

Global Bond Selloff Is Taking New Turn

U. S. and European yields diverge after unwinding of popular hedge-fund trades

By Chelsey Dulaney, Alexander Osipovich and Sam Goldfarb

The monthslong rout in global government bonds is getting messier and weirder.

For weeks, the bonds of most developed economies have moved broadly in tandem, but not on Thursday. A flight to bonds considered safe drove U.S. Treasury yields lower, while those of French, Italian and Greek bonds jumped in a sudden divergence helped by the unwinding of popular hedge-fund trades centered on Europe, fixed-income analysts and traders said.

The moves represented a reprieve of sorts for the U.S., a day after the yield on the 10-year Treasury note had reached its highest level in more than 24 years, promising steeper borrowing costs.

But it was also a reminder of how extended selloffs in bonds can cause unexpected problems. "Markets have a faint smell of a crisis in the making," said Ed Al-Hussainy, a portfolio manager at Columbia Threadneedle.

Thursday's action exposed the complicated nature of this year's bond selloff. Yields across the developed world have been propelled higher since March on concerns that rising energy prices spurred by the Iran conflict will force central banks to take aggressive action to contain inflation.

A recent run of strong U.S. economic data has added to the global pressure, suggesting that U.S. rates might have to rise much higher to do anything to cool the economy.

Still, the selloff has also had its idiosyncratic elements, with yields often rising especially sharply in countries—including France, the U.K. and Japan—where investors are on edge over government debt loads and unsettled political situations.

Investors say the latest selloff in Europe began as a ripple from the U.S.: Treasury yields were pushed higher a day earlier by data showing the U.S. economy grew much faster than expected in the second quarter, even as inflation was cooler than anticipated.

The problem with the global rise in rates, investors say, is that European countries are facing surging interest rates without the same level of economic strength to absorb it that the U.S. enjoys.

"You have the U.S. economy in overheating mode, which is a good thing, but too much of a good thing, maybe," said Benoit Anne, senior managing director at MFS Investment Management. "Obviously there's a contagion from the U.S.... People are looking at weakest links."

The selling intensified and turned chaotic in Thursday's trading session, with bond markets in France, Greece and Italy swinging between gains and losses. France's 10-year bond swung as much as 0.16 percentage point intraday, twice its daily average.

The French government on Thursday pledged to cut spending by about \$50 billion next year and bring its deficit down to 5%. But investors are skeptical of the plan, with President Emmanuel Macron's government facing a deeply divided Parliament and a looming vote.

"I would have thought a budget that does imply an effort of consolidation would get a more positive reaction, but markets skipped forward," said Benjamin Schroeder, an interest-rate strategist at ING. "Time is not in their favor."

The pressure on France has investors obsessing over a level known as “the spread,” or the extra yield on French bonds compared with the bloc’s safest investment: the German bund. The level ballooned to 1.4 percentage points on Thursday, the highest level since the eurozone debt crisis.

Recent polls have shown hard-left candidate Jean-Luc Mélenchon rising in the polls in France’s presidential election next spring, potentially setting him up for a runoff against far-right standardbearer Marine Le Pen.

The rise of Mélenchon, who has floated the idea of canceling some French government debt held by central banks, has been a “green light” for investors to short French government bonds, said Davide Oneglia, an economist with consultancy TS Lombard.

Investors say a cycle of forced selling intensified the rout in Europe. Investors, including hedge funds, had piled into France’s governmentbond market, one of the world’s largest, in recent years. They often trade the differences between the yields on bonds and related interestrate swap products.

Those trades, which rely heavily on borrowing and on bond yields staying relatively calm, have been unwinding in recent weeks, Wall Street traders said. That process turned especially violent on Thursday. Traders said that with French debt difficult to trade, investors sold the bonds of Italy and Greece, resurrecting fears that the debt problems that dogged the region last decade could return. In a sign of the building jitters, the euro fell close to 1% against the dollar, to around \$1.12, its weakest level in more than a year. Bond yields have also smashed through milestone levels where investors often set automated orders known as stop-losses.

Yields, which move in the opposite direction of bond prices, remained choppy into the afternoon of the U.S. trading session. The yield on the 10-year U.S. Treasury note settled at 5.233%, according to Tradeweb, down from 5.292% on Wednesday.

Igor Yelnik, founder of Alphidance Capital, a Londonbased global macro hedge fund, noted that funds are relying on leverage—essentially, borrowed money—more than the prior time rates were this high. Hedge funds are also a larger player in governmentbond markets than they were in years past.

“It’s a recession scenario, which can become a vicious circle like we have seen in previous crises,” Yelnik said. “Whether this scenario is going to materialize, I don’t know, but this is a plausible scenario.”

The selloff rippled through other markets and currencies on Thursday, with France’s benchmark CAC 40 down 1.6% and indexes in Spain and Italy down more than 2%. Japan, another nation with high debt, saw its long-term bond yield rise on Thursday to its highest closing level since 1996.

The Dow Jones Industrial Average rose around 20 points, or less than 0.1%, on Thursday. The S&P 500 gained 0.2% and the Nasdaq composite also added less than 0.1%.

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WALL STREET

Swings in the bond market shake markets worldwide

Translate

By Stan Choe
The Associated Press

NEW YORK>> More swings in the bond market rattled stock markets around the world on Thursday.

On Wall Street, the moves were relatively modest after U.S. bond yields cranked higher but then gave back the gains later in the day. The S&P 500 rose 0.2% and snapped a three-day losing streak.

The Dow Jones Industrial Average added 21 points, or less than 0.1%, and the Nasdaq composite inched up by less than 0.1%.

The moves were more dramatic in Europe, where stock indexes tumbled 1.7% in London, 1.6% in Paris and 1% in Frankfurt. They were hurt by sharp moves for bond yields on that side of the Atlantic. The yield on the 10-year French government bond, for example, shot to nearly 4.95% and then veered toward 4.80% and back up to 4.90%.

That is a punishing swing for the bond market, where moves get measured in hundredths of a percentage point.

High yields slow the economy by making it more expensive for everyone to borrow money, while undercutting prices for stocks and other investments.

Yields are on the rise for a range of reasons, including worries about high inflation and oil prices, signals that the U.S. economy remains solid and governments' insistence to continue to spend much more money than they bring in.

Those worries don't look to be going away anytime soon, and oil prices climbed again Thursday to keep the pressure up on inflation. The price for a barrel of Brent crude leaped 4.4% to \$102.31 for its latest yo-yo move on uncertainty about when the war with Iran will allow the global oil industry to return to normal.

Further reports also signaled the U.S. economy is powering through its many challenges. Fewer U.S. workers applied for unemployment benefits last week, which could mean companies are laying off fewer workers.

A separate report on Thursday said growth for U.S. manufacturing also continued in September. Potentially more concerning in that report from the Institute for Supply Management was that increases in prices accelerated, which could mean further pressure on inflation.

It all sent the yield on the 10-year U.S. Treasury toward 5.34% and its highest level since 2002. But the 10-year yield relented later in the day and pulled back to 5.23% from 5.29% late Wednesday.

That helped stocks on Wall Street recover their losses and turn higher.

