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PHILEQUITY CORNER

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Bond vigilantes

Ahead of Trump's inauguration, there has been a recent uptick in bond yields across the world. The yield on the 10-year Treasury touched a high of 4.8% from 4.2% in November. Likewise, the yield on the 10-year Gilt reached a high of 4.9% from 4.25%. Meanwhile, the yield on the 10-year Philippine government bond climbed to 6.4% from 6% in November. Some investors have attributed this move to bond vigilantes who are concerned that Trump's policies (tax cuts, tariffs, deregulation, immigration) would lead to increased debt issuances, spur higher inflation, and cause interest rates to rise.

What are vigilantes?

Vigilantes are persons or self-appointed groups of citizens who act to prevent or punish crimes and offenses without legal authority. Vigilantes are defiant; they act on their own and outside the law to address injustice that the system cannot address.

Batman, the vigilante

In comic books and in movies, superheroes are often portrayed as vigilantes. One of the most famous examples of a vigilante is Batman. Batman fights criminals without coordination with authorities in order to make the city orderly and peaceful.

What are bond vigilantes?

The phrase "bond vigilantes" was coined by economist Ed Yardeni in the 1980s. This refers to powerful bond investors who sell off bonds to protest government policies that are deemed irresponsible. Bond vigilantes refer to large-scale bond investors who try to force change in fiscal and monetary policies by influencing bond yields through the selling (or buying) of significant amounts of bonds.

A current example would be the divergence between the Federal Reserve's (Fed) policy rate and the yields on US Treasuries. Bond vigilantes acted on their own as they believe that government efforts are inadequate to address inflation and foster fiscal discipline. When the Fed started cutting rates to stimulate the economy, the expectations were that interest rates would go down. However, interest rates on the longer tenor Treasuries went up as bond vigilantes became wary of Trump's policies.

Forcing policy changes

A strong selling caused by bond vigilantes is intended to prompt governments to enforce policy changes. A bond selloff leads to higher bond yields which translate to higher borrowing costs. This can enforce fiscal discipline by prompting governments to cut spending and increase taxes. Higher borrowing costs can also help control inflation as higher yields discourage borrowing and spending, cooling down the economy and reining in inflationary pressures.

Impact of bond vigilantes on currencies

In a scenario of heavy selling of bonds, the yields on US Treasuries and other corporate bonds rise. This causes the US dollar to go up, thereby causing almost all currencies, especially Asian currencies, to weaken. This results in imported inflation which can drive bond yields even higher.

Impact of bond vigilantes on the economy

Higher bond yields translate to higher borrowing costs which discourage borrowing and spending. This can temper government borrowing and spending which serve as economic stimulus. This also translates to higher mortgage costs and higher lending rates which have a contractionary effect on the economy.

Impact of bond vigilantes on the stock market

Weak bond prices translate to weaker stock markets as higher yields make bonds more attractive relative to stocks. Higher bond yields result in a narrowing equity risk premium, making stocks more expensive compared to the risk-free rate. Moreover, higher borrowing costs can temper fiscal and economic expansion which are among the key drivers of corporate earnings growth.

Trump vs. bond vigilantes

Based on the recent movement of bond yields, it seems that Trump is on a collision course with bond vigilantes. Trump's policy agenda of tax cuts, tariffs, deregulation, and immigration would likely result in a wider budget deficit and spur higher inflation. There is also a concern that the yield on the 10-year Treasury would breach the 5% threshold if Trump sticks to his agenda.

Trump and Xi

Last Friday, Trump had a phone conversation with Xi. In a post on his Truth Social account, Trump said, "The call was a very good one for both China and the USA. It is my expectation that we will solve many problems together, and starting immediately. We discussed balancing trade, Fentanyl, TikTok, and many other subjects. President Xi and I will do everything to make the world peaceful and safe."

Trump's statement gives hope that tariffs would be scaled down and the prospectively high tariffs were just a negotiation tactic and election rhetoric. An amicable trade agreement between the US and China which is palatable to the markets can thwart the attacks of bond vigilantes. Today, January 20, is a crucial date as everyone awaits Trump's inauguration and his policy pronouncements. Market watchers will tune in to what Trump will say, how the market will react, and if bond vigilantes will strike again.