››› Oil prices and bond yields – hand-in-hand again

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One Pager

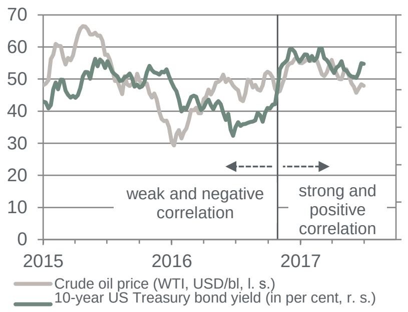
Author: Dr Sebastian Wanke, phone +49 69 7431-9784, sebastian.wanke@kfw.de

The yields of long-term US Treasury bonds and, to a lesser extent, of German government bonds fell significantly from March to June 2017. During that time the price of crude oil also receded noticeably. What is behind this trend?

Correlation between crude oil price and yields oscillates significantly

While the connection between the price of crude oil (in levels and annual variation rates) and yields of US Treasury bonds with longer maturities was still negative in autumn of 2016, it has since reversed and become increasingly stronger (Figures 1 and 2). From March to the end of June, both the price of oil and yields then fell. The yield on 10-year US Treasury bonds dropped temporarily from 2.6 to 2.14 %.

Figure 1: Oil price and yields of 10 year US Treasury bonds



Sources: Bloomberg, KfW Research

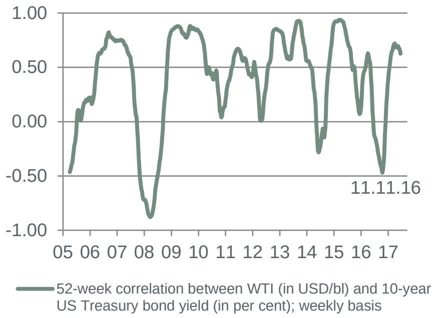
Reflection of economic performance and inflation

What does this show? The yields of longer-term papers primarily reflect investors' expectations about future short-term interest rates – besides risk premiums. Short-term investments always constitute an alternative to long-term ones and investors do not want to be worse off by tying up their capital for longer terms.

Expectations about short-term interest rates are shaped by investors' economic and inflation expectations. This is because economic performance and inflation are the parameters against which central banks set their benchmark interest rates which, in turn, determine short-term rates. Consequently, the yields of government bonds vary with investors' expectations.

The price of crude oil correlates with these expectations through two channels. First, oil price movements are in part a reflection of economic performance. Second, they are a crucial determinant of inflation. Consequently, a falling oil price can be a sign of a weaker economy and weaker inflation (ahead) – especially when its decline is caused by falling demand. But the correlation between the oil price and yields is not stable over time (Figure 2).

Figure 2: Correlation between crude oil price and US Treasury bond yields



Sources: Bloomberg, KfW Research

Global and US economy robust at the current juncture

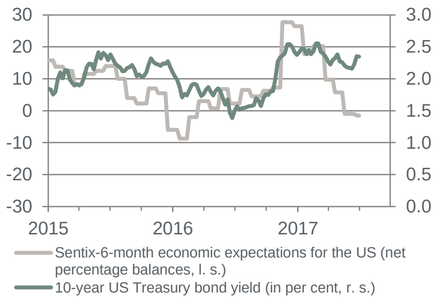
The question thus arises whether the oil price decline that could be observed since March and has been particularly pronounced in June is an expression of weak US and/ or global demand. At the current juncture, our estimate is no. The reason for this assessment is that sentiment indicators such as the purchasing managers' indexes of manufacturers, which very accurately reflect ongoing economic momentum, are extremely stable on a high level for the USA and also globally.

Falling expectations of US economic performance are weighing on yields

Nevertheless, the anaemic development of the yields on 10-year US Treasury bonds indicates that investors' growth and inflation fantasies are dwindling. That is reflected in the sentix economic sentiment index for the USA, which is surveyed each month among international investors (Figure 3). It is most likely due to the disappointing economic policy of the new US administration – compared with initial expectations.

Besides, whether driven by demand or supply (shale oil, OPEC output) – the lower oil price is putting downward pressure on inflation expectations. And finally, it is having an adverse effect on the US oil industry, which had generated high demand for capital goods in the past years.

Figure 3: US economic expectations and yields of 10-year US Treasury bonds



Sources: sentix, Bloomberg, KfW Research

Conclusion

Disappointed economic expectations are likely to be the main reason why US yields are currently lower than at the start of the year. Having said that, the lower oil price is not necessarily a sign of weak demand. But it is quite possible that some investors currently interpret it that way (contrary to our opinion) and have corrected their expectations of economic performance, inflation and interest rates downward for that reason as well. ■