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Bond markets – the next bubble?

Today's financial headlines are filled with negative views on bond market valuations, particularly with regard to government bonds. 'Treasuries make no sense,' 'the least attractive investment in the world,' and 'Ponzi scheme' are now commonly associated with global government bond valuations. Russian Prime Minister Putin recently called the US a 'parasite' due to its rising debt weighing on the world economy (although Russian Treasury holdings actually increased 8.3% to $US150 billion since August). Leon Cooperman of Omega Advisors called treasuries, 'the least attractive investment' and, 'the worst place to put money' while Warren Buffet stated that bonds are, 'among the most dangerous of assets'.

Such views have been fairly common over the past 10 years; let's take a look at how bonds and equities have historically performed over that period:

	1 year	5 year	10-year
Bond Indices (% p.a.)			
10-year US Treasuries	15.3	8.6	6.8
10-year German bunds	14.9	7.5	6.6
10-year UK gilts	17.1	9.0	6.9
10-year Japan Govt.	4.6	3.4	2.7
10-year Australian Govt.	16.4	8.2	7.0
Equity Indices (% p.a.)			
S&P 500	5.1	1.6	4.2
Dax	–5.7	0.4	3.1
FTSE 100	2.2	3.3	5.5
Nikkei 225	–6.5	–9.7	0.4
ASX	–5.0	–0.2	8.3

Through 29-Feb-2012. Source: Merrill Lynch: US Treasury 7-10 years, German Federal Govt 7-10 years, UK gilts 7-10 years, Japan Govt 7-10 years, Australian Govt. 7-10 years , local bond returns, equity indices include dividends reinvested into index

At some point commentators will eventually be correct and bonds will post negative returns and/or underperform equities. While US Treasury 10-year yields at 2.3% continue to look unattractive relative to inflation (February US CPI was 2.9% year on year), whose buyers who have supported government bond yields over the past few years are still looking for a return of their money, not a return on their money. And those buyers are still here: European investors seeking safety from their sovereign credit problems, Asian central banks recycling export earnings and the US Federal Reserve. The US Federal Reserve has added $US1.2 trillion since its first round of Treasury purchases in May 2009, and the Federal Reserve's Treasury holdings now total over $US1.65 trillion. Foreign Treasury holdings now total $US5 trillion, this equates to 50% of the $US10 trillion US Treasury market or 60% if you exclude the Federal Reserve's Treasury holdings.

Continuing support for government bonds?

The trillion dollar question is how long will foreigners and the US Federal Reserve continue to support the US Treasury market? This has been a main topic of debate at Kapstream.

Internally, our team mostly agrees with these negative views over the long-run. However, the active debate is concerning the short run or next six to nine months. Historically, we have taken the more conservative approach in believing sovereign yields could remain lower for longer than markets expected. This meant our portfolios maintained positive durations, albeit in the 0.5 to 1.0 year range. However, much of the current global risks which supported low Treasury yields seem to be easing:

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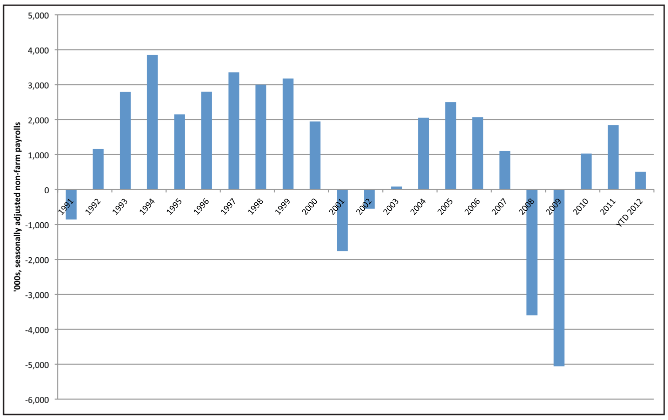
- **Prospects for a US double-dip?** We believe the probabilities of a double dip are becoming less likely.
  - We have seen a gain of 1.2 million jobs over the past six months;
  - consumer confidence is picking up and the US Federal Reserve may now be more reluctant to print additional money as the jobs market turned positive; and
  - the US needs to produce about 125,000 jobs per month to keep up with population growth. If the US produced three million jobs a year (250,000 per month), it will still take over 4 years to get back to the 2007 unemployment rate of 4.5%. It appears the US economy is moving down this track on the jobs front.

US Jobs Growth

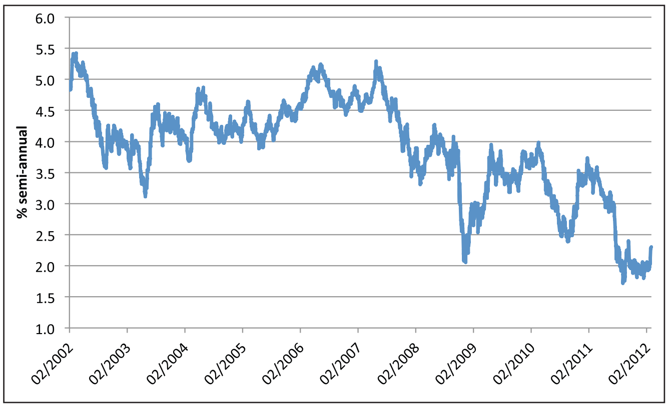


[1] Source: US Jobs data – Bloomberg –

- **European disintegration?** Given the controlled Greek default, we believe this is less likely.
  - The European Central Bank (ECB) have already executed two rounds of LTRO (long-term repo agreements) to the tune of Euro one trillion with a three year maturity;
  - this allows banks and insurance companies to put their bonds to the ECB as collateral and borrow money at 1% over the next three years. All while collecting the higher yield on the lent securities;
  - the ECB's balance sheet, at nearly $US4 trillion, is bigger than the Federal Reserve's balance sheet; and
  - other programs including the stability fund and IMF assistance appear to have limited the potential negative impact on other peripheral countries.
- **Chinese hard landing?** This is a chance this may happen given China's downgraded growth rate for 2012 (currently 7.5%, down from the 8% forecast). But the worst has likely passed, given the positive signals coming from the US and Europe.

Treasury markets have begun to incorporate the improving global conditions into higher yields. 10-year Treasury yields have now risen by approximately 0.40%, reaching 2.30% after trading in the 1.80% to 2.10% range over the past four months. It is hard to imagine that 10-year Treasury yields were in the 3.7% range only a year ago! Now that most of the despondent global news appears to be behind us, we may see a significant sell-off in yields. This has been at the centre of our recent debates.

10-Year US Treasuries



While the eventual unwinding of the US Federal Reserve's Treasury position is troubling and argues for much caution, it is unlikely in the short-run given the expected slow pace of economic recovery. US Treasury yields are expected to rise but if the yield increases are not material (i.e. 20 to 30 basis point weekly increases) it may stall economic recovery and impact on the rest of the world.

Controlled rise in yields

The recent stellar US Treasury market returns (as stated in the first table) were driven partially by central bank purchases, risk aversion, the European sovereign debt crisis and weak economic growth.

Given that central banks will eventually be in the process of unwinding the excess liquidity provided over the past few years, short-term European sovereign default risks have been contained and economic growth is picking up, we believe we will see a slow rise in Treasury yields. We believe the US Federal Reserve and most other central banks will leave rates on hold for at least another 12 to 18 months. Prospects for another round of quantitative easing are decreasing, which is likely to put further pressure on Treasury yields.

Is Australia slowing?

Australian economic growth is beginning to slow down. The economy grew at 2.3% year on year in the fourth quarter of 2011. Weaker economic growth was partially driven by a slow-down in Chinese economic growth (hence weaker demand for commodities), a strong Australian Dollar (up 18% vs. USD since 2010), rising borrowing costs for financial institutions and uncertainty in Europe. Given the above factors, the Reserve Bank of Austraila is likely to keep rates at 4.25% over the short-run and markets have reduced expectations for rate cuts over 2012, now expecting 0.40% in cuts over the year, down from 1.04% predicted cuts in January.

Portfolio implications – next 12 months

At Kapstream, the following themes will dominate our thinking over the coming months –

1. US Economic growth is starting to improve and the trend is up. We believe the US Federal Reserve will continue to be on hold for at least another 18 months. The biggest unknown is whether the housing market has bottomed. Risk assets should do well over 2012.
2. The European crisis has been resolved in the short-run and systemic financial risk has been temporarily avoided. There will still be much pain in the austerity measures to be implemented over the long-run. This will continue to produce high levels of unemployment in the near future and cause major uncertainties in financial markets. We will continue to mostly avoid European assets.
3. Asian economies will continue to grow. Global growth will depend upon the developing world. While Asian economies will remain the biggest drivers of global growth over the next few years, short term uncertainties remain. We will continue to hold select Asian corporates.
4. Central banks around the world will leave interest rates unchanged or potentially move lower if necessary. While a global slowdown is not our central theme, continuing risks and the use of central bank balance sheets will continue to cap potential sovereign rate increases. We expect to reduce portfolio durations over the coming months.
5. Problems in the Middle-East (especially Iran) could see a spike in oil prices – which will remain another global risk over 2012.
6. In a range bound market with sovereign yields likely to rise somewhat, we like corporate assets and will continue to invest in spread/carry assets with low interest rate duration such as floating-rate bonds.
7. While sovereign bond yields look extremely unattractive, we will remain conservative on interest-rate exposures as the risk/return trade-off in corporate bonds is considerably more attractive than the trade-off in interest-rate calls.

[1] Of the 8.6 million jobs lost in the US during the global financial crisis – the US has produced nearly 3.4 million jobs since then.

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