MACROECONOMIC ANALYSIS

The reasons for the fall in local long yields in 2014: the tipping point is close

Chile Unit

- The fall in long-term yields this year is explained to a large degree by the performance of external yields and by bad news on local activity. Taken together, both factors account for around 70% of the fall-back in BCP-10 since the beginning of the year.
- A scenario of persistently low yields is only consistent with one in which economic news continues to surprise to the downside and in which US long-term yields do not rise. We should not have any significant surprises to the downside in activity, and the yields in the US have reached a floor, with prospects to the upside in the medium term.
- As soon as the macroeconomic scenario begins to show signs of recovery and the activity figures stop surprising to the downside, and even surprise to the upside, we will see rises in long-term Chilean yields. These hikes will be reinforced if the postponed increase in long-term US yields is confirmed, and also by the greater issuance of public debt in prospect for next year which should be announced at the end of this month. BBVA Research forecasts that the Treasury will announce issues to the value of US$11bn.

Long term yields have shown huge falls over the course of this year. Several hypotheses have been considered to explain these reversals, since a correct understanding and evaluation of what has happened will answer questions such as whether these yields are close to reaching their floor and will subsequently move upwards, or whether they will remain at low levels for a prolonged period of time.

This Flash quantifies the impact on the performance of long-term yields (BCP-10) this year of both the change in international yields and the disappointing activity figures published to date. From a methodological point of view, we have combined two proposals presented in different central bank studies. The first estimates the impact of economic news on long term yields[1], and the other estimates the pass-through ratio from international to local yields[2]. The equation is as follows:

$$\Delta i_t \;=\; \alpha + \sum_{i=1} \beta_i * \Delta i_{t-i} + \sum_{j=0} \delta_i * \Delta i^*{}_{t-j} + \gamma * \; Imacec\ shock + \; \mu_t$$

With $\Delta i_t \;= monthly\ variation\ in\ the\ BCP - 10\ rate$

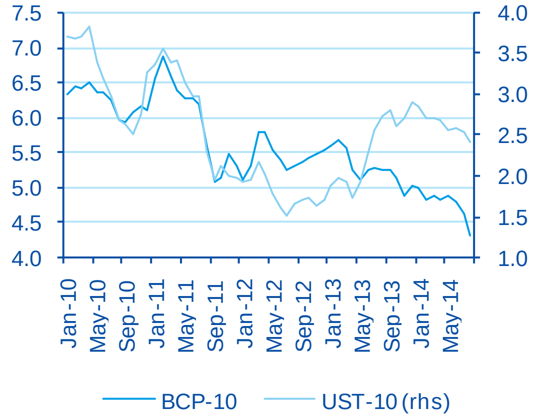
$\Delta i *_t = monthly\ variation\ in\ the\ UST - 10 + CDS\ rate$

1: Meyer, J. (2006). Impact of economic shocks on Chilean central bank bond yields. Revista Economía Chilena, volume 9 N°2, August.
2: González et al (2005). Ratio between domestic and external interest rates. Central Bank of Chile. Revista Economía Chilena, volume 8 N°2, August.

Our fidings are as follows:

We have confirmed the role of external yields in the performance of local yields, although this year the correction undergone by the BCP-10 has been higher than could be explained solely by the performance of international equivalents. Over this year, the US bond yield has fallen nearly 48bp, while the local bond yield has slumped by around 72bp (Figure 1). In a study in late 2013 we quantified that the pass-through ratio between external and internal yields lay between 20% and 60%; when we conducted the same calculation for January 2010 to August 2014, the result showed that the ratio was at the upper end of the historical range. This being so, the reverse suffered by the UST-10 this year would account for 39% of the fall in local long yields. However, as well as this element, there are idiosyncratic factors which are making contribution towards the same direction (Table 1).

Figure 1
External (UST-10) and local yields (BCP-10), variation (%)



Source: Bloomberg, BBVA Research

Table 1
Incidence of activity shocks and external yields on 10-year BCP: January to August 2014

		Incidence in BCP-10 (bp)
BCP-10 in December	**5.04%**	
Activity shocks *	-4.3 pp	-21 bp
UST10Y fall	-48 bp	-27 bp
Other factors (lack of paper, etc.)		-24 bp
BCP-10 in August	**4.32%**	

* The shocks considered by the Imacec up to June
Source: Bloomberg, BBVA Research

Controlling for the influence exerted by international yields, the negative news shocks over Imacec this year account for around 30% of the fall in the central bank's 10-year bond yields[3]. The estimated ratio is not very different from that found by Meyer (2006), which demonstrates the stability over time of this parameter. We also confirmed that a factor permanently impacting on the variation in long yields is economic activity performance, and in particular shocks that upset market consensus.

In consequence, we estimate that around 70% of the drop experienced by the BCP-10 this year is accounted for by the fall in external yields and by negative local activity shocks. The remaining 30% responds to other factors that have not been quantified, among which are, for example, the relative scarcity of long sovereign issuance (central bank and Treasury). In short, as soon as the macroeconomic scenario begins to show signs of recovery and the local activity figures start surprising to the upside (which, incidentally, was the case with the July Imacec) we may see increases in the long-term yields. These rises will be stronger if the postponed increase of long-term yields in the US is confirmed, and also by greater issuance of public debt, forecast for next year.

3: The "shock in activity" variable is the unexpected component in the indicators, representing the difference between the effective figure and the expected figures, according to the Economic Expectations Survey.

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