Lincoln Private Investment Office

London

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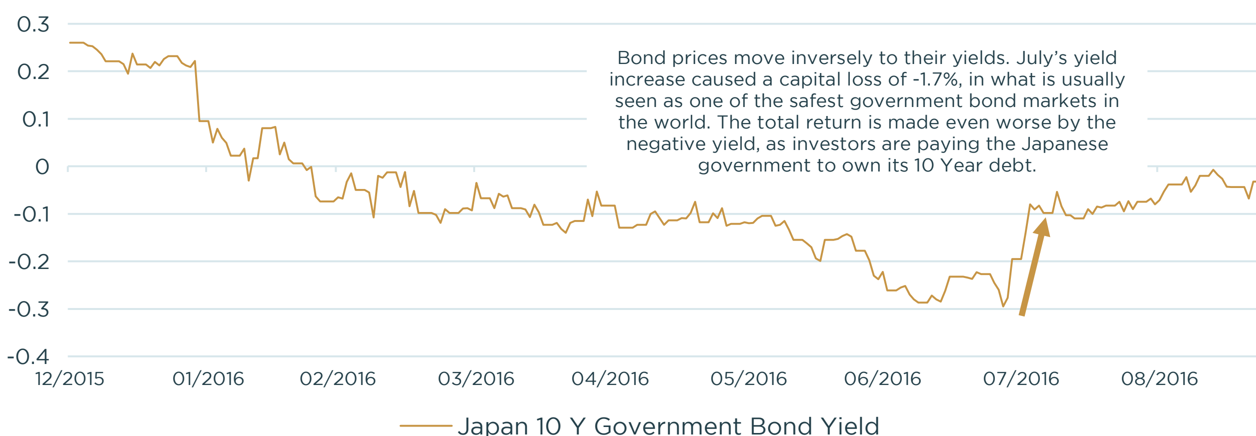
Central Bankers, Bond Bubbles, & Broken Markets

When news of poor growth in China weighs on the share price of a UK retailer to a greater extent than the Chinese economy, it becomes clear that the world has come to be unbalanced. Since 2008, traditional relationships between investments have broken down, as central bank intervention continues to pump up the prices of bonds and equities in tandem. The increased correlation between bonds and equities now makes conventional models for portfolio diversification inadequate.

Worryingly, markets continue to rely on central bankers to support asset prices, no matter what. Creeping into the investment advice dialogue is the argument that buying and holding, no matter the potential downside risk, is the winning strategy. To buy into this reasoning you have to presuppose that idiosyncratic events like the UK referendum, or the upcoming US election, are easily controllable episodes that last short amounts of time. You have to assume that the authorities have unlimited firepower to counteract every natural and man-made disaster. You have to assume that this time, it's different.

Equally troubling is the fact that both academics and analysts have taken to arguing that investors are overestimating the probability of crisis events. You don't need to be a trained statistician to note that we have been having "once in a hundred years" events on a regular basis for the last thirty years. But a portfolio built solely around the hope of continued central bank intervention is one destined to blow-up. The flawed logic of this strategy proposes not only buying every dip, but implies that money spent on hedging risk instead is wasted. It implies that central banks give investors perfect foresight, and that nothing can go wrong.

That said, perhaps we are finally seeing signs that the bond bull market that began as far back as the early 1980s is reaching its peak. Globally there is now almost USD 16 trillion of government debt trading with a negative yield. Just a few weeks ago, two European companies set a fresh record, issuing *corporate* bonds with negative yields. Last week saw a continuation of the selloff that began in July 2016 across fixed income markets, where Japanese government bonds, one of the pillars of the year's record-breaking global bond rally, looked particularly unstable. Investors into these bonds are suffering greater losses over the past two months than investors in any other country's debt. The reversal of sentiment spurred concern that the second largest debt market in the world is the canary in the coal mine of a broader selloff.



Of course, the bond sell-off of recent months may turn out to be just another blip in the extraordinary bond bull market. But trust in these instruments, and the central banks behind every rally, is beginning to wane. Trust lasts until it doesn't. Our job is to note when the system has shifted from being stable to unstable – a point which it has surely reached now. Government intervention in markets has led inevitably to unintended consequences that are precipitating further and further government intervention. Whether this will lead to even further unintended consequences for markets remains to be seen.

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Our view has long been that traditional government, corporate, and high yield bonds have been in bubble territory for a considerable amount of time. The unprecedented monetary support from central banks after the 2008 financial crisis has pushed the prices of bonds to a point where there is now far greater downside than upside: yields no longer reflect the risks of investing in their issuers given their levels of indebtedness. On top of this, increased regulation and a low interest rate environment have driven banks to cut costs in a lower-profit world, causing a substantial reduction in liquidity. Because of this we hold no conventional government, corporate, or high yield strategies in the portfolio. On a relative basis, we have been wrong, as the expansion of central bank balance sheets has continued to pump up prices for a lot longer than we thought possible. But in our topsy-turvy world where investors now buy bonds for capital gains, and equities for yield, we would rather miss out on some of this upside than face the implications of a reversal in the current trend.

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