

# Why bonds will always be attractive

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Over the past 25 years the worst sell-off in the fixed interest market index was 6.5% compared to 51% for the equity market index.

Treasury bonds are regarded as one of the safest assets and have been in a bull market since 1982. However, in recent weeks we have seen prominent calls suggesting that the 30-year bull market in fixed income securities is over.

Recent economic data from the US has been largely positive and there are signs that a US recovery is gaining traction. US household debt levels are falling and its housing market is showing signs of recovery. Consequently, many believe that the positive economic data coupled with the threat on inflation from quantitative easing will push up short-term rates.

Despite this strong economic data from the US, concerns around the global economy continue to linger. The eurozone remains a considerable risk and the threat of a hard landing in China is still a possibility after recent negative figures. Policy makers have expended much effort driving down long-term yields and may yet seek to contain them.

As well as fixed interest returns from income and capital, there is the added element of currency. On a country basis when bonds do well, the currency normally weakens, and visa versa. All three elements lead to the bond market generally always rising. Managing the term structure of fixed interest is a further tool to increase or diminish risk in this category.

Equities on the other hand are positively correlated to the currency and therefore when the equities sell off, the currency element contributes to further negative returns. Money invested in the equity market in 2000 will not have seen any growth in the past 12 years.

If \$100 was invested in the bond market in December 1987 it will now be worth \$514. If we compare the same time period and \$100 was invested in equities it will now be worth \$289.



This all serves as a good backdrop for the discussion as to the dearness of the bond markets.

There is no doubt that the flight to quality in the past two years has benefitted this sector tremendously. However the safe haven flight has been limited to the US Treasuries, Japanese bonds and German Bunds. The ten other countries in the basket have not seen their value increase to the same extent. On the contrary, Italy and Spain saw their fixed interest markets sell off sharply.

## Economic outlook

Central banks in Europe, UK, Canada, Australia and New Zealand have recently held policy interest rates steady and they should remain low until at least 2014. The central banks are managing different balancing acts as the markets remain fragile despite current cautious optimism. The current rally in risk assets is due to the liquidity provided by central banks. A withdrawal of liquidity or even a slight increase in interest rates could derail the whole scenario.

As governments make progress toward restoring sound fiscal positions and implementing structural reform they will have to move cautiously in order maintain the fragile growth picture and contain the European crisis as well as remaining wary of contagion.

European equity markets have rallied as the euro has weakened and bad news has dried up for the moment; however, these countries will experience a mild recession in 2012. The US on the other hand has delivered good economic data and this has supported its equity markets; the strong US dollar should, however, shave some growth off for the year.

As far as the US is concerned inflation is an important factor, but a broad-based rise in core inflation above 3% seems unlikely until the economy is much closer to full employment. An oil shock could temporarily increase inflation, but this will be a technical increase and will choke off growth well before inflation rises.