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The Upshot

ECONOMIC TRENDS

Can We Ignore the Alarm Bells the Bond Market Is Ringing?

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The financial media tend to report breathlessly about what the stock market did yesterday. But savvy economic analysts have always known the bond market is the place to look for a real sense of where the economy is going, or at least where the smart money thinks it is going.

And right now, if the bond market is correctly predicting the economic path ahead, we should all be terrified.

But, please, read on before panicking. There's a lot more to the story.

The stock market can rise and fall for all sorts of reasons, and sometimes for no apparent reason at all. But the bond market, where trillions of dollars change hands and long-term interest rates are determined, is steadier (normally). Its prices are generally tied closely to the outlook for growth and inflation over the years ahead.

The long-term interest rates that currently prevail across all the major advanced economies are consistent with a disastrous economic future. Taken at face value, they imply that the smart money expects inflation will remain extraordinarily low for years to come, and that growth will stay so weak that central banks won't be able to raise rates for years. It is a shift that has accelerated since Britain's vote on June 23 to leave the European Union, but one that has been underway for years.

Look at the current shape of the American "yield curve," the chart of how rates compare for short, medium and long-term bonds. It implies a 60 percent chance of a recession in the next year based on historical patterns, according to Deutsche Bank analysts. Long-term interest rates hit record lows last week — which is to say the lowest in the 227-year history of rates in the United States.

Prices for inflation-protected bonds suggest that consumer prices will rise only about 1.4 percent a year through 2021 — and only 1.5 percent in the five years after that. They suggest that not only is the Federal Reserve unlikely to find conditions that warrant an interest rate increase in the remainder of 2016, but also that there is only about a 50 percent chance of a rate increase in 2017.

Across other major advanced economies, the signals sent by bond prices are even worse. Ten-year bonds are now offering negative interest rates in Germany, Japan, Switzerland, Denmark and, as of Friday's close, the Netherlands. That means buyers of these securities will get fewer euros, yen, Swiss francs or Danish kroner back than they invested, a development without precedent in hundreds of years of financial history.

But that phrase "taken at face value" is doing some heavy lifting here. There are reasons to think that current prices are reflecting idiosyncrasies in the supply and demand for safe assets, rather than a conviction among global investors that very bad times are ahead.

Many of the purchasers of government bonds do so not because they find the returns offered compelling but because they have to. Insurers face regulators who may require that they do so. Pension funds seek to offset long-term obligations with safe assets of similar duration. Banks buy bonds to comply with rules limiting how much risk they can take.

In the last few years, central banks have become the biggest buyers of bonds. The Federal Reserve's program of quantitative easing — buying bonds to try to stimulate the economy — ended in 2014, but the European Central Bank and the Bank of Japan are just getting going; the E.C.B. is buying 80 billion euros' worth of securities a month.

So you have a strong demand for bonds coming from institutions that are willing to buy at almost any cost — they are inelastic, in economic terms.

Then on the supply side, governments have not exactly been issuing vast supplies of new bonds, for reasons involving anti-deficit domestic politics. The value of outstanding German general government debt was $1.8 trillion at the end of 2015, for example, down from $2 trillion a year earlier.

Whatever you think of the wisdom of using government deficits to try to prop up a faltering economy, governments for the most part simply are not responding to very low interest rates and depressed economies by radically increasing deficit spending and thus increasing the supply of bonds.

So rising demand for bonds that is largely indifferent to price (even a willingness to buy the bonds at a certain loss) along with pretty much fixed supply combines to drive up prices, which in the bond market means driving down rates.

And even though the United States isn't the prime driver of this — the Fed has ended its Q.E. program, and American debt outstanding continues to rise — the bond market is sufficiently global that it's an important part of the story.

When German and Japanese bonds are offering negative returns, the 2 percent or so that United States Treasury bonds were offering earlier this year looked extremely attractive. Essentially the United States has imported this very low interest rate environment from overseas, even though the domestic economy is in pretty good shape and the Federal Reserve had been planning interest rate increases.

So even though in normal times bond prices give useful information about the likely path of inflation and growth, this might be an instance when those indicators are less useful.

Among the evidence that the recessionary signals out of the bond market are wrong? If bond prices are an unreliable yardstick, we can look to other markets that may be flawed, but are at least flawed in different ways.

And those other markets are not flashing recession warnings at all: The United States stock market closed on Monday at a record high; indexes of future stock market volatility are quite low; and oil prices, after a furious rally since the winter, have mostly held onto their gains.

So how much of the drop in interest rates can we really pin on these supply-and-demand factors in the market for bonds, as opposed to a genuine shift in investors' expectations about the future? Roberto Perli, an economist at Cornerstone Macro, has tried to disentangle the parts of the puzzle.

He estimates that about three-quarters of the drop in American Treasury yields since the start of the year is because of a decline in the "term premium," or the compensation investors demand for tying up their money over many years. This is largely attributable to those supply-and-demand factors. He attributes about one-eighth of the drop to investors' perception that the Fed will raise rates more slowly for any given economic circumstance than they had assumed at the start of the year.

He attributes only one-eighth of the drop to an actual belief among bond buyers that the economy will grow more slowly in the years ahead than they had thought at the start of 2016.

There is good news in that as well as bad. The good news is that most of the drop in long-term interest rates is being driven by things that have little to do with the underlying strength of economic growth. The bad news is that some portion of the drop really is being driven by more pessimistic economic views, at a time a great deal of pessimism is already baked in.

The bond market right now is like a speedometer that is miscalibrated and therefore unreliable. It may be less useful than usual, and is not to be interpreted literally — but it's still telling us something. And that something is that we should be worried about the possibility the world is in a nasty deflationary economic trap that won't get better anytime soon.

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