think yields are headed back to 4.8% any time soon. Our forecast for the 10-year Treasury is 3.0% in 2018. But, the risk is to the upside on bond yields, not the downside. The bullish case for bonds has finally run out of steam.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-8 / 2:00 pm	Consumer Credit– Nov	$18.0 Bil	**$17.6 Bil**		$20.5 bil
1-10 / 7:30 am	Import Prices – Dec	+0.4%	**+0.8%**		+0.7%
7:30 am	Export Prices – Dec	+0.3%	**+0.4%**		+0.5%
1-11 / 7:30 am	Initial Claims – Dec 6	245K	**242K**		250K
7:30 am	PPI – Dec	+0.2%	**+0.2%**		+0.4%
7:30 am	"Core" PPI – Dec	+0.2%	**+0.2%**		+0.3%
1-12 / 7:30 am	CPI – Dec	+0.1%	**+0.2%**		+0.4%
7:30 am	"Core" CPI – Dec	+0.2%	**+0.2%**		+0.1%
7:30 am	Retail Sales – Dec	+0.5%	**+0.3%**		+0.8%
7:30 am	Retail Sales Ex-Auto – Dec	+0.3%	**+0.4%**		+1.0%
9:00 am	Business Inventories – Nov	+0.4%	**+0.4%**		-0.1%