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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 the10-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 BoJ.

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 Forbes).

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.*

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