The Dollar And Risky Bonds

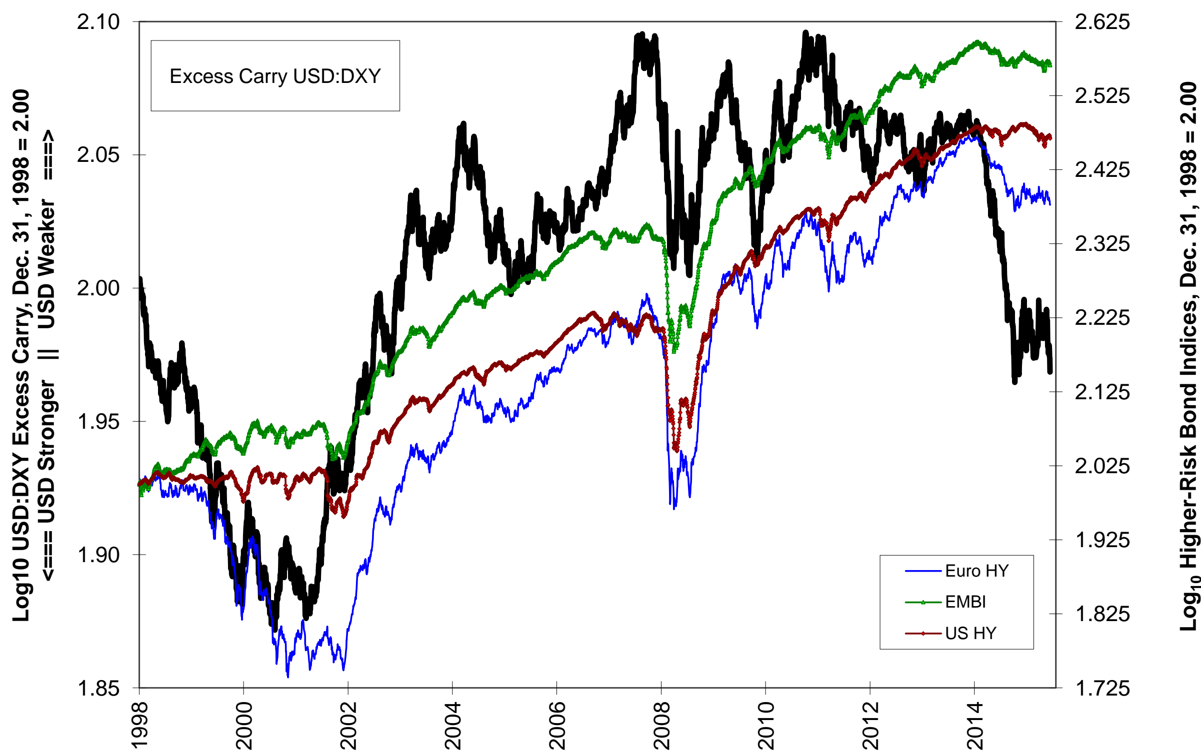
There are not too many definite cause-and-effect relationships in finance and monetary policy, but two of them are staring us in the face right now. The prospect of higher short-term interest rates in the U.S. combined with accommodative monetary policies elsewhere is pushing the dollar higher. In addition, those same higher short-term rates are flattening the U.S. yield curve as long-term inflation expectations and overall credit demands remain weak. What will these two factors do to risky bonds?

Carry Into Dollar Index

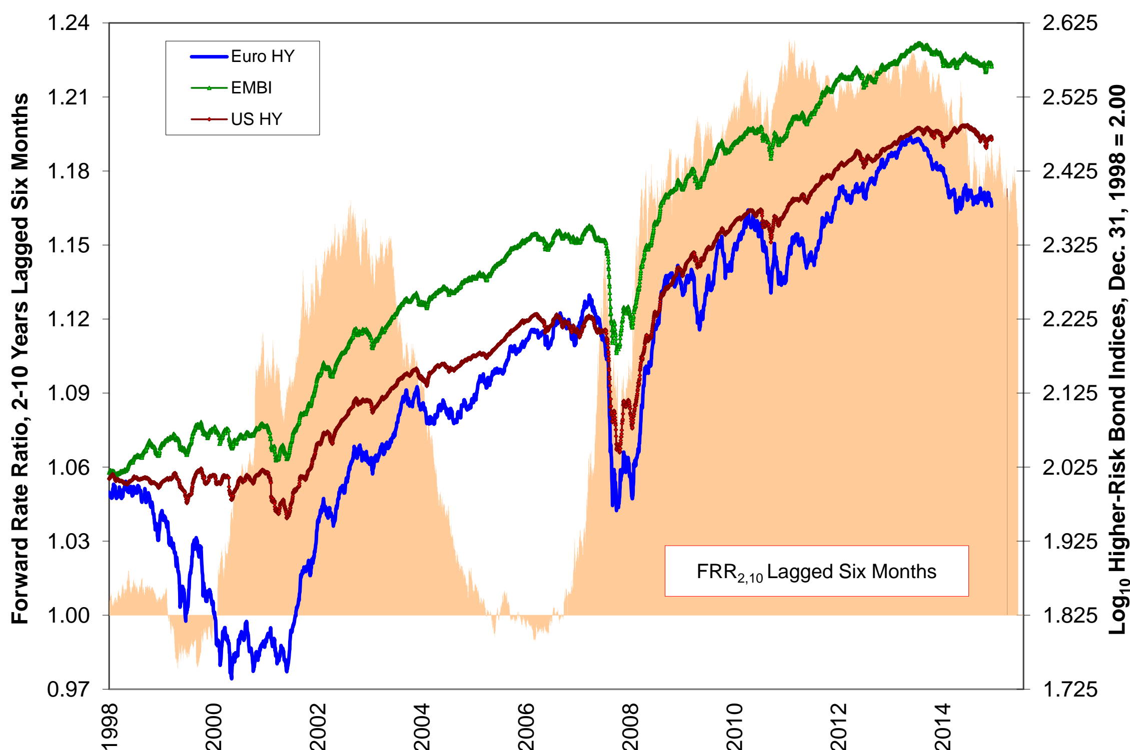
First, let's create a measure of the excess carry return for borrowing the USD and lending into the six members of the ICE dollar index. This measure has decreased 5.45% since October 14, 2015. Eurozone high-yield, emerging market and U.S. high-yield bonds over this period have returned -4.18%, -0.97% and 0.04% in USD terms, respectively.

If we map this excess carry return against the total returns for the three risky bond indices examined from the advent of the euro in January 1999, we see the present episode of USD strength is the only one not accompanied by a decline in Eurozone high-yield bonds. Whether Mario Draghi did whatever it took, whatever that means, is unknown; we do know the bond-market's equivalent of Eurotrash has done quite well.

The USD:DXY Carry And Higher-Risk Bond Indices



What about the U.S. yield curve as measured by the forward rate ratio between two and ten years lagged six months and risky bond returns? The $FRR_{2,10}$ is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself. The steeper the yield curve, the more the $FRR_{2,10}$ exceeds 1.00. This measure has led risky bond returns by six months on average. It has flattened from 1.1820 on October 14, 2015 to 1.1588 at present.



The U.S. yield curve has been flattening rather steadily since November 21, 2013. Only Eurozone high-yield bonds have lost in USD terms since then, declining 12.17%. Emerging market and U.S. high-yield bonds have returned 0.46% and 2.94%, respectively.

If you put these two factors together, you find three month-ahead returns for the three classes of risky bonds are positive at the present time. Only an abrupt steepening of the $FRR_{2,10}$ combined with a rapid decline in the USD:DXY excess carry return, the unlikely combination of a stronger USD and a steeper yield curve, would put prospective returns back into a negative zone.