Why Are You Buying Bonds?

The question needs to be asked. Why are you buying bonds?

At this point, you may be thinking, "Isn't it self-evident? Bonds diversify risk, provide income and hedge liabilities." However, my motivation for asking the question lies in addressing the current market conditions and challenging the assumptions that investors make in their decision to invest in bonds.

In the abnormal and extreme market conditions of 2008, and so far in 2009, some of the assumptions being factored in currently don't work. The 2008 S&P/TSX index plunge of 33%, and the 37% loss in the S&P 500 Index (US Dollars) [(1)] are prime examples of an abnormal market. Both appear to be extreme event scenarios. The same phenomenon holds true in a bond market with no yield on a Treasury Bill, (actual yield was about 0.6% at the end of February 2009 in Canada and 0.25% in the US for 91 Days) and under 4% yield on a 30 year bond (actual yields are currently about 3.7% in both Canada and the US).[(1)]

One reason for these low yields is that the Bank of Canada rate is very low, as is the Federal Reserve "Fed Funds Rate". Secondly, the flight to safety has pushed up bond prices and lowered bond yields across all maturities. Looking more closely at this, additional questions arise. Can a yield go lower than zero? If a yield cannot go lower than zero per cent, what would happen to the price of that instrument? The price would be at its absolute highest possible value, and would likely drop should the yield rise to anything above zero per cent. This offers some alternative suggestions. Why not go into cash instead of a Treasury Bill? They both pay similar low rates, but cash is more liquid, and there is no spread or fees to think about. Cash can also be purchased at any institution.

A counter argument is that a Treasury Bill is safer than a bank. However, given the short term duration of a Treasury Bill, this would imply you cannot hold even cash at the bank for a matter of days. If the fear is that great, banks cannot be used for any transactions or investments of any kind. This scenario is not likely to happen, but one never knows.

What about at the longer end of the yield curve? A 30 year bond yields 3.7% as at the end of February 2009. This implies that by factoring in risk, inflation, and premium, you will only get 3.7% for the next 30 years. One alternative is the GIC market, which presently yields over 4% for a 5 year term without fees or spreads.[(2)(3)] This instrument would have to be held for 5 years without sale. Additional risks are that the yield curve could change, or that an immediate need to sell the investment may surface. With a bond, there may be a gain or loss on it unless one buys it at par and holds it to maturity. Given that these yields are extremely low, the market demands that the prices be extremely high. Given the flight to safety and fear mode that the current capital markets are in, this adds an extra "fear factor" to the price of bonds.

The spectre of deflation is also adding to the retraction in bond prices. Where does a price at the extreme go? It tends to go the other way, eventually. Adding more risk to the mix is potential inflation. Is this realistic in the current environment? On the one hand, when you have extreme deflation, it usually is followed by extreme inflation. Why? During deflationary times, stimulus is added to the economy to increase production, by increasing the money supply. There is a lot more money being issued to buy fewer goods being produced. This implies that each good will require many that more dollars be allocated to it, or a large increase in prices. The evidence is shown by the price of gold reaching $1000/oz in February 2009, combined with record US budget deficits and debt in the year 2008. Coupling that with a severe decline in world production due to a recession, and inflation becomes a distinct possibility. Large inflation would likely follow with large interest rate hikes, and result in plummeting bond prices.

It's Your Call: What if the above scenario comes true? Perhaps the bond market can be played short. There are 30 years to wait for the reversal, and the odds are fairly high that a gain will be made. There is the argument that pension plans need to hedge their liabilities, so they are lengthening duration and leaving it long to keep liabilities constantly matched. It is unlikely that Fixed Income used for this purpose would be sold for at least 10 years, as the income from the coupons would pay for the liabilities.

Another variation on this theme would be to short the government bonds and long the corporate bonds. Corporate bonds have been sold-off over the past year, which has resulted in low prices. Either way, if government bonds were not sold, then the short play may be worth making. A short play would also generate cash, which could be used to pay any expenses. I am not suggesting that the entire bond portfolio should be sold short, or allocated to 100% cash. Consideration to these ideas might be prudent. In normal market conditions, these ideas would not have a high probability of succeeding. However, we are in an extreme situation. Extreme times call for extreme measures. So, why are you buying bonds?

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Sources:

(1) Index Returns and Bond Yields come from Bloomberg – February 27, 2009 for Yields and December 31, 2008 for index returns.

(2) TD Canada Trust GIC rates are used as a proxy for cash rates and are very similar to bond rates as of February 27, 2009. www.tdcanadatrust.com/GICs/GICTable.jsp

(3) BMO Investorline used as a second proxy for comparison – www.bmoinvestorline.com