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Bond investors: caveat emptor

There are high prices at which even safe assets become risky

THE last time a bond bear market was getting started, I was still in diapers. It would be difficult to find any investor who lived through and vividly remembers the impact of losing money year after year in bonds, but this is the most likely scenario that will start unfolding from now.

For the last 35 years we have experienced a bond bull market which is unrivalled in history in both magnitude and length. Many savvy investors in the last six years have repeatedly tried to anticipate the end of this bull market. All of them have been early, because they assumed that hyper-inflation was just around the corner, and yet it never materialised. In this business being early is indistinguishable from being wrong, leading to more fuel for the ongoing bond bull market. As one of my mentors was fond of saying: "Don't tell me what to buy/sell, tell me when to buy/sell!"

While it seems logical that large balance sheet expansion via repeated QE (quantitative easing) by all the major central banks should be inflationary, in reality negative interest rates are deflationary, causing a cycle that pulls the velocity of money towards zero. With the economy unable to benefit from the money multiplier, a self-fulfilling deflationary cycle is started. The only limit to how long QE could continue is when inflation finally started gaining traction in the economy, which was not seen in the past six years, but we are likely to now be at the tipping point.

Consider the following US data:

- Recent average hourly earnings growth at 2.8 per cent is the fastest growth rate in seven years, indicating building wage pressure. The Atlanta Fed wage growth has even higher figures at 3.6 per cent.
- Non-farm productivity just hit 3.1 per cent in early November, a two-year high.
- Every single inflation measure is trending higher.
- The oil price drop in 2014-2015 was highly deflationary. Since early 2016, bottom oil prices have doubled and will no longer contribute to deflation going forward. Many other commodities have similarly strengthened this year from multi-year lows.

The Federal Reserve has well telegraphed an interest rate hike in December, and in aggregate all the data above suggests that we are at the start of a sustained rate hike cycle, while the Fed is consciously behind the curve to stoke even more inflation.

Inflation pressures

Inflation pressures are most obvious in the US, but are starting to be seen in other countries as well. In my summer column I wrote the day after Brexit, I argued that this event was not significant for global investors and would not precipitate a recession anywhere in the world, least of all England itself. The currency devaluation instead would be a big positive for the country as a whole. This was correct but we have now seen an additional effect of the devaluation, with UK inflationary pressures increasing as well. The generous Bank of England (BOE) post-Brexit monetary stimulus has caused many measures of economic activity to rebound, with some even surpassing pre-Brexit levels. The BOE will likely be the second central bank to stop QE, and then start normalising interest rates.

Even in Europe where deflation has been the norm post-2008, CPI (consumer price index) climbed 0.5 per cent in October from a year earlier, with core inflation flat since 2014.

The last time bond yields were this low (and prices this expensive) was 1946, as interest rates were low due to large levels of debt to fund World War II. Rates were kept low for years to enable governments to finance their debt, but bond yields had already started creeping higher. The decline in bond prices accelerated in the late 1960s as inflationary pressures mounted and became obvious to even the casual observer. The bond bear market culminated in yields close to 20 per cent per annum in the early 1980s, more than a decade later. The full extent of the bond bear market lasted more than three decades, which for the average investor is far longer than his or her investment horizon.

The period of 1955-1983 had four separate double-digit bond bear markets, two of which caused price losses of 24 per cent on AAA-rated debt. While the biggest falls happened late in the bond bear market in 1981-1982, when measured as losses versus bond yields received, the most acute losses were felt in the early years after 1950 when interest rates were slowly but steadily increasing. Over a six-year period yields rose only by 1.7 per cent, but bond investors in longer dated issues lost eight years' worth of interest during that period. This is the most likely situation that is ahead of us in the coming years for bond investors.

Bond investors should consider acting defensively and shortening duration, or even selling outright to raise cash. Any investor who is in leveraged structures linked to bonds, or a leveraged bond portfolio, should at the very least consider repaying all leverage.

Investors who are looking to profit from such a secular shift in inflation can target assets and sectors that do well in such environments. While commodity-related investments are the obvious choice that comes to mind, there are other equity sectors that are positively correlated to higher interest rates, such as capital markets and financial services.

While bonds are traditionally considered safe assets, there are high prices at which even safe assets become risky. Buyer beware: We are at such a turning point now. W

AL Wealth Partners is an independent Singapore-based company providing fund management and advisory services to accredited investors