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Are U.S. Investors Watching the Wrong Central Bank?

In the last year and half, investors have been paying attention to the U.S. Federal Reserve, and with good reason. The Fed has been reacting to the elevated inflation data by raising interest rates, and, after all, government interest rates are the foundational bedrock of investing because of the role they play in discounting cash flows and in asset pricing more generally. Indeed, with the Fed having lifted interest rates from near 0% to over 5%, that move has been substantial and at a pace not seen for a few decades.

Domestic investors are still fixated on what the Fed will do for the remainder of 2023 and beyond, with intricate debates over whether the US will face a recession or whether we will have a soft landing, among other issues. These are worthwhile topics to consider and factor into investing, and no investor should act without expressing some opinion on them.

However, with U.S. interest rates having risen so much, can we say that much of the volatility has been already experienced and is behind us? After all, we are aware of no mainstream forecasters who are predicting an additional 5% move higher in interest rates. And the current debate seems to have narrowed to whether policy interest rate cuts over the next 24 months will range from the negligible to a solid handful of cuts. At the long end of the bond market, the current 10-year interest rate is 3.7%, over 3.0% higher than its 2020 lows, and the market is not expecting similar volatility in the horizon ahead.

However, while the Fed and the European Central Bank have both been raising interest rates aggressively, there is one prominent central bank which hasn't even begun to raise interest rates: The Bank of Japan. Now quite the outlier among major central banks, the BOJ has tenaciously maintained its ultra-aggressive monetary policy, both in keeping the policy rate below 0% and in adding to its massive portfolio of bond holdings.

Does this matter for U.S. investors? We think it does.

To start, let's agree that money market and bond yields in Japan have been suppressed by monetary policy and by the so-called Zero Lower Bound, and have nowhere to go but up. In addition to that asymmetric payoff pattern, we might argue that when the BOJ removes the proverbial cork from the bottle, as the Fed and the ECB have done before it, that interest rates in Japan have further to run in 2023 and 2024 than might U.S. and European rates from today's levels.

Why this matters for U.S. investors is that Japanese bonds are something of a substitute for U.S. bonds, and that Japanese investors might repatriate some of their also-massive foreign bond holding if and when interest rates in Japan return to normal levels from today's ultra-low levels. We estimate a flow-through effect of roughly about 50% -- that is, for every 1% move in Japanese yields, U.S. Treasury yields might move 0.5% or 50 basis points. Given that Japanese bond yields are currently 0.4% against an inflation target of 2.0%, there is conceivably a bear market awaiting in the Japanese bond markets, and one that could have an impact here in the U.S.

So, while it of course makes sense for U.S. investors to ask whether the Fed will be raising interest rates 25bp or pausing, we would ask: where is there more likely volatility in interest rates ahead? In Japan, we think. And doesn't it also make sense for U.S. investors to focus on that bond market, even if it is far away. If, for example, Japanese bond yields rose to the 2% inflation target over the next 24 months and if the flow-through to U.S. yields was as argued, then the real action in U.S. bond yields would arise not from Washington, but from the spillover impact from a 160bp yield in the close-substitute bond market in Tokyo.

Here at Northeast, we think domestic investors should pay attention to all central banks and all bond markets. And, not just bond investors, because as we mentioned at the beginning, bond yields are the foundation of finance and impact investments up and down the risk spectrum, and necessarily drive all asset pricing. As Henry Kaufman, the legendary Salomon Brothers economist used to say during the bond bear market of the 1970s, "The bond market will always outbid the stock market".

Bruce H. Monrad is chairman and portfolio manager of Northeast Investors Trust (NTHEX), a no-load, high-yield fixed income fund whose primary objective is the production of income. Bruce is among the longest-tenured bond fund managers in the industry, having run Northeast Investors Trust for over 30 years.

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