Business Standard

A bond bubble?

We need to worry about a bubble building in the bond market

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Something odd is happening in the bond markets globally. Just look at some of these data points. Unprecedented on multiple dimensions. Never seen anything like these.

- $15 trillion worth of bonds now trade at negative yields globally.
- 43 per cent of bonds outside the US are negative yielding and in Germany, the entire government bond yield curve is in negative territory (up to 30-year maturity).
- Multiple junk bond issuers in Europe are effectively getting paid to borrow money.
- Despite nearly destroying the world economy 10 years ago, sub-prime, zero down payment mortgages are making a comeback.
- 75 per cent of commercial real estate mortgages are interest only, the highest percentage since 2006.
- The size of the US corporate bond market rated BBB (just above junk) has never been bigger.
- We have matched the all-time low yield for 30-year bonds in the US, andcurrently, we have negative bond yields in Japan, Germany, France and Switzerland. The yield curve has inverted across most maturities.
- In 2008, when the global financial system was on the verge of collapse, the G7-government bond yields were at 3 per cent. Today, these same yields are below 1 per cent.
- The 100-year Austrian bond price chart has gone parabolic, rising from 110 to 185 in the past 12 months; from 150 to 185 in the past two weeks. The price chart looks very similar to many of the tech stalwarts in their heydays.

There are two possible explanations for this type of exaggerated price movements in the fixed income markets. One, the fixed income markets are signalling a very weak economic outlook on both growth and inflation. The inversion of the yield curve signals that a recession is imminent, and negative real yields imply that the markets expect inflation to continue to weaken. The markets seem to be implying a scenario of very weak economic growth and the rising risks of deflation. The current trade wars and weakening corporate confidence globally could take us to a global recession, not an impossible scenario, but even then price moves seem exaggerated.

Bubbles are common in the equity markets. We have seen many, across geographies and time periods. The biggest arguably being the dot-com bust of March 2000. The bond markets are seen to be far more stable. Investors look towards bonds for stable and secure incomes, not wild swings in prices. We do not typically see much media attention, identifying bond bubbles.

However, recently, we have started to see bubble-like behaviour among bond investors.

In a classic bubble, investors do not care about the intrinsic value of the asset they are purchasing. They are convinced that they can flip the asset purchased in a short period to another buyer (greater fool theory). Today, the greater fool is assumed to be central banks, which will buy assets at any price, once they restart quantitative easing or QE (asset purchase programmes). Alternatively, pension funds and insurance companies may be forced to buy fixed-income assets at almost any price due to regulatory requirements. Surely, someone buying German 15-year bonds at negative yield has no intention to actually hold these bonds till maturity and lock in a guaranteed capital loss. They are buying these bonds to flip them at a higher price to another buyer.

In bubble-like environments, investors also extrapolate current economic conditions far into the future. We have had a 30-year bond bull market. This bull phase was built on the back of gains in fiscal consolidation, productivity and globalisation. Rates and inflation have almost continuously declined over the past 30 years. It is very unlikely these trends can continue from here. Neither rates nor inflation has much scope for further decline. Central banks are telling us, going forward, they want more inflation. Inflation being persistently below target has been cited as one of the reasons for further rate cuts. Similarly, governments are being less fiscally responsible. Spending more is winning votes. There is no Tea Party in the US, and fiscal restraint is losing favour in the UK and the EU, as well.

Globalisation has seemingly stalled. In country after country, trade and immigration barriers are rising. The deflationary shock of India and China liberalising and becoming part of global supply chains is unlikely to be repeated. No other region of the world has the scale to lower goods prices globally.

With these factors reversing, can we really expect inflation to continue declining from here, as bond pricing indicates?

Illustration: Ajay Mohanty

In bubbles, valuations do not really matter. Such is the case today. Bonds are being priced as if growth and inflation will never return. The theory goes that this is due to the mountain of debt already dragging down the global economy. The more debt that is issued, the more these conditions of no growth/inflation get reinforced. The more these conditions are strengthened, the more debt is bought by investors as that seems to be the sensible asset to own in a world of no growth/inflation. It almost seems to be a self-reinforcing loop.

Simple common sense dictates that these yield levels are unrealistic. How can Greece have a lower cost of borrowing than the US treasury? Why will investors chase after the Austrian 100-year bond, when even a 1 per cent rise in yields will deliver a 30 per cent capital loss? The price of money is the most critical signal in the entire economic system. Everything else is priced off the risk-free rate. An artificially low risk-free rate will create pricing distortions across all asset classes. Any normalisation of rates, even real rates going to zero, may cause significant asset price volatility across all asset classes. There will be unintended consequences.

As an aside, without getting into the debate of whether India should issue a foreign currency sovereign bond, surely, if we are ever going to do it, there cannot be a better time. This is an issuers market. You may be able to raise money at silly yields. Take advantage. If a market or asset class is in a bubble-like environment, surely you should use it to your benefit.

The writer is with Amansa Capital. The views are personal