Opinion **Inside Business**

Long live Jay Powell, the new monarch of the bond market

Scale of central bank action to fight pandemic emblematic of profound shift

ROBIN WIGGLESWORTH

US Federal Reserve chair Jay Powell on a school visit last year. Interventions in bond markets are becoming more heavy-handed in successive crises © AP

Robin Wigglesworth 13 HOURS AGO

Move over Bill Gross. Get outta here Jeffrey Gundlach. There's a new bond king in town.

Over the years there have been many pretenders to the crown once worn by Pimco's founder. But the new monarch of the bond market is undoubtedly Jay Powell, head of the Federal Reserve.

Led by the Fed, central banks have now committed $17tn to fight the economic devastation wrought by the coronavirus pandemic, according to estimates from JPMorgan Asset Management. That even overshadows the scale of measures taken through the entirety of the financial crisis in 2008-09.

The aggressiveness has led some investors to declare that central banks have in practice nationalised the bond market — fears the Fed chairman sought to allay in Congressional testimony last week. “I don’t see us as wanting to run through the bond market like an elephant or snuff out price signals,” Mr Powell said.

Whatever Mr Powell may say, the Fed elephant has been doing a tap-dance all over markets. Just last week, the average yield of US investment-grade corporate bonds hit the lowest ever level, at a time when many companies are seeing their revenues shredded. This may be a shortlived recession, but even optimistic economists reckon it could take years before activity is back at the levels reported when the last bond yield low was seen in early February.

This is natural. The Fed’s $250bn planned purchase of corporate debt alone is nearly as big as Mr Gross’s famous Total Return Fund was at its peak in 2013. The US central bank’s balance sheet has since March grown by almost $2tn, more than Pimco’s entire assets under management.

The enormity reflects the scale of the coronavirus crisis. But perhaps more importantly, it is also emblematic of a profound but under-appreciated shift in the financial system, the consequences of which we are now starting to realise.

Banks have since their emergence in Renaissance Italy been the central locus of capitalism, the dominant lenders to people, companies and countries around the world. But the bond market now accounts for well over half of all global debt, according to the Bank for International Settlements. The magic of securitisation means that virtually any loan can now be packaged into a bond and sold on to investors.

This is a secular trend that shows no sign of slowing down. And for the most part this is a healthy development. Capital markets are in many respects a better warehouse for the financial risk that any loan represents. When there are issues it doesn’t imperil depositors, or the functioning of the payment system that banks still dominate. But it also has major implications for the conduct of monetary policy — especially at times of crisis.

Central banks were originally set up to backstop commercial lenders and eventually began regulating the level of economic activity by controlling the price of their funding. But the increasing importance of the bond market means that they have had to dabble far more in what would once have been considered radically unorthodox areas.

Think of central banks as old-school mechanics, but the current financial system as a modern Tesla. They may be able to pop the hood and do rudimentary repairs, but when a Tesla breaks down you’ll probably need an electrical engineer to understand the problem. Similarly, to fix economic crises today, it is not enough to merely open the spigots to commercial banks. Central banks have to dive deep into the plumbing of the bond market to ensure that they are functioning properly.

Of course, the Fed has often intervened in markets in past crises. But the scale was humdrum compared with what we have seen this year. Although Covid-19 has been an exceptionally abrupt and brutal shock, we are likely to see more heavy-handed bond market interventions in any future downturns as well.

The result may well be far more political scrutiny and regulatory control of various parts of the fixed income industry. If banks had to accept more onerous shackles in return for their rescue in 2008, it makes sense that bond funds — which have now enjoyed an indirect bailout — are also subject to more control. More immediately, the next natural step may be for the Fed to follow the Bank of Japan in instituting "yield curve control" — in other words dictating a specific target or ceiling for long-term Treasury yields and vowing to buy an unlimited amount of US government debt to keep it there.

Whatever happens in the short term, though, the Fed's reign over the bond market is from now on likely to be even more total, and potentially permanent.

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