The Big Read **US Treasury Bonds**

Bond markets: Is the bull run over?

A sell-off in government bonds has triggered fresh concern that a three-decade boom in the $50tn market could be coming to an end

Robin Wigglesworth in New York
YESTERDAY

In *Trading Places*, the entrepreneurial prostitute played by Jamie Lee Curtis reveals that she has saved up $42,000 in US Treasury bills, and reckons that with the accruing interest from the bonds she can retire after a few more years on the job.

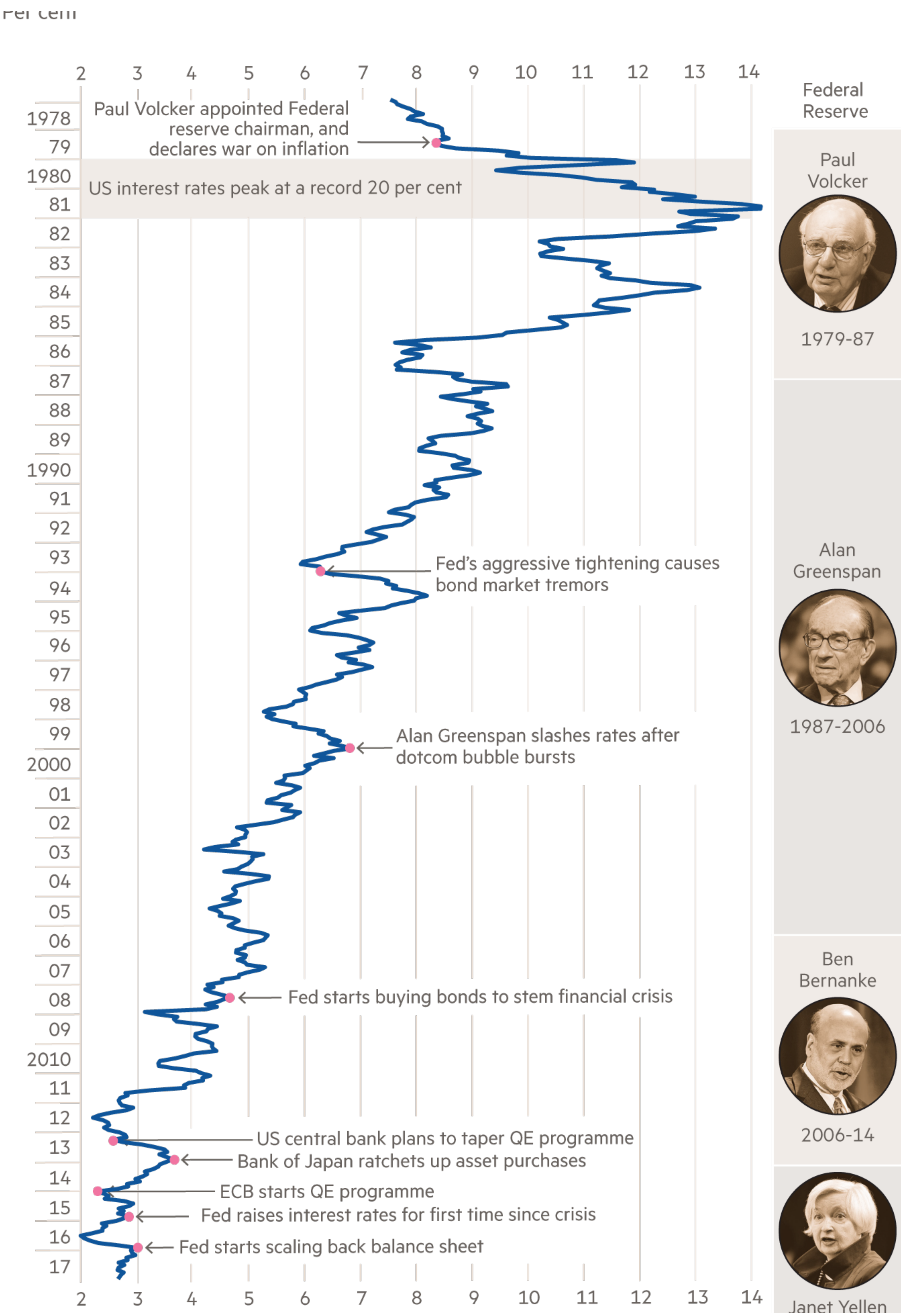
Modern viewers might be surprised that a modest stash of short term, ultra-safe loans to the US government could ever yield a big enough bonanza to retire on. Yet in 1983, when *Trading Places* was released, the three-month T-bill yield averaged nearly 9 per cent, an abundance compared to the paltry 0.7 per cent average of the past decade. To put this in context, *Trading Places*-era bills would double your money in less than nine years. At today's yield it would take more than half a century, according to Bank of America Merrill Lynch.

It highlights one of the most dramatic market shifts in history — the slow but sure collapse in bond yields over the past three decades. The financial crisis supercharged the great bond bull rally, by spurring more than 700 central bank interest rate cuts across the world and multitrillion-dollar bond-buying programmes.

However, the era of super-easy monetary policy is receding. This year will probably mark the first since the financial crisis where major central banks start shrinking their market footprint, reawakening concerns over the $50tn global bond market where governments, companies and banks raise vital funding.

"Central banks have been everything for fixed income markets for a long time. But the direction is now unquestionably towards the Great Tapering," warns Michael Hartnett, chief investment strategist at Bank of America Merrill Lynch.

Ten-year US Treasuries: the end of the long decline in yields?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Paul Volcker appointed Federal reserve chairman, and declares war on inflation
US interest rates peak at a record 20 per cent
Fed's aggressive tightening causes bond market tremors
Alan Greenspan slashes rates after dotcom bubble bursts
Fed starts buying bonds to stem financial crisis
US central bank plans to taper QE programme
Bank of Japan ratchets up asset purchases
ECB starts QE programme
Fed raises interest rates for first time since crisis
Fed starts scaling back balance sheet
Federal Reserve
Paul Volcker
1979-87
Alan Greenspan
1987-2006
Ben Bernanke
2006-14
Janet Yellen

2014-18

Source: Thomson Reuters Datastream

A sell-off across government bond markets this week and warnings from two of the investment industry's biggest names that we are entering a new era added to the anxiety. Bill Gross, the founder of Pimco who now works at Janus Henderson, declared that bonds were already in a bear market, given that the 10-year US Treasury yield had risen above 2.5 per cent. Jeffrey Gundlach of DoubleLine Capital said that was premature, but argued that central bank policy was ushering in a market-unfriendly "era of quantitative tightening".

That could have implications, not just for investors. The bond market is arguably the most important cog of the global financial system and if it stutters entire regions can feel the impact.

The end of the bond bull market has been called before. Last year, many analysts predicted a gloomy outlook. Instead, global fixed income enjoyed its best year in a decade, returning 7.4 per cent to investors in the Bloomberg Barclays Global Aggregate bond index. Few believe bonds will replicate those gains in 2018. But many investors say it is far too early to read the market's last rites, given some of the long-term global forces — such as the inflation-subduing forces of demographics and technology — that keep yields suppressed.

"This isn't the end of the bull market," says Gregory Peters, a senior portfolio manager at PGIM Fixed Income. "The market action has been pretty sizeable, but I don't think this is a regime shift."

Dan Fuss of the Loomis Sayles bond fund believes that several factors now point to a difficult period ahead for fixed income assets © Bloomberg

On Wednesday, Dan Fuss, the bond fund manager at Loomis Sayles, the Boston-based investment group, spoke to a group of financial advisers in Providence, Rhode Island. Normally it would have been a breeze for the feted investor with nearly six decades of experience, but the questioning was unusually pointed this time.

Mr Fuss has shifted over a third of his $13bn Loomis Sayles Bond Fund into cash, Treasury bills and other short-term, safe bonds, more than double the level of a year ago. It is the 27-year-old bond fund's most defensive portfolio, and the most conservative Mr Fuss has been since the late 1970s — raising concerns among some of his investors.

"I'm an old man so they cut me some slack, but not that much," he admits. "The questions have been hard."

The former Navy officer says the stance is less motivated by fears of a downturn than a pervasive sense that everything in bond markets looks egregiously expensive, at a time when many factors — ranging from valuations to politics and technical elements — are moving in the wrong direction.

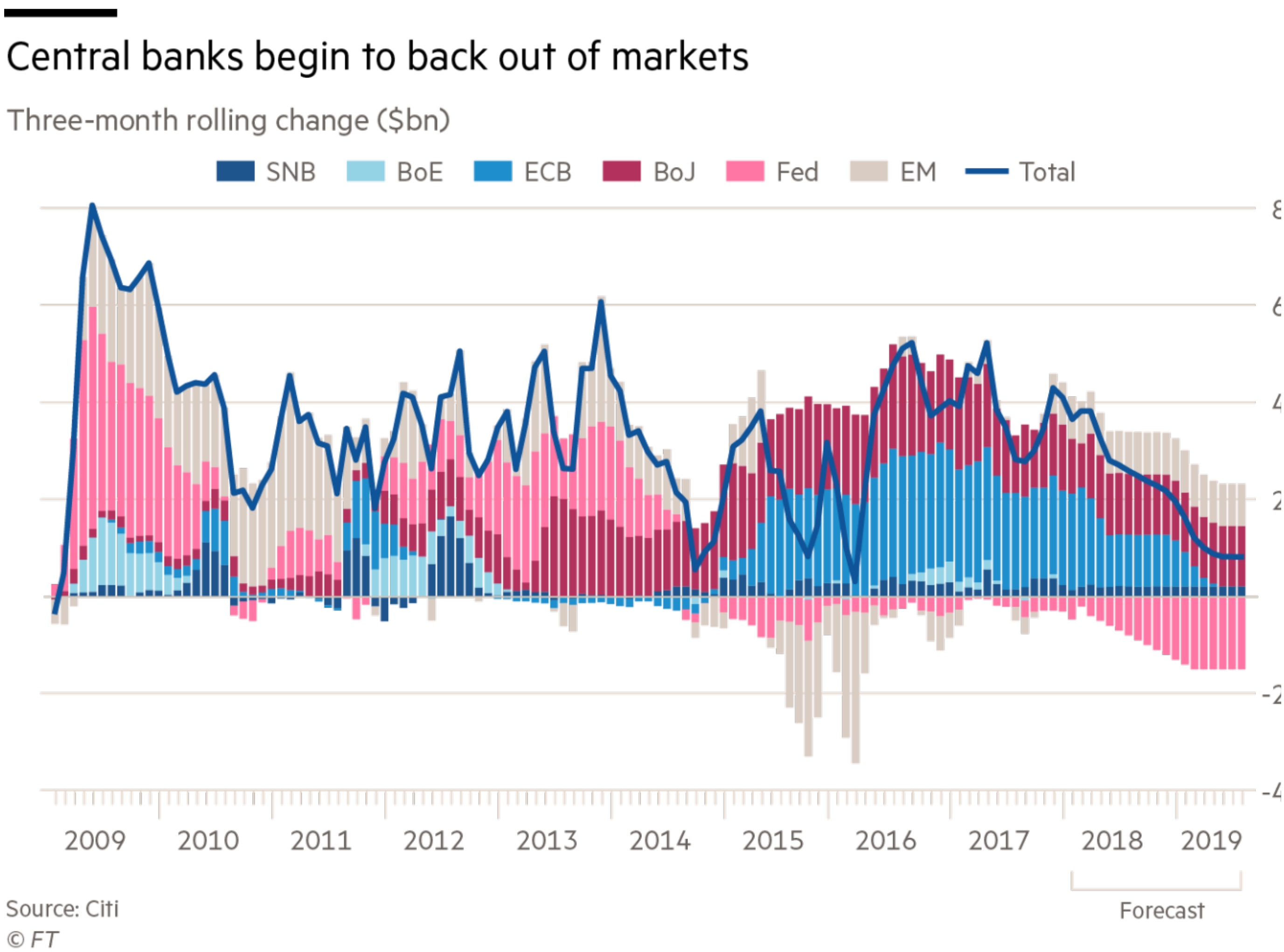
"When we look at the opportunities in fixed income, they're just not very good," Mr Fuss says. He believes there is a high probability that bonds will continue to sell off through the year, pushing the 10-year Treasury yield above the 3 per cent mark. But there is a danger of a deeper rout, he warns.

Markets have for years enjoyed ample, if alternating, monetary support. When the Federal Reserve began unwinding its quantitative easing programme in 2014, the Bank of Japan stepped in to unveil an even bigger scheme. When the US central bank started raising rates in 2015, the European Central Bank floored its monetary pedal. Central banks bought $1.5tn of bonds last year, up from an annual average of $1.25tn between 2011 and 2016, according to Citi strategist Matt King.

But investors now face a shift in central bank policy.

The Fed started cautiously shrinking its balance sheet last year. This month the ECB's bond-buying fell by half to €30bn a month, and analysts expect the programme to end this year. For the first time in a decade, central banks will probably be withdrawing money from markets by the end of 2018.

The primary cause for this week's bond ructions — which saw the 10-year Treasury yield rise to a nine-month high of nearly 2.6 per cent — was data that showed the BoJ's purchases of long-dated bonds had slowed, with the sell-off then exacerbated by reports, later denied, that China was considering reducing its Treasury purchases.



While the Japanese central bank will still buy as many bonds as needed to keep the 10-year government yield pinned at zero, the deceleration was enough to cause the global debt market to shiver. “The market reaction shows just how sensitive it is to any whiff of the central banks being less aggressive,” Mr Peters says.

At the same time, supply of freshly-issued government debt is expected to rise. In 2017, the central banks of the US, Europe, Japan and the UK bought about $170bn more government bonds than were issued, meaning the net supply actually contracted. But BNP Paribas estimates that markets will have to absorb $600bn of debt in 2018.

Another potential risk for investors is whether 2018 is the year when inflation finally emerges from its slumber.

The 10-year “break-even” rate, a measure of inflation expectations derived from comparing the yields of conventional and inflation-insured Treasuries, has climbed above the 2 per cent mark this year, for the first time since March 2017. Although largely driven by rising oil prices, other popular measures are also edging higher, and inflation-proofed bond funds have enjoyed 11 straight weeks of inflows.

The recent US tax cut at a time when the economy is already in rude health is the biggest concern of Bob Miller, portfolio manager for BlackRock’s Total Return Fund. “The market still underestimates the impact of the stimulus, and the supply increase that will be needed to fund it,” he argues. “We’re not in the raging inflation camp, but we will see faster inflation in 2018.”

Bill Gross, known as the bond king, told investors that bonds already faced a bear market © Bloomberg

Some analysts and investors worry that the end of the QE era will be more dangerous for stock markets and corporate debt than government bonds.

Mr King at Citi points out that the Fed's QE programmes led to higher Treasury yields, as deflationary fears faded, while yields tumbled soon after the initial shock of the US central bank plan to end QE emerged in 2013. His research indicates that riskier assets such as equities and corporate bonds are acutely sensitive to the flow of central bank bond purchases. "I think people are excited about the wrong thing," he says. "Valuations are so extended that markets are far more vulnerable now."

Indeed, the bond market's bull run predates QE and has survived previous interest rate rises because it is driven by secular forces greater than the ebb and flow of financial cycles.

Ageing demographics is pushing a global savings glut into safer fixed income and helping keep inflationary forces at bay, aided by technology that is proving to be a deflationary force across a range of global industries. Jim Reid, a Deutsche Bank strategist, says that bond market squalls might become more frequent as central banks tighten their monetary spigot, but argues that it would take accelerating inflation "to really turbo charge any bond sell-off".

Derivatives contracts indicate that investors believe the 10-year Treasury yield will be below the 3 per cent mark in two, five and even 10 years' time. Equivalent German and Japanese bond futures show that investors think their benchmark bond yields will stay below 2 per cent and 1 per cent respectively over the same timeframes.

Highlighting the ravenous demand for safe fixed income returns, droves of buyers were attracted this week to the auctions of 10 and 30-year US government debt, helping quell the turbulence.

Even Mr Gross later moderated his comments, predicting that the 10-year Treasury yield would only creep up to 2.7 per cent by the end of 2018 and that most bond portfolios would still eke out slender positive returns — hardly a bear market. In an interview with CNBC, the fund manager used a coffee analogy to explain his view: “It’s not a strong Colombian bear market,” he said, “it’s a decaffeinated bear market.”