

Insights

The secular bond bull market will not return

Nordea Research, 17 January 2014

- Some economists, including Larry Summers who fears secular stagnation, are still very pessimistic regarding the US economic outlook due to what they see as structural constraints on the demand and/or the supply side of the economy.
- In this analysis we look deeper into these gloomy views and argue why we disagree and how we see the longer-term outlook for US interest rates.
- We believe there is strong evidence that most of the sluggishness of the economic recovery after the Great Recession can be attributed to a big demand shock rather than to some structural economic deficiencies.
- As a result, we believe that 2013 did mark the end of the 30-year secular bond bull market. However, the end of the bull market is believed to be followed by a long and grinding bear market, rather than anything more dramatic like a 1994-style bond crash.
- Still, we expect a faster bearish flattening of the US Treasury curve than currently priced by the forward market.

The end of the 30-year bond bull market

After last year's sell-off in US Treasuries many are wondering whether this was the beginning of the end of the 30-year secular bond bull market, which began in the early 1980s when Fed Chairman Paul Volcker started to slay the inflation dragon.

The secular decline in bond yields lasted nearly 31 years, with 10-year Treasury yields peaking at 16% in September 1981 and troughing intraday at 1.37% in July 2012. Such an extreme low yield below 1.40% was only reached because markets feared a total collapse of the European financial system, a risk which has faded not least thanks to the ECB's "Super Mario" and his "whatever it takes" pledge.

We believe that 2013 did mark the end of the secular bond bull market. Thus, we forecast a cyclical normalisation of interest rates as the global economic recovery, led by the US, strengthens over the next few years and the risk of stagnation and deflation gradually fades.

But obviously not all economists share this view. The pessimists believe our presumption that normal economic and policy conditions will return at some point is wrong at least for the next several years, and that western economies including the US are headed toward long-term stagnation similar to Japan's lost decades.

In this analysis we look deeper into these gloomy views and argue why we disagree and how we see the longer-term outlook for US interest rates.

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Great Stagnation – the new normal?

Remember the era of the Great Moderation? Before the financial crisis, many economists believed the US and other developed economies since the mid-1980s had entered a “great moderation era”, where expansions lasted longer and recessions were fewer, shorter and milder. The Great Recession in 2008 and 2009 obviously put that thesis to rest.

Not all economists share our optimistic outlook

Where does the US economy go from here? While our outlook for the next few years is rather optimistic and more so than current consensus forecasts, some economists are still very pessimistic due to – what they see as – structural constraints on the demand and/or the supply side of the US economy.

Summers: secular stagnation is here to stay

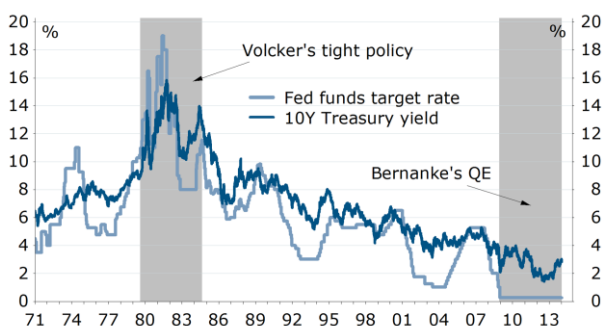
Thus, [Larry Summers](#), the former US Treasury Secretary who was briefly considered as Bernanke’s replacement, recently poured gallons of icy water on many optimists as he suggested that there is no easy return to pre-crisis normality in high-income countries. Instead, he sketched out a disturbing future of chronically weak demand and slow economic growth – a so-called secular stagnation – as the new normal. Economist Paul Krugman has had a similar view for years¹.

Negative equilibrium real rate of interest

Summers’ argument is that the equilibrium real rate of interest, the rate consistent with full employment, in the global economy has been significantly negative, around -2% to -3%, since at least the mid-2000s. The actual real rate, on the other hand, has due to the zero lower bound on nominal rates consistently been much higher than this. The low equilibrium real rate is due to a supposed glut of saving and dearth of investment opportunities, the argument goes.

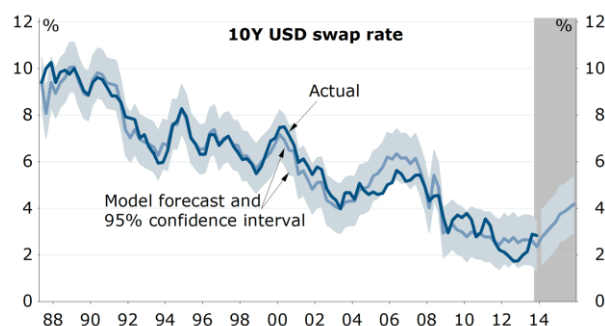
The alleged consequence of this disequilibrium is that there has been a prolonged period of underinvestment in developed economies, with GDP

The end of the 30-year bond bull market



Source: Nordea Markets and Reuters Ecowin

Model points to higher long-term rates



Source: Nordea Markets and Reuters Ecowin

¹ Originally the secular stagnation hypothesis was famously formulated by Alvin Hansen, born to Danish immigrant parents at Viborg, South Dakota, and often referred to as “the American Keynes”, in the late 1930s to explain America’s poor economic performance. Hansen claimed that technological innovation and population growth had played out, depressing investment – and that only government spending could keep aggregate demand up. From our perspective, it is quite obvious that secular stagnation didn’t happen then.

falling further and further behind its underlying long-run potential.

In other words, the economy is caught in a liquidity trap as monetary policy is virtually ineffective. This difficulty predates the recent crisis, but the crisis made it even worse, according to Summers.

All what central banks can do is to create bubbles

In a largely unsuccessful effort to close the output gap, central banks create asset price bubbles (IT stocks in the late 1990s, housing in the mid-2000s and possibly credit today). But as we all know, bubbles may boost the economy temporarily toward full employment but they inevitably burst and have no lasting effect on demand – secular stagnation continues.

No inflation pressures

The absence of traditional signs of overheating like inflation in the past two decades, even as there were two major market bubbles, is evidence of the drop in equilibrium real interest rates to well below zero, according to this hypothesis.

We don't agree with Summers

We see a number of problems with this neo-secular stagnation hypothesis. First, the US economy did reach full employment at the end of the last two cycles. Inflation was rising, but the absence of a major pick-up in inflation was due to the disinflationary impact of globalisation and, more importantly, the Fed's policy tightening as well as its credibility as inflation fighter built up since the Volcker era. (Ironically, the Fed's high credibility appears to raise the potential for asset price bubbles because it contributes to excessive complacency in markets. One day the Fed is bound to become more concerned about asset bubbles).

Second, secular stagnation implies that afflicted countries, which are saving more than they are investing, are running current account surpluses. That seems to describe Germany, but not the US.

Supply-side pessimists

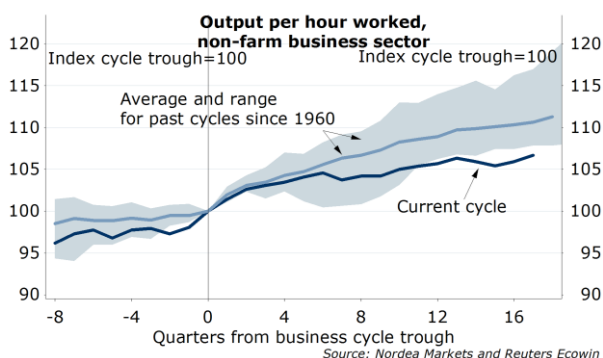
Constraints on the supply side

While Summers and Krugman seem mainly concerned about a permanent shortfall of aggregate demand, other prominent economists postulating stagnation in the longer run worry more about supply side deficiencies.

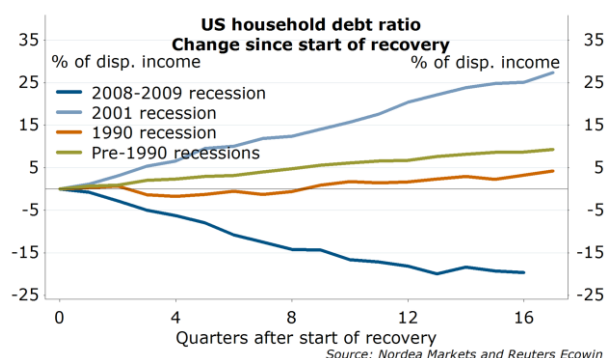
Gordon: growth is over

[Robert Gordon](#) of Northwestern University argues that the period of technological progress that followed the Industrial Revolution will likely prove to be a 250-year exception from the rule of stagnation in human history. Indeed, he suggests that today's technological innovations pale in significance compared to earlier advances like the steam engine, electrification, the internal combustion engine, telephones, running water,

Unusually weak productivity growth



Deleveraging: the key drag on the current recovery



antibiotics and other breakthroughs that are now more than a century old².

As a result, Gordon argues, economic growth in coming decades will likely be noticeably slower than the pace which Americans have been accustomed to.

Cowen: no low-hanging fruit left

[Tyler Cowen](#) of George Mason University also believes stagnation is the new normal in the US. His argument is that the US has run out of the “low-hanging fruit” that fuelled economic growth for three centuries: free land (spurring immigration), technological breakthroughs (Gordon’s point) and smart kids waiting to be educated.

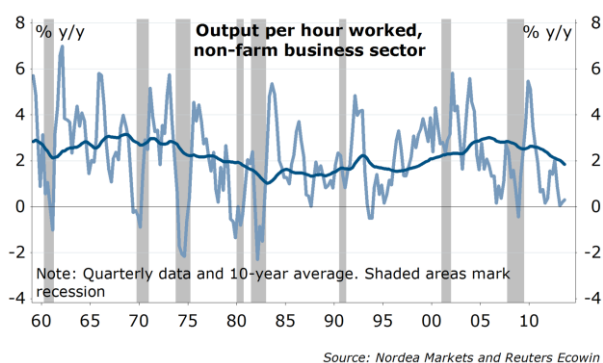
Regarding the educational fruit, Cowen’s point is that easy gains from education are gone. In 1990 only one in four hundred Americans went to college. Decades ago the rich world was moving most of its population from very low levels of education to university educations, and was shifting lots of geniuses from the fields to the factories to the research labs. That was relatively easy to do and it fuelled a big growth boom. Today, improvement in educational attainment is quite high as nearly half of young people go to college. Moving marginal students into college will require a lot of effort and will not yield large gains, Cowen believes.

We don’t agree with the supply-side pessimists either

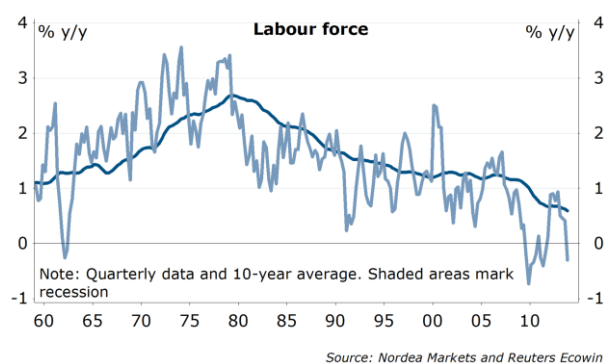
Gordon and Cowen obviously have some good arguments, and recent weak productivity growth gives some support to their ideas (see chart). However, we believe a significant share of this weakness is cyclical rather structural in nature, related to the big demand shock caused by the bursting of the US housing bubble. We will discuss this view in more detail below.

Second, the pessimists could also easily be underestimating the further potential of recent innovations in areas like IT and biotechnology. Moreover, forecasts of future technological change can be, and often are, wildly wrong³.

Weaker productivity growth



Weaker labour force growth



² Between the days of the Roman Empire and when the Industrial Revolution took hold in Europe in the mid-1700s, the standard of living of the average person throughout most of the world changed little from generation to generation. However, according to Gordon’s school of thought, the technological innovations during the first industrial revolution, beginning around 1750 or so in England, and the second industrial revolution, beginning around 1870, were so unique and so fundamental that they are unlikely to be repeated.

³ See footnote 1.

Finally and very importantly, the supply-side pessimists seem to be paying too little attention to the impact of globalisation and the fact that the great majority of human beings still live in economies that are far indeed from the economic frontiers described by Cowen. Thus, real output per head in emerging economies like China and India is still significantly below US levels. The rich world will therefore likely reap significant further benefits from growth in developing countries through the adoption of already existing knowledge in addition to potential improvements in domestic education and new technological innovations. And because globalisation increases the size of the potential market for new products, the incentives to innovate are greater today than at any other time in history.

Our view: more cyclical than structural weakness

Weakness: more cyclical than structural

Overall, we believe there is strong evidence that most of the sluggishness of the economic recovery after the Great Recession can be attributed to a big demand shock rather than to some structural economic deficiencies.

In other words, the economic weakness is more cyclical than structural.

Balance-sheet recession

While part of the reason that the recovery so far has been weak by past standards is indeed secular, most of the weakness is, in our view, due to deleveraging as the economy went through a balance-sheet adjustment process of epic proportions, caused by the bursting of the US housing bubble and the deep global systemic financial crisis. For more analysis on the US balance-sheet recession, see [Break out your sunglasses – the future is bright](#).

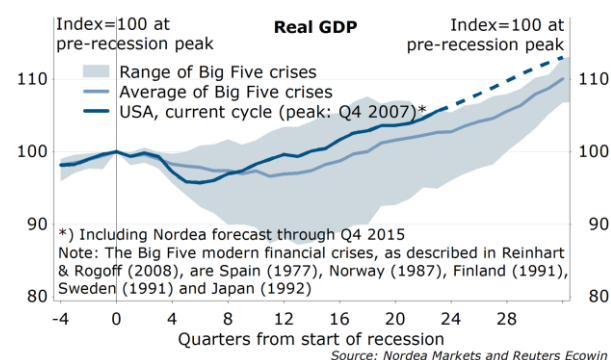
US recovery actually a bit better than the norm following a severe crisis

The view that the main cause of the slow recovery is the severe financial crisis rather than some longer-lasting structural constraints is supported by the fact that the US economy's performance since the crisis has roughly been in line with (actually a bit better than) the performance of other economies following major financial crises, as shown by [Reinhart and Rogoff](#) (see chart).

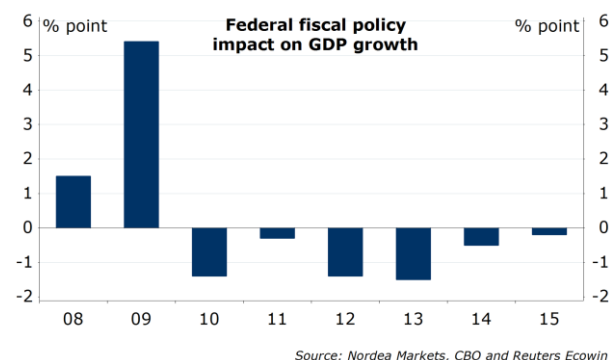
Destructive Washington politics

In addition to private-sector deleveraging in the wake of the collapse of the housing market, destructive policy coming out of the US Congress has also been a significant impediment to economic expansion over the past few years. Not only because of (badly timed) tightening of fiscal policy (cuts to spending and expiration of tax cuts) but also due to repeated disruptive political crises (two debt ceiling showdowns and one government shutdown), which clearly have been very negative for confidence among households and businesses. According to our estimations, the drag on growth from fiscal

US recovery actually stronger than the norm following major financial crises



Fiscal tightening a massive drag on growth in recent years



Strongest half year in a decade

Less headwind from Washington going forward

US GDP growth to accelerate

Somewhat weaker potential growth

Aging is a drag

tightening has averaged a massive 1¼% of GDP per year in the past four years.

Fortunately, the fact that the US economy in H2 2013 likely saw the best half of a year in a decade suggests to us that the key reasons for the weakness in demand over the past few years have now begun to diminish.

Going forward, further improvements in the US economy are believed partly to come from the capture of policy-low hanging fruit. Thus, the fiscal policy will switch from being a gale-force headwind to a stiff breeze, with a fiscal drag of just ½% of GDP this year. Moreover, the two-year budget deal reached by Congress in December should reduce the risk of another Washington-made crisis, when lawmakers tackle the federal debt ceiling again in coming months, see [US: budget deal further boosts the case for Fed taper](#). The spending bill passed by Congress this week, which funds the government for the next 8½ months, further illustrates the waning influence of the tea party-backed conservatives.

Having said that, the recent deal obviously doesn't mean that the political gridlock is now completely over. Thus, Washington politics remain a significant, although somewhat reduced, downside risk factor to the economic outlook.

Still, reduced economic and political risks make it more likely that we will see a significant boost in business investment and hiring.

Against this background we expect an acceleration in US GDP growth from the 2¼% average annual pace in the recovery so far to 3-3½% over the next two years.

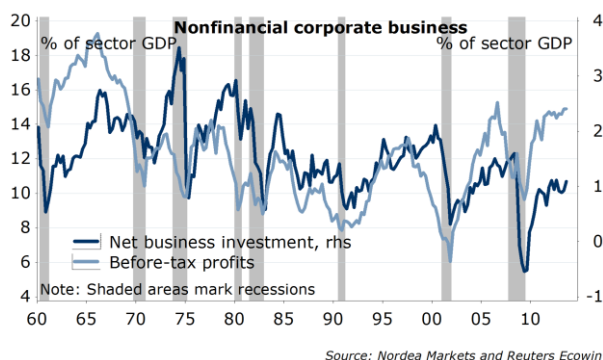
Potential growth down but not out

The prospects for aggregate supply, however, seem less encouraging than for aggregate demand.

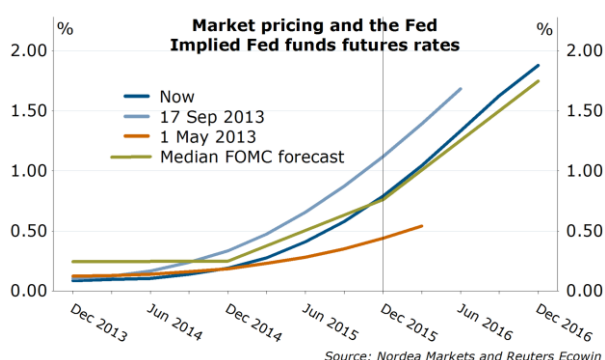
Most important, the underlying trend in labour force growth is much weaker now than earlier in the decade (see chart). That secular slowing, which reflects the aging of the population, is in our view the main reason why the labour force participation rate has been declining.

It is for the same reason we believe the Fed is currently overestimating the amount of slack in the labour market and hence underestimating the risk of inflation. Thus, the majority of the Fed still seems to believe that the decline

An aging capital stock in need of replenishment



Markets and the Fed currently in sync



Negative structural effects of the crisis

in labour force participation is mainly cyclical.

In addition, there are reasons to believe that the economic crisis itself has had some negative structural/secular effects on growth. Thus, the long stretch of weak business investment has been associated with sluggish productivity growth, while high long-term unemployment has caused a significant deterioration of workers' skill and attachment to the labour market.

Also the high, and increasing, income inequality is believed to be detracting from the expansion of the US economy's potential to produce. Lastly, there is a risk that overregulation, for example through the Dodd Frank Act, will turn out to be a negative structural factor for growth.

On the positive side, however, technological advances in oil and gas extraction are expected to strengthen productivity and encourage business investments.

US potential growth around 2% annually

Adding this up, we believe that US potential growth is around 2% annually, down from around 2½% in the years prior to the recession.

But no negative equilibrium real rate

A slower potential growth rate implies a lower equilibrium real interest rate, but we simply don't buy Summers' idea that the equilibrium rate is and will remain negative.

Cyclical normalisation of interest rates going forward

Long and grinding bond bear market

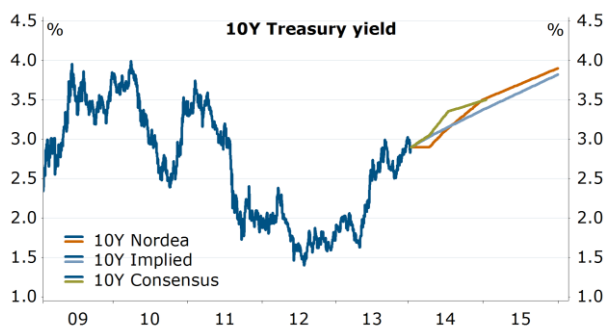
Against the background of a rather optimistic US economic outlook, we expect a cyclical normalisation of interest rates as the fear of stagnation and deflation gradually fades over the next few years.

No 1994-style bond crash

However, the end of the 30-year secular bond bull market is believed to be followed by a long and grinding bear market, rather than anything more dramatic like a 1994-style bond crash.

One reason for that is that the return to economic normality is not likely to be all that rapid. And at least as long as inflation is under control, central banks are unlikely to allow very sharp increases in bond yields. Thus, because central banks still seem to feel more comfortable with the risk of tightening too late compared to the risk of tightening too early, a major shift in monetary policy toward aggressive tightening seems rather unlikely the next two years.

10-year Treasury yields expected to rise further



Source: Nordea Markets and Reuters Ecowin

2-year Treasury yields expected to rise faster



Source: Nordea Markets and Reuters Ecowin

10Y yields to rise somewhat faster than what is currently priced

Thus, following the sharp rise to currently around 3% in 10-year Treasury yields since their lows in July 2012 we expect the pace of increase to be more gradual over the next few years. Thus, our forecast is now 3.50% by end-2014 and 3.90% by end-2015, somewhat higher than what is currently priced by the forward market (see chart).

Neutral level for 10Y yield around 5% reached in 2017?

Beyond our current forecast horizon covering the next two years, our best estimate is that 10-year yields will continue to move towards a “neutral” level, estimated at around 5%, potentially reached in 2017.

Fed to return rates to more normal levels faster than currently priced

In the shorter end of the Treasury curve, however, we expect yields to begin to rise more quickly than currently priced, starting later this year (see chart).

While we agree with the widely held view that the Fed will keep rates unchanged until 2015, we expect the Fed to return rates to more normal levels faster than markets’ currently anticipate. Especially signs of labour market pressures are expected to cause markets to price in significantly more tightening in 2015 and 2016.

Thus, our fed funds rate forecast is 1.25% by end-2015, around 3% by end-2016 and around the estimated neutral level of 4% by end-2017.

Faster bearish flattening of the curve

As a result, we expect higher yields especially in the 2-5 year segment of the Treasury curve over the next two years and see a faster bearish flattening of the curve than currently priced by the forward market.

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