Why are long-term rates rising when they should be falling?

28 August 2023

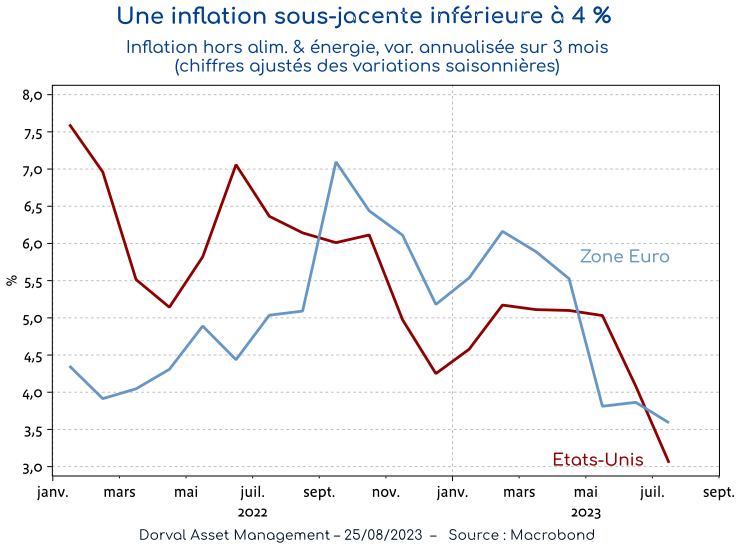
Dear Clients and Partners,

Despite the disinflation and deteriorating business conditions seen since spring, long-term interest rates have risen significantly over the summer. This paradox confirms our diagnosis that there is a problem with the valuation of bonds relative to money-market yields.

The data for summer has confirmed a trend of widespread disinflation extending beyond food and energy prices. In the United States, underlying inflation stood at +0.16% over the month, the same as in June. In the eurozone, the ECB's seasonally adjusted figures showed monthly increases of almost 0.35% for June and July, which, while high, are lower than the figures we have seen for the past year. Over the last three months, both regions saw annualised inflation of less than 4% (chart 1). According to the various surveys available, households' inflation expectations also continued to decline and head towards central bank targets.

Underlying inflation at less than 4%

Inflation excluding food and energy, var. over 3 months annualised (seasonally adjusted figures)



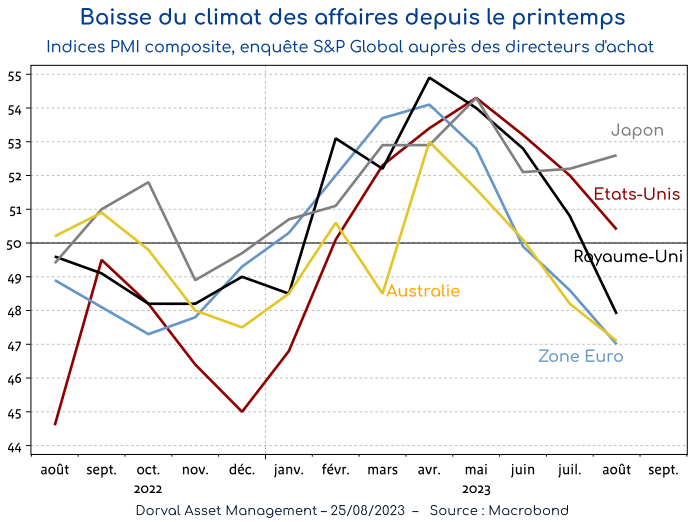
- *Eurozone* / *United States*
- *Jan. / Mar. / May / Jul. / Sept. / Nov. / Jan. / Mar. / May / Jul. / Sept.*

On the economic activity front, the situation remained complex. In developed countries, labour market statistics pointed to strong resilience, but surveys of companies showed that business conditions were deteriorating almost everywhere

(chart 2). These survey results suggest two things: first, the euphoria of those service sectors most affected by the post-COVID reopening has reached its logical conclusion; and second, industry is facing downward pressure due to excessive stock levels. These pressures appear particularly strong in Europe, partly because disinflation arrived here later than in the United States and consumption has not yet picked back up.

Business conditions have been deteriorating since spring

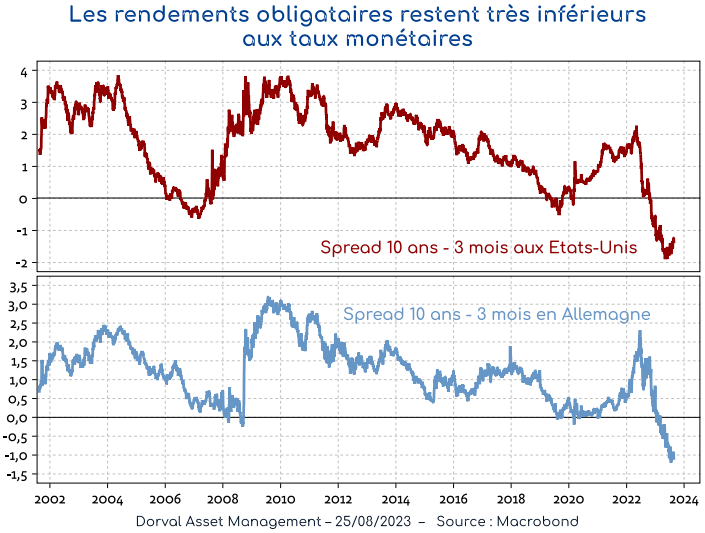
Composite PMI indices, S&P Global's survey of purchasing managers



- *Japan / United States / United Kingdom / Eurozone / Australia*
- *Aug. / Sept. / Oct. / Nov. / Dec. / Jan. / Feb. / Mar. / Apr. / May / Jun. / Jul. / Aug. / Sept.*

Although disinflation and declining PMIs could have lowered long-term interest rates, these actually rose over the summer. As we have pointed out many times since the beginning of the year, the major problem on the sovereign bond markets is relative valuation. With bond yields well below money-market interest rates (chart 3), only the prospect of short-term interest rates falling reasonably soon could justify the current level of long-term interest rates.

Bond yields remain well below money-market interest rates



- *10-year/3-month spread in the United States*
- *10-year/3-month spread in Germany*

Quantitative easing is certainly not out of the question if the gloomy diagnosis suggested by the PMI surveys is ultimately borne out. For the time being, however, the debate in central banks is between those in favour of a further rate hike and those calling for a pause – nothing more. There is also reason to question the relevance of conclusions drawn from surveys of business conditions, as the results of such surveys were very low in late 2022 but were not ultimately harbingers of recession.

Of course, things could change quickly if all economic statistics were to significantly deteriorate (or if new financial problems were to arise). From this standpoint, the situation seems particularly uncertain in Europe, where growth is more fragile. On the contrary, should it appear that the economy could function more-or-less as normal with money-market rates at 5% in the United States and 4% in the eurozone, then we could see long-term rates start to rise again. For the time being, we are therefore still favouring money-market investments over government bonds within our diversified international funds.

Our exposure rates are as follows:

- **Dorval Convictions:** The equity exposure rate is 100%.

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