

July 19, 2019

The risk of being left high and dry on the wrong side of government bond markets



Central bank intervention has altered the laws of financial gravity and bond yields across the globe are seemingly stuck at low or even negative levels. The Japanese market holds some lessons for those betting that yields surely have to recover.

In Europe, the once-exclusive club of countries with a sub-zero yield on their treasury bonds is expanding. In Germany, the 10-year Bund yield has dipped beneath ECB's deposit rate (currently at -0.4%) for the first time in history.

Despite this, the country just managed to sell €3.2bn worth of those bonds. Given that price and yield are inversely correlated, and the opinion that yields surely can't go *that much* lower, are buyers rational?

Perhaps the answer is yes.

The bulk of the world's \$13 trillion

worth of negatively-yielding debt hails from Japan, a country which offers a valuable lesson in betting against government bonds. Japan is home of the so-called 'widow maker' trade - a name borrowed from the Lockheed F-104 Starfighter plane, which caused the death of 116 German pilots in peace years from 1962 -84 earning it the name 'Witwenmacher' (widow maker). In financial circles, the widow maker trade has claimed many casualties amongst traders who shorted Japanese Government bonds (JGB) which, seemed to be obviously mispriced.

It's easy to see why the trade was alluring. In 1990 the 10-year JGB yield was 8%. By 2000 it had spiraled down to 2%. But since then, regardless of the incredible amount of debt piled up by the Japanese government, the yield has only fallen.

In March 1999, the Bank of Japan (BoJ) lowered its overnight rate to an unprecedented 0% and it has spent the majority of time at the level ever since. It was thought that this would catalyse inflation, but the demand for credit was almost non-existent and the velocity of money in the Japanese economy contracted. Government bonds became more and more mispriced and those waiting for a collapse, were put out of business one-by-one, often making colossal losses. Bond bears had been convinced that the stars were aligned for yields to rise, citing the slow economy and eye-watering government debt levels. The market is still trundling along two decades later due to the invisible hand of the Bol.

Already there

are echoes of the widow maker trade in the European market. The threat of a 'synchornised global slowdown' sent the masses fleeing towards the safety of government bonds at the tail

end of 2018, pushing

yields in many corners of the fixed income market back below zero. In 2015, bond maverick Bill Gross said that betting against the eurozone benchmark (the Bund) was the short of a life time. But its yield today is lower than it was then. Likewise, hedge funds such as Electra, have been left high and dry on the wrong side of the Bund market, with higher yields failing to materialise.

In going against the grain of central banks

you can very easily get burnt. And those on the other side of the bond market buying negatively yielding instruments may be rational indeed if you consider that many have no intention of holding the instruments to maturity, rather they hope to make a margin from carry - a concept that is nicely illustrated by the parable of the sardines (published in <u>Forbes</u>).

There are three traders who decide to

go into the business of trading sardines. The first trader bought a can of sardines for \$5. He sold the same can of sardines to the second trader for \$10, doubling his money. The second trader again doubled his money by selling the can of sardines to the third trader for \$20. The third trader, knowing very well that he was overpaying for the sardines said to himself that "if the market for sardines crashed, at least I will be able to open the can of sardines and eat it". The market did crash, and he opened the can to find that the sardines were rotten. He promptly went to the trader who had sold him the bad sardines and said "these sardines are no good!", to which the second trader responded "of course they are no good for eating - they are trading sardines"!

All in all, a host of dovetailing factors are keeping Government bond yields across the globe depressed. Central banks are taking the lead role as they adopt a 'lower for longer' interest rate policy among other measures, but trade and recession fears, political risks and elusive inflation are also playing a part. If tempted to bet against Government bond markets, its worthwhile remembering the old adage of John Maynard Keynes - the market can stay irrational longer than you can stay solvent.

Disclaimer

All financial data and/or economic information released by this Publication (the "Publication"); (the "Data" or the "Financial data and/or economic information"), are provided for information purposes only, without warranty of any kind, including without limitation the warranties of merchantability, fitness for a particular purpose or warranties and non-infringement of any patent, intellectual property or proprietary rights of any party, and are not intended for trading purposes. Banque Internationale à Luxembourg SA (the "Bank") does not guarantee expressly or impliedly, the sequence, accuracy, adequacy, legality, completeness, reliability, usefulness or timeless of any Data. All Financial data and/or economic information provided may be delayed or may contain errors or be incomplete. This disclaimer applies to both isolated and aggregate uses of the Data. All Data is provided on an "as is" basis. None of the Financial data and/or economic information contained on this Publication constitutes a solicitation, offer, opinion, or recommendation, a guarantee of results, nor a solicitation by the Bank of an offer to buy or sell any security, products and services mentioned into it or to make investments. Moreover, none of the Financial data and/or economic information contained on this Publication provides legal, tax accounting, financial or investment advice or services regarding the profitability or suitability of any security or investment. This Publication has not been prepared with the aim to take an investor's particular investment objectives, financial position or needs into account. It is up to the investor himself to consider whether the Data contained herein this Publication is appropriate to his needs, financial position and objectives or to seek professional independent advice before making an investment decision based upon the Data. No investment decision whatsoever may result from solely reading this document. In order to read and understand the Financial data and/or economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your relationship manager. This Publication is prepared by the Bank and is based on data available to the public and upon information from sources believed to be reliable and accurate, taken from stock exchanges and third parties. The Bank, including its parent,- subsidiary or affiliate entities, agents, directors, officers, employees, representatives or suppliers, shall not, directly or indirectly, be liable, in any way, for any: inaccuracies or errors in or omissions from the Financial data and/or economic information, including but not limited to financial data regardless of the cause of such or for any investment decision made, action taken, or action not taken of whatever nature in reliance upon any Data provided herein, nor for any loss or damage, direct or indirect, special or consequential, arising from any use of this Publication or of its content. This Publication is only valid at the moment of its editing, unless otherwise specified. All Financial data and/or economic information contained herein can also quickly become out-of- date. All Data is subject to change without notice and may not be incorporated in any new version of this Publication. The Bank has no obligation to update this Publication upon the availability of new data, the occurrence of new events and/or other evolutions. Before making an investment decision, the investor must read carefully the terms and conditions of the documentation relating to the specific products or services. Past performance is no guarantee of future performance. Products or services described in this Publication may not be available in all countries and may be subject to restrictions in some persons or in some countries. No part of this Publication may be reproduced, distributed, modified, linked to or used for any public or commercial purpose without the prior written consent of the Bank. In any case, all Financial data and/or economic information provided on this Publication are not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law and/or regulation. If you have obtained this Publication from a source other than the Bank website, be aware that electronic documentation can be altered subsequent to original distribution.

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of the date indicated in the matrix or the publication date. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof. Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch I L-2953 Luxembourg I RCS Luxembourg B-6307 I Tel. +352 4590 6699 I www.bil com

