# Keep Your Enemies Closer

SYNOPSIS
- At any time, some market somewhere is either unattractive or faces mounting risks.
- The global bond market continues to show signs of irrationality with no end in sight.
- Although risks are developing in fixed income, an allocation to the asset class is still warranted to preserve diversification.

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## Sage Advice

Don Corleone taught his son, Michael, to keep his friends close and his enemies closer. These words helped to preserve Michael's safety through the *Godfather* trilogy, and as an investment professional, I've come to believe that this sage advice is also applicable to financial markets.

The enemies of the investment world are those events and trends that pose material risk to investors' financial future. They quietly develop over time, and if gone unnoticed can cause irreparable damage to the unsuspecting and/or greedy investor.

At the moment, it's hard to find an asset class with more unsuspecting enemies than in the market for government bonds. Since the early 1980s, this was a fruitful land of opportunity. Interest rates were falling alongside inflation in most of the developed world, so it did not take much skill to be successful.

Even a decade ago, an investor could have very easily purchased a number of U.S. Treasury bonds and locked in a rather attractive yield for many years to come.

Fast forward to today, and owning these assets without a well-crafted strategy poses material risk to investors via (1) interest rate risk, (2) inflation risk, and (3) credit quality risk.

Three events that have transpired in the global bond market over the past few weeks highlight the growing risk in this asset class, so let's explain what's been going on and why I feel the ramifications are pointing to a tumultuous future for several government bonds.

## Interest Rate Risk

Thanks to central banks across the globe, in particular, the Bank of Japan and the European Central Bank, the average yields on $48 trillion of debt securities in the BofA Merrill Lynch Global Broad Market Index has fallen to a record low 1.29 percent.

As bond yields continue to fall towards – and even beyond – zero, investor returns are incredibly vulnerable to small movements in bond prices and yields. In fact, it's now to the point where a whole year of income can be erased by a tiny uptick in interest rates.

For example, as of March this year, it would take a mere 5 basis point rise in German 10-year government bond yields to erase the next 12 months of returns. Japan is closer to 1 basis point. More broadly, a half-percentage point increase would wipe out $1.6 trillion of value in the global government bond market, according to research from Bank of America.

***NOTE****: A basis point is 1/100th of a percent, so five basis points equates to 0.05 percent. There is not much room for error here.*

These statistics make me nervous because it violates a key tenet of investing, which is to never invest when the risk outweighs the return to such a degree.

Admittedly, many of these securities have performed well over the past few years. Those who have profited in trading government bonds are probably happy so far, but I question how many of them realize just how much risk they have put in their portfolio.

Simply put, a lot of government debt appears to be nothing more than "return-free risk" at the moment, and I continue to remain on the sidelines.

## Inflation Risk

Governments across the globe are now able to lock in ultra-low borrowing costs for generations. Just recently, France issued a new 50-year security for the first time since 2010, while Ireland sold its first ever century bond in March. Yes, a century bond is a 100-year bond.

Ireland raised 100 million euros of bonds due in 2116 (not a typo) and locked in a rate of 2.35% (also not a typo) for the life of the bond. For scale, Germany's 10-year government bond offered around the same yield back in 2011. Said another way, five years ago, an investor could have seen similar returns in a bond that matured 90 years sooner.

The increase in demand for longer dated bonds is concerning because the longer an investor holds a bond, the more risk that investor faces from rising inflation. Since a bond coupon is fixed over time, the value of that cash flow rises and falls as inflation moves.

For example, if a 10-year bond pays 3% in annual yield, and an investor purchases that bond when inflation is at 2%, then the "real" yield to the investor is 1% (3% - 2% = 1%). If inflation rises the next year to 2.5%, then the real yield to the investor is cut in half (3% - 2.5% = 0.5%).

***NOTE**: This inflation risk is one of the reasons why longer-dated bonds offer higher yield versus shorter maturity bonds. Investors must be compensated for taking the risk of locking their money up for longer periods of time.*

My concern here is that investors are ignoring the risk that inflation could creep up out of nowhere and wipe out any gains. Admittedly, inflation is very low in most of the developed world at the moment, but I don't know anyone who can forecast longer than a few years, let alone a few decades.

## Credit/Quality Risk

Argentina's history is truly fascinating, having gone from an economic powerhouse to a socialistic mess, and its rise and fall over the last several hundred years can teach us all a valuable lesson in economic and financial prudence.

As of February, the country had been locked in a 15-year battle with bondholders who declined to accept the terms of a debt restructuring after a huge default back in 2001. This dispute caused tremendous damage to their economy, as former leaders refused to negotiate with the holdouts, because it locked the country out of international debt markets.

Everything changed a few weeks ago when its newly elected President, Mauricio Macri, ended the dispute and struck a deal with the holdouts. Argentina will now pay these bondholders back most of what they are owed, plus interest, which will now allow the country to move forward.

Argentina is covering this bill by issuing new bonds. In effect, they are borrowing money to pay back prior debt, which is a process referred to as "rolling debt." As crazy as it may sound to use new debt to cancel out old debt, the process is an accepted practice and was to be expected by the Argentinian government.

What was not expected, was how badly investors wanted its new debt. The bankers who sold the bonds to investors saw 4.3 times more demand than supply offered. Meaning, Argentina could have issued way more debt than what they had sold if they so desired.

Furthermore, the yields offered were far lower than one would expect to see from a country that still has a very long way to go to get its fiscal house in order. Yields are a function of implied risk, and those buying Argentina debt are saying that they are willing to loan them cash for the next thirty years for a yield below 8 percent.

***NOTE**: According to the International Monetary Fund, Argentina still faces significant risks to its economic future, including a deep recession in Brazil (big* *trading partner), a bulging fiscal deficit, and inflation at 25% run rate this year.*

The amount of demand for such low yielding debt from a country that is only five months into a turnaround that may or may not stick is absolutely staggering. Argentina is not alone. Greece is on the verge of defaulting, yet their 10-year debt currently yields just north of 10 percent.

As an investor seeking income and stability from bonds, I can't fathom taking on this type of credit/quality risk for such paltry returns.

## Implications for Investors

As low as the yields described above may sound, keep in mind that it's all relative and at least they are above zero. There is still over $7.8 trillion, or roughly one-third of global government debt trading with a negative yield!

An investment purchased with a negative yield is guaranteed to lose an investor money if held to maturity. In effect, the buyer is *paying* the bond issuer for the privilege of loaning it money, which is analogous to paying interest on money loaned to a friend.

It's still too early to tell if this strategy will (1) work and/or (2) create unintended risks, but what I do know is that I'm not interested in owning these bonds.

At the end of the day, this business is about risk management, not risk taking. Although we may continue to see these investments rise in value, the risk makes an investment in many of these assets akin to running in front of a steam roller to collect a few pennies.

However, that's not a license to go sell all government bonds in a conservative portfolio either. When used properly by trained professionals, these assets can still offer stability and diversification.

For that matter, high-quality government bonds purchased several years ago may continue to pay yields that are very attractive relative to current interest rate levels and are shielded from the risks facing much of what's been discussed above.

The bottom line is that investing in government bonds is not what it used to be, but proper planning and a sound strategy can still deliver attractive risk-adjusted returns.

Sincerely,

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