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MARKET INSIGHT

Can Bonds Make You Money in a Negative-Yield Environment?

August 2019

On August 7, 2019, the central banks of New Zealand, India, and Thailand all stunned markets, slashing rates far beyond expectations. Although shocking, this activity came in the midst of a broad embrace of monetary stimulus, with central banks desperately trying to prop up a faltering global economy. It is no secret that yields today are nowhere near the levels they occupied prior to the last financial crisis, and we do not yet know how negative central banks are willing to go to combat a recession. As we all acclimate to the possibility of a sustained period of negative yields, it is natural to question whether there is still money to be made in bonds. In this piece, we will briefly explain why our answer is a resounding "Yes!" and why we continue to see attractive return potential in bond markets.

While many investors pay attention to leadership across asset classes (i.e., will bonds outperform equities?), there is also a question of leadership within asset classes (i.e., within bond markets, which will see the most gains?). It is the latter area that has presented significant opportunity throughout 2019, and we have been able to benefit considerably from our relative bond views within our macro strategies.

To identify these kinds of opportunities across bond markets, we tend to take a different approach than others by forming views on how different market participants will influence relative pricing, within the context of the market environment. As one example, we can distill the very broad set of market participants into two general groups: return-seeking investors and mandate-driven central banks. Throughout the year, we have perceived Australian bonds to be highly undervalued, and we have expected investors to take advantage of these opportunities. Put differently, the story so far in 2019 has been about price, perhaps even more so than carry. If yield were driving investor demand across bond markets, we might expect to see similar appreciation for Canadian bonds, which also offers relatively high yield. While Canadian bonds are indeed up on the year, however, they still lag their counterparts in many other developed markets – including German bunds, whose yields have again breached negative territory.

And what about central banks? Reporters have cast an increasingly bright spotlight on interest rate decisions and forward guidance, and of course, rates have a significant role in creating demand. But although interest rates have received all the attention, they are only half the story. We have been seeing significant influence from the supply channel, since central banks also control the money supply. There are

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no widely known and carefully tracked "dot plots" to monitor likely evolutions in money supply; but this is another tool that central banks can (and do!) employ to influence the economy. We have been benefiting this year from using central banks' adjustments to money supply to forecast bond market pricing.

Our expectations related to relative value and money supply evolutions have both contributed to our highly favorable view of the Australian market, and importantly, both support our stance that considerable upside remains. Our long positioning in Australian bonds is just one component of a bond spread trade that has been successful for our macro strategies this year. In other words, bonds can serve as a genuine alpha opportunity, rather than simply a hedge or duration play. While headlines continue to write off bond markets as a viable source of return, our experience this year shows that there is still the potential to make money through bonds – as long as you know where to look.

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