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Is the end nigh for the bond market, or will the bull continue?

BIG ON BONDS

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WITH APOLOGIES TO MARK TWAIN, the death of the bond market has been greatly exaggerated.

Over the past few years some very prominent investors have made strong and vocal calls to exit the bond market.

Why? Because they were adamant that interest rates were going to rise. None of them anticipated the huge decline in yields to a record low in July of 1.4 per cent for 10-year Treasury yields.

Here are some noteworthy examples:

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☛ Nassim Taleb, co-founder of a hedge fund and bestselling author of The Black Swan, from February, 2010 (10-year U.S. Treasury yields: 3.6%): With respect to shorting U.S. Treasuries, “every single human being should have that trade.” Shorting 10-year U.S. Treasuries at 3.6 per cent would have resulted in a loss of about $20,000 per futures contract by the summer of 2012, or $140 trillion (by my calculation) lost across every single human being. That’s one giant black swan, Nassim!

☛ Bill Gross, co-founder of PIMCO and manager of the world’s largest bond fund, from March, 2011 (10-year U.S. Treasury yields: 3.5%): “Treasury yields are perhaps 150 bps (basis points) or 1.5 per cent too low… Yields may have to go higher, maybe even much higher to attract buying interest.”

Treasury yields need to go to five per cent to attract buying interest? It was reported that Bill was increasing his allocation to U.S. Treasuries in late 2012 when yields were below two per cent. In 2011, performance turned out to be so bad for Bill’s fund that he issued a letter of apology to unitholders, calling 2011 “a stinker."

☛ Larry Fink, co-founder of BlackRock, the largest money management firm in the world, from February, 2012 (10-year U.S. Treasury yields: 2.0%): "I’d be 100 per cent in equities." Evidently, Larry’s clients don’t agree. And that’s a good thing. With $3.6 trillion in total assets under management, BlackRock still manages approximately $1.3 trillion in fixed income securities.

☛ Warren Buffet, the oracle of Omaha, from February, 2012 (10-year U.S. Treasury yields: 2.0%): Bonds “are among the most dangerous of assets.”

Well, it turns out that Warren likes to live dangerously! Asset allocation to bonds at his Berkshire Hathaway Inc. has remained fairly stable at around 25 per cent this year, as it has for the past several years when interest rates were much higher.

CONTRARIAN VIEW

History tells us that the market almost always thinks interest rates will rise. Since December, 2002, Bloomberg has conducted a monthly survey of economists' forecasts for 10-year U.S. Treasury yields for the following six month period. In 97 per cent of the surveys conducted, economists forecasted higher rates.

Only three per cent of the time did economists forecast lower interest rates for the next six-month period. Given the economic fundamentals over the last four years, we find this to be astounding.

One can conclude that economists are nearly always bearish on interest rates, regardless of the state of the economy, central bank policy, government finances, inflation, the geopolitical situation or the stock market! They may be right one day, but we believe they're wrong in the near-term.

From our vantage point, we believe that the economic, geopolitical, and fiscal environment continues to point to an extended period of low interest rates.

There are several reasons why we think this, despite the market's consensus to the contrary.

We are not expecting the Bank of Canada rate to increase over the next 12 months

In the aftermath of the debt binge in the early years of the 21st century, deleveraging (the reduction of debt) at the sovereign level, in the financial sector, and within individual households in the developed world is still a work in progress.

Consequently, there will be sub-par growth for years to come. Europe is in recession; Asia is on a slower growth path; the U.S. is setting records for food stamp and federal disability insurance recipients; and Canada is slowing with the downturn in construction.

An extended period of slow growth and deleveraging has been our base-case scenario for some time now, and it impacts all of our top-down strategies of duration, sector allocation, and yield-curve positioning.

The recovery will be delayed and the deleveraging period longer if debt write-offs are postponed, as is the case right now in Europe.

In addition, the aging population in the developed world will continue to keep rates low. As baby boomers retire over the next 15 years, national income levels and discretionary spending in the economy will decline, keeping economic growth levels lower than what we have been accustomed to for the past several decades.

Older people tend to save, not spend; pay off debt, not borrow. Government medical and income support programs will consume greater proportions of government revenues unless they are retooled to the demographic reality of retiring baby boomers.

Also, we will be expecting inflation to remain at low levels, allowing low interest rates to continue. The latest reading has headline and core inflation in Canada both in the low one per cent range.

Recent difficulties with certain food crops have led some market participants to believe that we were facing an outbreak of higher inflation due to rising food prices.

That is not likely the case. In North America, food costs are only a minor component of the Consumer Price Index (a measure of inflation), in the range of 15 to 18 per cent in the U.S. and Canada.

Many other commodities have seen significant price declines over the past year which can offset, to some extent, these potential food price increases.

Finally, the Bank of Canada sees headwinds ahead in the domestic economy, and is not as optimistic about the pace of economic growth as it was early in 2012.

The ongoing strength of the Canadian dollar is another reason for the bank to avoid increasing interest rates in the face of a U.S. Federal Reserve that is on hold until a sustainable recovery occurs in the U.S. and unemployment has fallen significantly.

We are not expecting the Bank of Canada rate to increase over the next 12 months. The fact that the U.S. Federal Reserve continues to take extraordinary measures to influence longer-term interest rates gives us further conviction – in our contrarian view – that the bull market in bonds will continue.

ASSET ALLOCATION

For these reasons and more, we believe that investors are too bearish about the bond market. But in this market environment, it is prudent to remain well diversified within the fixed-income asset allocation.

Government bonds provide the bedrock of a fixed income portfolio in times of intense equity market selloffs.

The corporate sector can help the fixed-income portfolio returns overcome prevailing low yields. Allocations to the investment-grade corporate sector, non-distressed high yield and crossover issuers make sense.

Corporate default rates are below historical levels, while the yield advantage of corporate bonds compared to government bonds remains attractive. In our assessment, the market is under-valuing the corporate sector.

Non-financial corporations in Canada have done a superb job of reducing leverage on their balance sheet, more so than corporations in the U.S., the UK and the euro zone. So from a risk adjusted standpoint, we remain positive on the corporate sector.

Depending on where the bonds are held, it may be appropriate to consider bond investments with tax-advantaged structures.

Real return bonds look expensive considering our outlook for inflation. Floating rate notes may be an alternative to pure cash holdings, but don't expect the floating interest rate to increase any time soon.

The Mayan calendar is calling for the end of the world on December 21, 2012. We believe that date will come and go, disappointing those who are preparing for the worst.

And what about investors and economists saying that the end is nigh for the bond market? They too will be disappointed in 2013. ▼