



The End of the Bull Market in Bonds?

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Even the most bullish bond fund managers will admit that, in time, U.S. government bond yields will head higher—not so much over the near term, as strong flows continue into these triple-A rated highly liquid investments, near-zero short-term borrowing costs encourage the carry trade, and private-sector credit demand continues to contract or at least grow very slowly. But, with the U.S. government issuing record volumes of debt and little prospect for dramatic deficit reduction, a recovery in the economy all but ensures that bond yields will eventually rise.

Initially, the yield curve might steepen further as the Fed maintains its very accommodative stance, especially in light of the disappointing December employment report. There is plenty of excess capacity in the economy and inflation remains very low with no demand-pull or cost-push inflation pressure in sight.

However, as private credit demand rises with the economic recovery, the Fed will raise overnight rates and the carry trade will unwind. The timing of this inflection point is the only question. While it is not expected to happen before late this year, markets have a way of anticipating future events. Credit spreads will likely narrow further as default rates continue to fall, but much of the narrowing may be due to the rise in Treasury yields rather than a fall in corporate yields.

Corporate bonds, however, might not be the best place for investors to find longer-term income. For many companies, especially in the U.S., yields on short-term (under 5-years) AA corporate bonds are equal to or less than the dividend yields on their common stock (for example, Procter & Gamble and Clorox). The unprecedented near-zero fed funds rate and quantitative and credit easing, as well as investor nervousness about the stock market, have generated this dislocation.

Stocks yielded more than bonds in the 1930s, reflecting the prolonged contraction, deflation and dismal earnings-growth prospects; but that changed in the 1950s, and now we have apparently returned to a paradigm of higher perceived risk in U.S. equities to justify their higher dividend yields. Dividend yields are even higher still for the Canadian stock index as, contrary to the U.S. experience, banks did not eliminate or even cut dividends.

Dan Fuss, manager of the \$18.5 billion Loomis Sayles Bond Fund and Morningstar's #1 bond fund manager for 2009, recommends Canadian government bonds to U.S. fixed-

income investors, not for the yield pickup, but for potential Canadian dollar appreciation and the underlying stronger fundamentals in the Canadian government debt market. While debt ratios have risen in all major countries, the total government net debt-to-GDP ratio in Canada will rise from 22% in 2008 to roughly 30% by 2014, according to the IMF. In contrast, in the U.S., it will increase from 48% to 85% over the same period.

The downside risk for U.S. government bonds is also augmented by political considerations going into the 2010 mid-term elections as the Democrats might be tempted to add to popular stimulus measures. In addition, state and local governments and some underfunded pension funds are in such dire straits that federal assistance may be necessary, further increasing federal debt financing.

Bottom Line: The bull market in bonds began in the early 1980s, nearly 30 years ago. To be sure, interest rates could fall further if the economic recovery stalls; but, in the longer run, there is nowhere for rates to go but up. The timing of the inflection point in yields is unknowable, but might well be less than a year away. Any unwinding of the carry trade might have a rapid and dramatic impact given the volumes and leverage involved. High-quality dividend-paying stocks could well outperform corporate bonds on a risk-adjusted basis, especially given that stocks provide an inflation hedge—as do TIPS and RRBs.

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