The Trouble With Bonds: Do Low Yields Provide Enough Safe-Haven Benefits?

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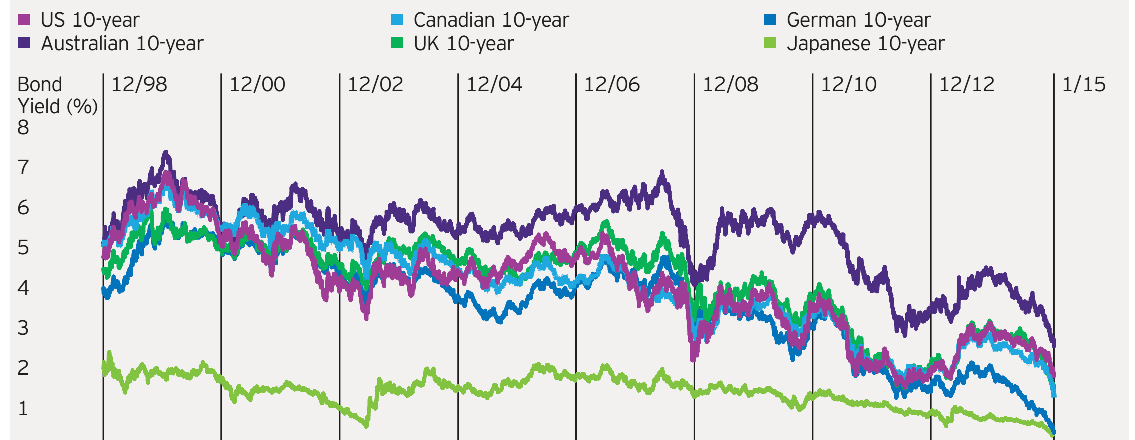
At the end of January, all of the sovereign bonds markets we cover look over-valued in our process. In and of itself, this is not a problem: All things equal, we will simply reduce exposure to bonds to reflect the reduced risk-reward expectation. Unlike previous episodes of over-valuation, two of the bond markets have such diminished yields that they can no longer mathematically fulfill one of their key functions in our strategies: the ability to rise enough in periods of distress to offset much of the loss experienced in stocks and commodities. Specifically, with Japanese government bonds yielding 0.29%, one should not reasonably expect them to rise more than a percent or two.[1] A good outcome would be relative stability. In other words, they essentially turn into cash with downside.[2] More surprising perhaps is that the same holds true for German bunds, yielding 0.30% at month-end (Figure 1).

Figure 1: 10-Year Bond Yields



Source: DataStream. Daily yields from Dec. 31, 1998, to Jan. 30, 2015.

The situation clearly calls for some action from a process/research perspective to determine how to reduce or remove bonds that increasingly fit the "cash with downside" description. If low nominal yields prevent a bond from having its normal yield variation to the downside, it should be reduced or eliminated based on this skew. Mathematically, if the historical standard deviation of yield change is greater than the nominal yield, the bond's weight should be adjusted proportionately. In turn, these assets would simply be redistributed to other, higher yielding markets in proportion to their yields.

As a result of this on-going research, Figure 2 reflects the strategic bond portfolio as implemented at the beginning of February. The top row represents notional weights to each market based on equal duration contribution followed by the new skew adjustment enhancement. Finally, we further adjust the weights to account for the credit quality of the underlying markets based on CDS spreads (first introduced in early 2011) which leaves us with the new strategic weights across the six markets. Please note that the overall allocation to bonds remains the same as it relates to balancing risk across asset classes.

Figure 2: Strategic Bond Allocation (%)

	10 Year Bonds						
	Australia	Canada	Germany	Japan	UK	US 30 Yr	Total
Equal Duration Contribution	15.1	14.1	13.5	13.5	14.3	6.1	76.6
+							
Yield Adjustment	2.1	1.9	-4.9	-1.9	2.0	0.8	0.0
+							
Credit Quality Adjustment	0.9	0.0	0.4	-2.5	0.8	0.4	0.0
Final Strategic Weight	18.0	16.1	9.0	9.1	17.0	7.4	76.6

1 With duration of approximately 10 years, a decline of yields to zero would result in a 2.5% gain.
2 One could point to Swiss bond yields of -0.10% as evidence that 10-year bonds have no lower bound to their nominal yield, but we are more than a little skeptical.

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