For Whom the Yield Falls

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Analysts have been struggling to pinpoint the cause of this year's biggest slow-motion surprise for markets—the steady decline in North American bond yields to their lowest level in a year. There is no shortage of suspects, with **Europe near the top of the list**. The ECB is still in easing mode as Euro Zone inflation continues to wallow at just 0.7% and GDP growth is also stuck below 1%. European bonds have been on fire, with 10-year yields in Italy and Spain both plunging by more than 100 bps, while German yields have tested record lows. In this environment, the 2.5% yield on offer from the U.S. looks almost generous.

The **soggy start to the year for the U.S. economy and many emerging nations** has also played a role in the bond rally. U.S. Q1 GDP put an exclamation mark on the nasty winter, with the 1% drop prompting us to slash our annual forecast to a modest 2.2% (no better than Canada). And while we look for a rebound in Q2 GDP to 3.8%, that still leaves average growth for the first half at just 1.4%. Soft housing has accounted for much of the underlying downside surprise in activity, but weaker exports have also weighed. GDP growth in each of China (7.4% y/y), India (4.6%), Brazil (1.9%) and Mexico (1.8%) was on the soft side in Q1.

But if the root cause of the bond rally is a weak global economy, **other financial markets haven't read the memo.** The S&P 500 hit a record high in May, and emerging market equities are quietly staging a comeback. Credit spreads are probing multi-year lows. Commodities are generally stronger, not weaker, with the CRB up roughly 10% so far this year. The commodity currencies have also been firming, hardly a sign of widespread strain in the global economy. The Australian dollar has been one of the strongest in the world this year with a gain of more than 4%, while everyone's previously favourite short—the Canadian dollar—has quietly worked itself almost back. And, the Fed is also not validating the view that the economy is struggling, as it seems to be on autopilot to end QE.

Regardless of the source of the rally, the effect will be real. The **steady drop in yields has helped cut 30-year mortgage rates** to only a tad above 4%. And just as last year's mortgage rate spike may have done more damage to housing than initially expected, this year's retreat could help juice housing more than expected in coming quarters.

It's been a **broadly similar story in Canada**, somewhat surprisingly. Typically, the Canadian bond market tends to lag Treasuries during hefty rallies. Yet, GoCs have matched the drop in U.S. yields almost tick-for-tick this year, with 10-year Canadian rates plunging just over 50 bps to 2.25%. This renews the dilemma for t**he Bank of Canada**. The plunge in yields has prompted some banks to slice 5-year mortgage rates below 3%, which in turn could throw yet another log on the fire for housing prices. Yet, the BoC can hardly warn about higher rates with the C$ marching higher again and GDP growth disappointing in Q1 at just 1.2%.

Looking ahead, we continue to believe that it's a matter of time—and better U.S. economic data—**before yields start heading higher again**. Note that even with a weak Q1, U.S. nominal GDP growth is still running at 3.4% y/y, and yet the 10-year yield is less than 2.5%. The gap is even more extreme in Canada, where nominal GDP is running at 4%, or nearly double the current 10-year yield. To those who are tempted to buy bonds at these levels, just be mindful—**the yield also rises**.

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