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Debt markets: After the binge

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Low interest rates sparked record bond issuance but with rates set to rise the market is anxious

Martin Schroeter was a worried man. It was October 2008 and the IBM treasurer had seen Lehman Brothers go bust just a few weeks earlier, triggering a global financial crisis. The technology giant was in good shape, but with capitalism seemingly on the verge of unravelling no one could feel completely safe.

Bond markets were in turmoil, some banks were teetering and all were severing their lending lines even to their most creditworthy clients. "Everyone told us we'd be fine, but the best way to test that was to go to investors and find out," recalls Mr Schroeter, now IBM's chief financial officer.

That month the company pulled off one of the first big corporate bond sales after the Lehman bankruptcy: a $4bn three-part deal that served as a reminder that investors would still fund solid companies — albeit at a steep price. The 10-year bond yielded over 7 per cent, and the 30-year part over 8 per cent; extremely high for a company of IBM's creditworthiness.

These days, even impoverished African countries and ramshackle companies can borrow more cheaply than that, thanks to extraordinary central bank stimulus across the world — and, above all, by the Federal Reserve's zero interest rates and $4tn quantitative easing programme. This has supercharged a three-decade bond market rally and battered yields down to levels unimaginable just a few years ago.

But with US interest rates set to rise for the first time in almost a decade, questions are being raised about whether the end of the great bond party is nigh. The US central bank has been at pains to stress that it will only move gradually to "normalise" interest rates, but the first rise will signal that the era of ultra-loose US monetary policy is over — with painful implications for global debt markets.

Many companies, banks and governments have become accustomed to ultra-low borrowing costs, tapping bond markets for record amounts. They have issued more than $6tn of bonds annually for the past three years and have sold $3.8tn already in 2015 — to fund investments, acquisition sprees and public spending. Fed rate increases could imperil this feast.

“Rate increases are like cockroaches. You never see just one,” warns Ralph Segall, chief investment officer at Segall Bryant & Hamill, a Chicago-based asset manager. “There has to be some pain after a binge.”

Super taper tantrum

It has been a long and hearty indulgence for bond investors. Since former Fed chairman Paul Volcker won the war against inflation by ramping up interest rates in the 1980s, bond yields have plummeted, only occasionally climbing higher due to [Fed rate hiking cycles]() or calamities like the global financial crisis.

That has burnished returns. Simply buying the bonds in the Barclays Aggregate index — which includes a mix of highly-rated corporate and government debentures — in 1981 would have bagged 8.4 per cent a year on average since then. Corporate bonds have done even better, on average returning 9.3 per cent annually. Equities have only marginally outperformed and at the cost of considerably more volatility.

But the outlook now looks much murkier. Mathematically it will be impossible to replicate those returns, and some analysts fear that the bond “super-cycle” is now about to reverse. Research Affiliates, a consultancy, predicts after-inflation annual returns of just 0.7 percentage points in the coming years — a far cry from the bounty of the past three decades.

“It’s obvious to everyone that this is more or less the end,” says Jeremy Grantham, founder of GMO, the asset manager. “We just don’t know how dramatic it will be.”

Mr Grantham is a prominent bear, but is far from the only one fretting. A slew of big-name money managers have lined up to call the end of the bond super-cycle lately. Even the International Monetary Fund is worried, warning that there is a danger of a “super taper tantrum” — a fiercer repeat of the events in 2013 when the central bank said it would begin unwinding QE and investors fled bond markets — when the Fed lifts rates.

“Everyone is scared stiff at what happens when rates rise,” admits Michael Materasso, a fund manager at Franklin Templeton. Many in the industry now joke that bonds no longer offer “risk-free returns” but rather “return-free risk”.

The seemingly inexorable rally, which had left trillions of euros worth of European bonds trading in unchartered, negative-yield territory, suddenly reversed at the end of April without an obvious trigger, dragging US bond yields higher too. “The bear market has started,” Michael Novogratz, the head of Fortress Investment Group, told Bloombergshortly afterwards.

Corporate treasurers certainly appear to be preparing for tougher times. Companies have tapped bond markets for money with gusto in recent years, a frenzy that reached record-breaking levels — before the traditional summer slowdown as finance directors locked in cheap borrowing costs before rates rise.

For most companies, rising borrowing costs will prove unproblematic. Some extremely indebted businesses — or weak ones in struggling industries that have found temporary succour in falling bond yields — may fail as a result. But most chief executives on both sides of the Atlantic have remained conservative despite the surge in bond issuance in the wake of the financial crisis. Overall corporate indebtedness remains low, and most companies are well-prepared for less buoyant debt markets.

However, the corollary is that investors have also been locking in low-yielding, long-term investments just as the Fed is preparing to raise interest rates, which will likely hurt their value. A bond with a 3 per cent coupon becomes marginally less valuable if interest rates climb from zero to 0.5 per cent, and much less valuable if rates go higher.

Billions of dollars have gushed into bond mutual funds in recent years, as retail investors scarred by two dramatic stock market collapses in less than a decade sought out the relative safety of fixed income. Many are likely to find out that safety is relative, and that bonds can also lose value.

Adding to the concerns, bond markets have been plagued by a trading downturn in recent years. In the industry parlance, the "liquidity" has dried up, especially for corporate debt, which means it is increasingly difficult to sell big bond positions without depressing the price.

The concern dogging markets is that if retail investors reverse course and yank their money out of bond vehicles such as mutual funds and exchange-traded funds — which like bank deposits promise them the ability to withdraw money at the drop of a hat — it will trigger a rash of forced selling of assets that only trade infrequently, exacerbating any turmoil.

Frayed nerves

The bond industry is fighting to quell these concerns, but fund managers are girding themselves for choppier times. Cash holdings are at their highest level since December 2008, according to a survey by Bank of America Merrill Lynch, as many prepare themselves for possible investor outflows.

Some have gone further. Marcus Brookes, manager of Schroder's Multi-Manager Diversity fund, has allocated close to one third of his portfolio in cash in part because he worries that bonds are overvalued. Norway has begun to shift bond holdings in its $900bn sovereign wealth fund to shorter maturities, which are typically more liquid and less affected by interest rate changes, in anticipation of further volatility.

Nonetheless, while the great bond bull market might be on its last legs, few investors or analysts foresee its replacement with a "bear" market, where investors suffer sustained or severe losses. Even in 1994, an annus horribilis for bonds, when the Fed raised rates aggressively, the Barclays Aggregate index lost less than 3 per cent.

While the Fed is going to lift interest rates eventually — perhaps as early as next month — it has sought to reassure markets that it will act with caution. Most policymakers see the benchmark interest rate still below 3 per cent at the end of 2017, and estimate that the new longer-term average rate is below 4 per cent, hardly Volcker-like levels.

At the same time, the Bank of Japan and the European Central Bank have cranked up their own quantitative easing programmes, and are buying even more bonds than the Fed ever did, helping to keep global borrowing costs low. The 10-year Treasury yield is already higher than over 80 per cent of the $20tn of debt — issued by the likes of Germany, Denmark, Canada, Australia and Japan — in JPMorgan's Global Bond Index, which will help maintain international appetite for US bonds.

The main danger — inflation — looks distant. While doomsayers have long prophesied rampant inflation from whizzing electronic money-printing, prices have remained subdued across most of the world. Global growth is limp, and economists say that the excess capacity built up in the pre-crisis boom will keep international inflationary pressures low for years to come.

At the same time many investors would embrace a reversal in yields as a chance to pile into the market, thereby muting the danger of entering bear territory. Insurers and pension funds in particular have laboured to get the returns they need to match their long-dated liabilities at a time when interest rates have plumbed record lows.

This has presented "serious problems to the solvency" of pension schemes and insurers as they struggle to produce enough income to fund their obligations, the OECD said this summer. Swiss Re recently estimated that the lost yield income for insurers on both sides of the Atlantic could total $400bn.

Buying opportunity

"I've been in the business for three decades and I can't remember a time when there were so many investors waiting — dying — for rates to go up," says Jim Sarni of Payden & Rygel. "They need higher yields. The market will embrace rate increases in a way it hasn't before."

One such investor is Tod Nasser, the investment chief of Pacific Life, an insurer that snapped up a big chunk of the IBM bonds issued in 2008, as well as other high-return deals at the time from the likes of Boeing, ConocoPhillips and Pfizer. "It was the best of times for us, even if it was the worst of times for many others. Those deals were among the best we've done in a quarter century," he says. The 10-year bond issued by IBM at the peak of the crisis in 2008 with a yield of more than 7 per cent now trades at just 1.7 per cent.

While Mr Nasser admits that the returns of the past three decades will not be repeated, he highlights the still-ravenous appetite at auctions of longer-dated debt as evidence that demand remains high from pension funds, insurers and other less short-term investors.

"We hope a sell-off happens, it would be too good an opportunity for too many people that still have to buy a lot of bonds," he says. "The bull bond market is over, but that doesn't mean we're heading into a bear market."

Demographics: How an ageing population threatens the bond markets

Many theories have been proffered to explain the remarkable decline in long-term bond yields over the past three decades, but demographics has emerged as a leading contender.

Former Federal Reserve chairman Ben Bernanke suggested in 2005 that a “global savings glut”, caused by increasingly parsimonious Asian economies and oil-rich Middle East countries, was the primary cause of falling bond yields — a thesis he reiterated earlier this year. His argument was recently backed up byresearch from economists at the Bank of England, who estimate that the “global neutral rate” of long-term interest rates after inflation has fallen by 4.5 percentage points since the 1980s. But the BoE economists reckon that shifting global demographics account for almost 1 percentage point of the decline, far more than Asian savings or tepid investments.

Over the past three decades the proportion of dependents — those aged below 19 or above 65 — has fallen from 50 per cent of the global population to 42 per cent, the BoE pointed out. Workers save more than dependents, especially when they get older, and are particularly keen on bonds and other safer investments later in life.

But the baby-boomer generation is now eyeing retirement, when they will not only stop saving but also start depleting their nest egg, representing a slow-moving but significant threat to the bond market in the coming decades.

The BoE’s economists were relatively relaxed about this, pointing out that global savings will only start to fall gradually after 2020 and forecast that the global neutral rate will stay low at about 1 per cent after inflation over the next five years.

But research by Michael Gavin at Barclays suggests that longer term this may be too optimistic. He believes the neutral rate will rise by 2.25 percentage points in 10 years and 3.5 percentage points over the next two decades.

Even this may prove too sanguine, he argues.

“The increase in the observed interest rate [one stripped of inflation] is likely to be larger, because it is now below the natural rate, as a result of many monetary authorities’ attempts to promote economic recovery and raise the rate of inflation,” the report said.