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Alternatives sought as global bonds have a tough time

THE outlook for global bonds is less than rosy with valuations stretched as a result of monetary policy stimulus, and the subsequent capital flow to bond instruments.

Adriaan Pask, chief investment officer at PSG Wealth, says in the US, nominal and real 10-year Treasury yields have been falling for the past 30 years, leaving both real and nominal yields historically low.

"Global bond yields are running at 1.3% relative to their historic average rate of 4.3%. When these yields normalise, capital losses to investors could be severe.

"Currently, global bonds are (on aggregate) about 69.5% overvalued. Relative to historic yields, global bonds are one of the least attractive asset classes, second only to global cash yields," Pask says.

He says Federal Open Market Committee (FOMC) research supports the view that current yields should increase by roughly 3% to normalise.

Recent research by JP Morgan provides some guidance on expected losses on various Treasury securities per 1% increase in interest rates. It indicates a 30-year Treasury bond will incur an approximate loss of 18.6% per 1% increase in US interest rates. Even shorter dated instruments such as two-year Treasury notes stand to lose as much as 6% should rates normalise.

"Monetary policy normalisation will happen. The question is when, by how much, and over what period?" Pask says.

Adriaan Pask ... expect volatility.

"With the US Federal Reserve already completing their asset repurchase programme last October, the only remaining monetary policy normalisation mechanism is interest rates.

"The Fed has long indicated that it will not consider hiking rates prior to stabilising labour markets, targeting a sub-6% unemployment rate.

"With US labour markets largely stabilised (US unemployment at 5.5% as at the end of February) one might now reasonably expect more hawkish discussion regarding rates, which could well result to the first step towards normalising yields and valuations."

He says the latest year-end rate expectations released by FOMC shows that both market participants and FOMC expect rates to increase by year end. In addition, FOMC research suggests that market participants expect the Fed Funds rate to be much lower than what is being projected by FOMC, meaning large and unexpected rate hikes could disrupt the market.

"Normalisation is unlikely to be synchronised, and a protracted period of volatility should be expected.

"The true challenge for investors — particularly those in multi-asset portfolios — is to find an alternative asset class that offers similar diversification properties to that of global bonds.

"Historically bonds have been negatively correlated with equity, which made it a good diversifier in multi-asset portfolios. In the current environment, however, the diversification properties have been largely nullified as a result of valuation risks," Pask says.

He says the research suggests that global equities are trading at a slight discount to fair value, and if investors accept that volatility either via bonds or equity is to be expected, then equities offer the best risk adjusted returns.

"Core complements such as absolute return, floating rate, convertibles and inflation-hedging strategies can also help diversify portfolios as they are less sensitive to rising rates.

"In terms of our in-house product offerings, we continue to carefully assess the risk adjusted returns of various managers, asset classes and securities to ensure that we construct portfolios with prudence and care to deliver better outcomes for our clients," Pask says.

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