

The dangerous quest for bond yields

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For several months now, we have seen a spate of alarmist articles and statements claiming that a bond bubble is about to burst. Major asset managers, which need to ensure that the securities they hold in their funds are liquid, have expressed concern and some have set up protection systems to guard against liquidity in the global markets drying up. Jamie Dimon (CEO of JP Morgan Chase) recently said that bond market liquidity was a major risk. He underlined extreme price volatility, including in the US Treasuries market, which is usually very calm. To support his comments, he pointed – like many market professionals have recently – to the sharp reduction in liquidity caused by the disappearance of market-makers. To meet tougher capital requirements and more conservative regulations regarding leverage in their balance sheets, many banks have scaled down or stopped their market-making activities. In the corporate bond segment, the number of issues and the volume of bonds in issue have risen by over 50% since 2007, while market dealers' positions in these securities have fallen by 75%.

We are therefore in a highly paradoxical situation in which bond market volumes have increased sharply and central banks have been injecting historic amounts of liquidity for years, and yet the markets are showing a worrying lack of liquidity. A market that lacks liquidity always becomes much more volatile and represents a much greater risk for all concerned.

In addition, regulatory constraints and investors' desire for safe havens have led to negative interest rates in almost 30% of the global economy. In response, private clients are taking on much greater risk in their portfolios by investing in lower-quality issuers in order to achieve positive yields that meet their expectations.

For private-banking clients, fixed income investments generally account for 30-40% of assets under management depending on their country of origin. Private clients have always regarded bonds as a liquid investment and one that is much less risky than equities or commodities. Accordingly, bonds meet the needs of clients who want to receive a regular income and preserve their capital. For these reasons, bond management and bond trading account for a significant proportion of profits in the private banking industry. It is therefore not surprising that figures published by all private banks in the second half of 2015 showed a significant decline in trading revenue, because of the volatility and substantial price falls in certain bond categories since the summer of 2015. Clients who made large investments in the riskiest segments of the bond market – i.e. emerging-market and high-yield debt – have seen the value of their positions fall sharply. As is often the case, private clients have therefore changed tack, restricting themselves to a "buy and hold" strategy that involves waiting until bonds mature in order to recoup their capital, and avoiding any decision to sell as they should when issuer risk increases.

As a result, private banks are in a tricky position, like those they have experienced in the past: account performance is suffering, trading volumes and therefore revenues are falling, and clients are questioning how much value their advice really adds. Bond corrections always raise questions about banks' stock-selection and risk-analysis capabilities.

When they happen, therefore, we need to advise our clients to assess the real issues connected with their bond positions, and particularly issuer risk, which has increased sharply because of the risk of bankruptcies in the high-yield segment. We need to highlight liquidity risk, and naturally we need to offer alternatives.

There are several ways of dealing with the situation, including by switching assets into high-quality equities that pay large dividends. In many cases, equities are currently much more attractive than bonds in terms of both yield and risk. Some high-quality stocks in low-volatility sectors are paying very high dividends, whereas the same issuers' bonds are sometimes offering negative yields. This situation suggests that a bubble may be forming, which could lead to a sharp bond correction in the medium term.

Equity-market volatility in the last few weeks also represents a real opportunity to buy this kind of high-quality stock that offers a much better risk/return profile than bonds.

To deal with the long-term impact that the current situation could have on portfolio performance, as well as on the economics of private banking, traditional remedies must be used. They include diversification and, naturally, a focus on long-term returns that includes a genuine analysis of global risks as part of the asset allocation process. Times have changed. Bonds, which private clients have long regarded as a guarantee of safety, must now be seen as a real source of risk that must be mitigated and managed.