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Flash

Higher volatility in "safe haven" bond markets is here to stay

The sell-off in European bond markets in recent weeks has surprised many investors. After all, government bonds are meant to protect against volatility and not be the source of it. "Safe-haven" European bond markets seem particularly expensive as their yields imply a multi-year period of deflation. Also prices are being manipulated by ECB buying and other factors. The bull market in bonds lasted over 30 years and is now over. While we think too soon to assume a turn in the interest rate cycle, private investors should only hold "safe haven" bonds for insurance purposes.

European bond markets have had a unusually sharp reverse.

Many investors have been surprised recently by the sharp reverses in European bond markets. Yields on 10 year German Bunds started rising in mid-April, from around 0.05% on April 17. They spiked in intra-day trading to nearly 0.8% on May 7 before falling back to around 0.55% next day and are now around 0.7%. In the panicky trading on May 7 one illiquid Spanish 50 year bond briefly lost 20%. In a multi-asset portfolio, the rational for owning government bonds with near-zero or negative yields, is that they provide portfolio protection against the price swings of other assets. However, in the last few weeks, rather than protecting against volatility, European "safe haven" bonds have been the source of it.

Increasing regulation leads to less liquid financial markets.

After the event, it is always easy to come up with explanations. One reason for the unusually sharp correction in bond prices is certainly the loss of liquidity in the bond markets. Yet again we see new regulations having unintended consequences. Attempting to discourage bank trading activities, the authorities now demand this business be backed by higher own-capital reserves. With banks now less active in trading as a result, there is less capital available for market making, with negative consequences for market liquidity. A second reason is that ever more investors, not least hedge funds, now work with technical models which often send out similar trading signals at the same time. Thirdly, the market was heavily long-positioned in the context of the ECB's massive bond-buying program (QE), with widespread speculation that the yield on the 10 year German government bond would rapidly move to -0.2% (the lower level at which the ECB is prepared to buy bonds). It's worth noting that previous Fed announcements on QE tended to provoke a surge of speculative buying that was later reversed. The very low yields in the bond market are a further factor. With investments, income tends to stabilize capital values. Thus bonds yielding 1% are more likely to be volatile than the same bonds yielding 4%. The oil market probably also had some impact. With oil prices rising in recent months expectations on inflation may have moved higher, helping to trigger an up-move in bond yields.

Prices in the government bond markets are being manipulated.

In spite of the recent rise in yields, government bonds remain unattractive for a variety of reasons. On the one hand, their prices are being manipulated. A good part of the outstanding debt of governments is now sitting on the balance sheets of the central banks, who are not price sensitive when making their purchases. There is also an "unnatural" demand coming from pension funds, insurance companies and other financial institutions as regulation forces them to buy and hold government bonds. Such price manipulation means that government

bonds no longer offer “value”. This is particularly true of Japan and the Eurozone. For some perspective on this, consider the average yield pick-up that investors have been able to achieve in the past by investing in long-dated bonds as opposed to short term paper. 1.5% is a fair estimate. The current 1.3% yield on the 30 year Bund suggests that, for this 1.5% pick up over short-term rates to hold, short term rates would have to be on average negative over the coming 30 years. This implies deflation - or at the very least no inflation – but that is not in line with the expectations of either households or the markets (via the break-even inflation rates implied by bond prices). Given current yields on conventional bonds, Germany’s inflation-protected bonds imply that German inflation will be around 1.25% pa over the next 10 years. In other words, today’s low yields on conventional Bunds assume a deflation while other parts of the German bond market are forecasting some inflation. Based on current macro data, Goldman Sachs suggest that the “fair yield” on the 10 year German government bond is 1.7%.

Investors are prepared to pay a premium for protection provided by government bonds against crisis.

Clearly, government bonds attract other investors besides the central banks and the regulation-driven financial institutions. The question is why? One part of the answer is that they provide portfolio protection against crises, and in particular against deflation. In the European context this may well indicate that investors are prepared to pay a premium (i.e. accept an almost non-existent yield) to protect portfolios in the event of a fragmentation of the Eurozone. Should this happen, Germany might well face deflation through the rapid appreciation of her currency. The current yield curve for German government bonds, which implies negative or near-zero short-term rates over many years, suggests that this deflation risk is to some extent “priced in”.

The bull market in bonds lasted more than 30 years but it is now over.

We believe that the bull market in bonds, which lasted over 30 years and which took the yield on 10 year German government bonds down from nearly 11% in 1981 to just 0.7% now, is now over. On the other hand, given the generally weak growth trends, the aggressive policies of monetary expansion to which the central banks are committed and the worldwide “savings glut”, we don’t think the time is yet ripe for interest rates to be heading upwards. However, the higher volatility that we have seen in bond markets in recent weeks is likely to continue. An engagement in “safe haven” bonds only makes sense for private investors as an insurance against crises. One should not count on capital gains.

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