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Harvard Academic Sees Debt Rout Worse Than 1994 ‘Bond Massacre’

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(Bloomberg) -- If you thought you had already read the gloomiest possible prognosis for bonds, wait until you read this one.

Paul Schmelzing, a PhD candidate at Harvard University and a visiting scholar at the Bank of England, said if the latest bond market bubble bursts, it will be worse than in 1994 when global government bonds suffered the biggest annual loss on record.

“Looking back over eight centuries of data, I find that the 2016 bull market was indeed one of the largest ever recorded,” wrote Schmelzing in an article posted on Bank Underground, which is a blog run by Bank of England staff. “History suggests this reversal will be driven by inflation fundamentals, and leave investors worse off than the 1994 ‘bond massacre’”.

Schmelzing, whose research focuses on the history of international financial systems, divided modern-day bond bear markets into three major types: inflation reversal of 1967-1971, the sharp reversal of 1994, and the value at risk shock in Japan in 2003.

The Bank of America Merrill Lynch Global Government Index of bonds fell 3.1 percent in its worst-ever annual loss in 1994 as then-Fed Chairman Alan Greenspan surprised investors by almost doubling the benchmark rate. Treasury 10-year yields surged from 5.6 percent in January to 8 percent in November.

The current bond market is facing the “perfect storm” of potential steepening of the bond yield curve, monetary policy tightening, and a multi-year period of sustained losses due to a “structural” return of inflation resembling that of 1967, he said. Last quarter was the worst for government bonds since 1987, according to data compiled by Bloomberg.

“By historical standards, this implies sustained double- digit losses on bond holdings, subpar growth in developed markets, and balance sheet risks for banking systems with a large home bias,” Schmelzing said.