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Bond Trader Buzzkill Is the Suspicion That Losses May Come Fast

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By Lisa Abramowicz

(Bloomberg) -- Making easy money in the bond market has perhaps never felt this unnerving.

Bond investors are questioning themselves as they cast aside their historical models and watch their debt holdings keep on rallying -- thanks to central banks across the globe that are making government bonds scarce by hoarding trillions of dollars worth of them. So, even though the $40 trillion broad global bond market is handing investors above-average returns in 2015, asset managers are preparing for catastrophe.

Why? Mainly because the market feels increasingly one-sided and dependent on the decisions of a handful of policy makers.

That means a sudden shift in sentiment could rapidly undo any gains eked out in a seventh year of near-zero interest rates from the Federal Reserve, a risk that's amplified by how much harder it's become to trade bonds.

One of the main risks to debt markets right now is a "policy error," or a misperception of central bankers' intentions, said Arif Inayatullah co-founder of Tricadia Capital Management LLC, a hedge-fund firm that oversees about $4 billion. There's the potential for a "disorderly" move in benchmark interest rates that may cascade into other asset classes, he said.

Taper Tantrum

The bond rally's gotten its latest boost from Federal Reserve policy makers who've said they have no intention of raising benchmark interest rates quickly, even as they plan for their first rate hike this year. Fed Chair Janet Yellen said on March 27 that "it is appropriate for monetary policy to remain accommodative for some time."

Meanwhile, in Europe, the region's central bank is holding deposit rates below zero, meaning that investors need to pay for the privilege of lending to many creditworthy borrowers. If policy makers in one of these regions were to suddenly reverse course, or indicate that the market's misunderstood their intentions, that would likely wreak havoc on bond and stock markets.

That same sort of thing has happened, of course, already in recent years. The so-called taper tantrum of mid-2013 -- sparked by then Fed Chairman Ben S. Bernanke's discussion of ending asset purchases -- sent Treasury yields surging and prompted a 3.2 percent loss in U.S. government debt, according to Bank of America Merrill Lynch index data.

Riskier debt lost even more, with dollar-denominated investment-grade notes dropping almost 5 percent.

Negative Yields

Since then, Treasuries and corporate bonds have retraced their losses and then some. The Bank of America Merrill Lynch Global Broad Market Index has returned 1.8 percent this year, following a 7.8 percent gain in 2014.

Part of the reason is that even though yields on 10-year U.S. Treasuries have dwindled to 1.9 percent, about a half-a- percentage point from their all-time low, they look high compared with what's available on other nations' debt.

Stimulus from the European Central Bank to the Bank of Japan has sent yields on about $1.9 trillion of government debt below zero, according to data compiled by Bloomberg.

"Easy-money central bank policies are throwing certain principles of human nature and finance out the window," UBS Wealth Management Chief Investment Officer Mark Haefele wrote in a March 26 report. "Adjusting to a new world in which investors often pay for the privilege of lending money, has been occupying much of our thought."

This booming bond market is causing some somberness among investors who are waiting for the other shoe to drop.

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