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Society of Actuaries in Ireland

Are we living in a Bond Bubble?

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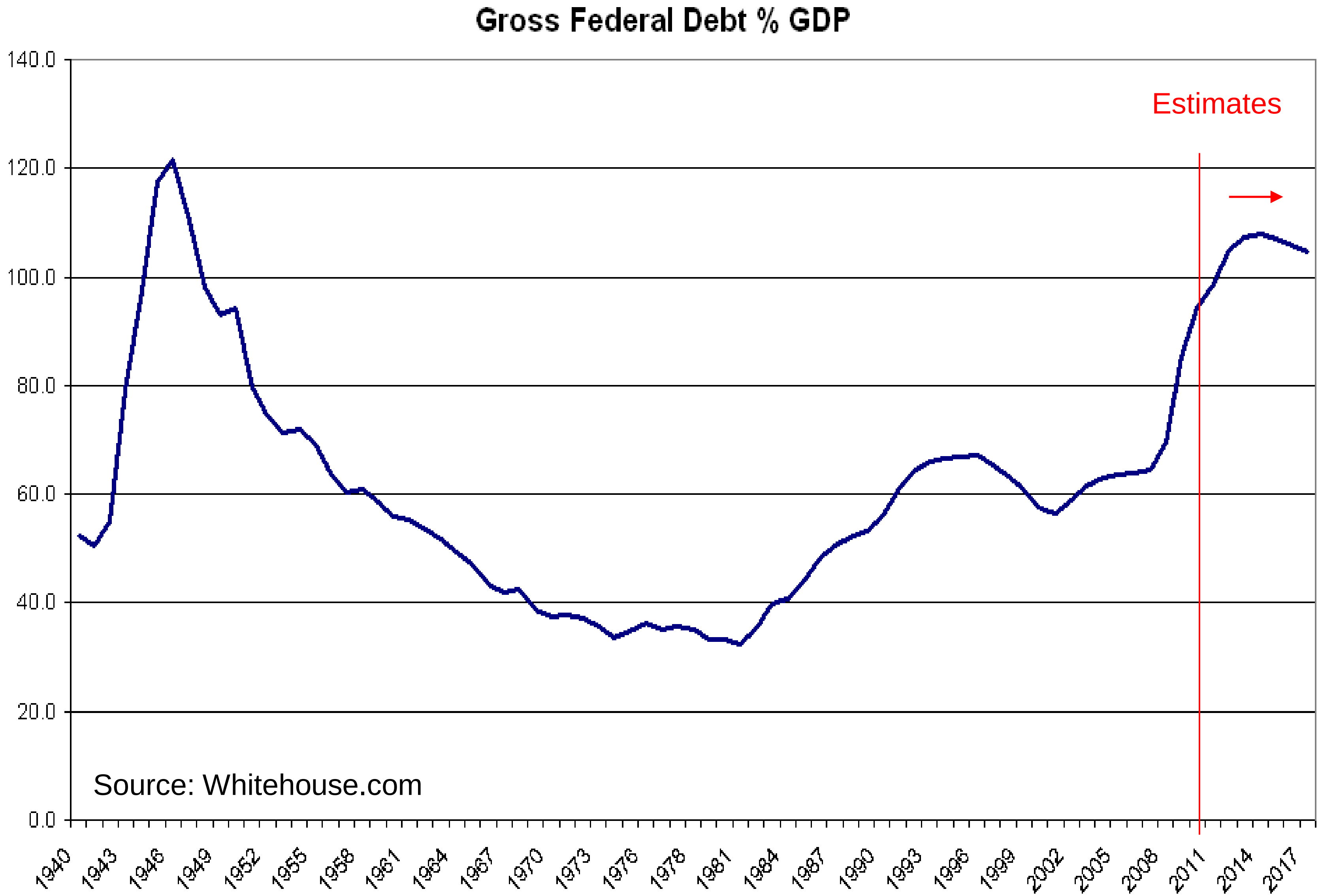
Global Financial Crisis saw debt levels soar to highest since WWII

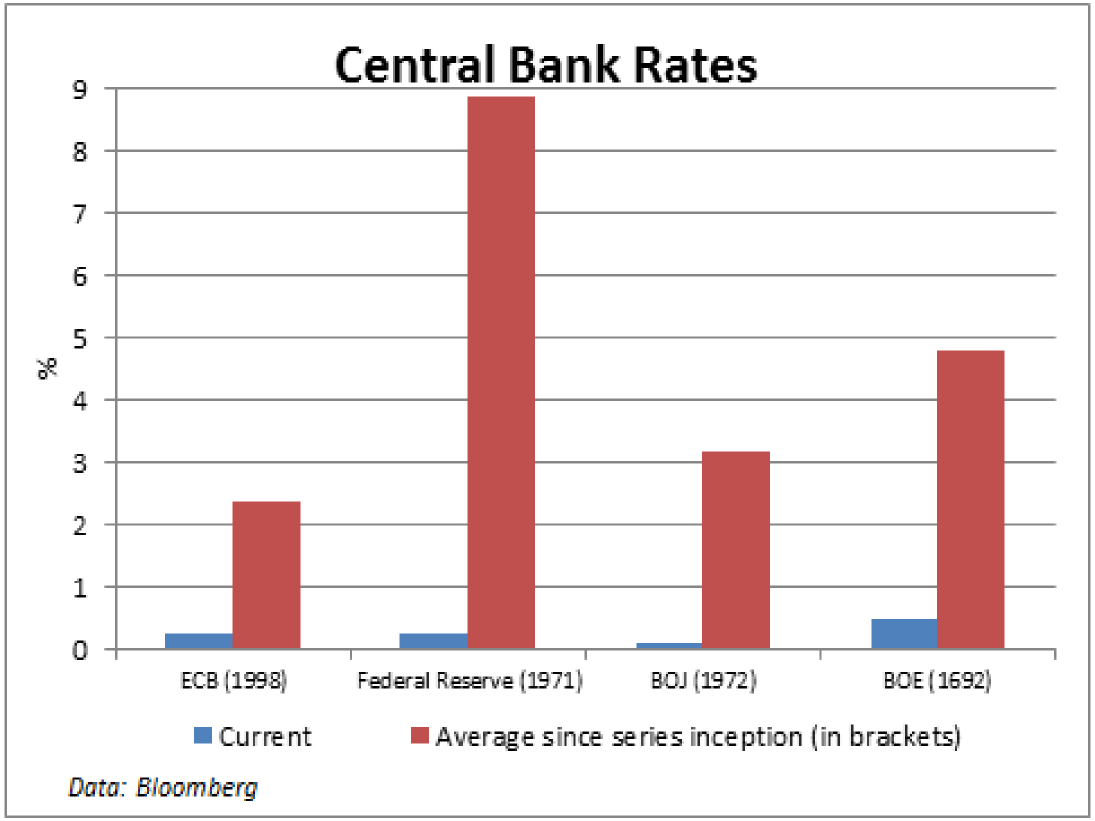
Governments were too highly indebted to significantly counteract the Global Financial Crisis.

With no room for Fiscal Stimulus, the heavy lifting was left to Central Banks and Monetary Policy.

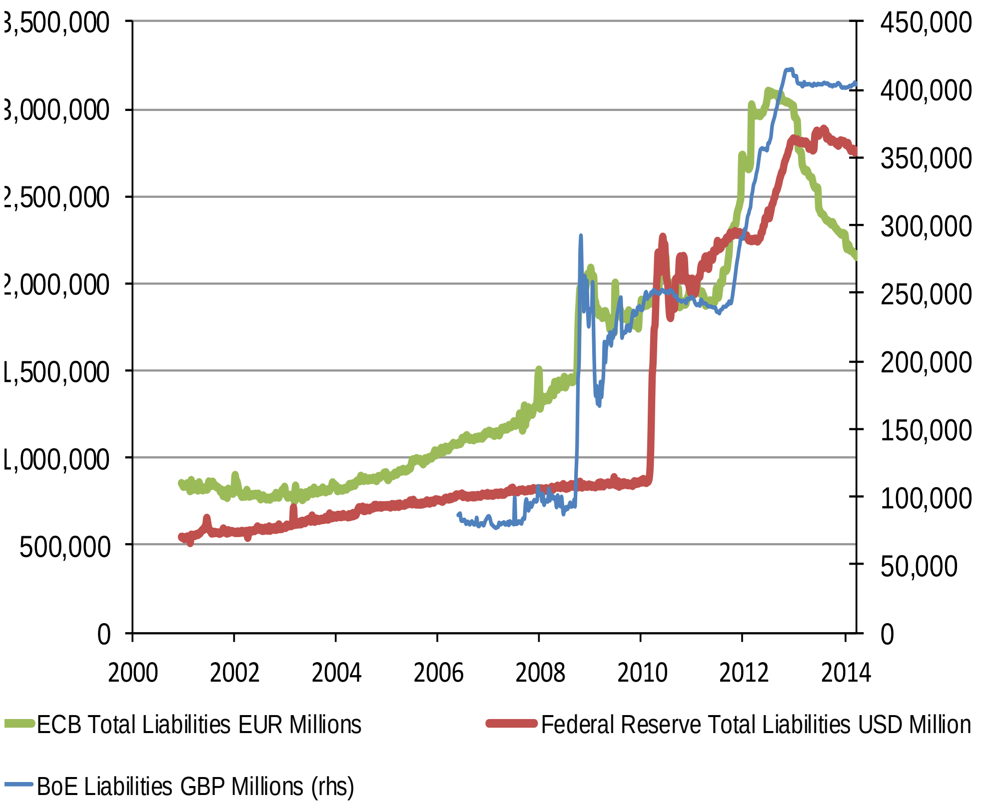


Central Bank Response to the Global Financial Crisis

Zero Interest Rate Policy

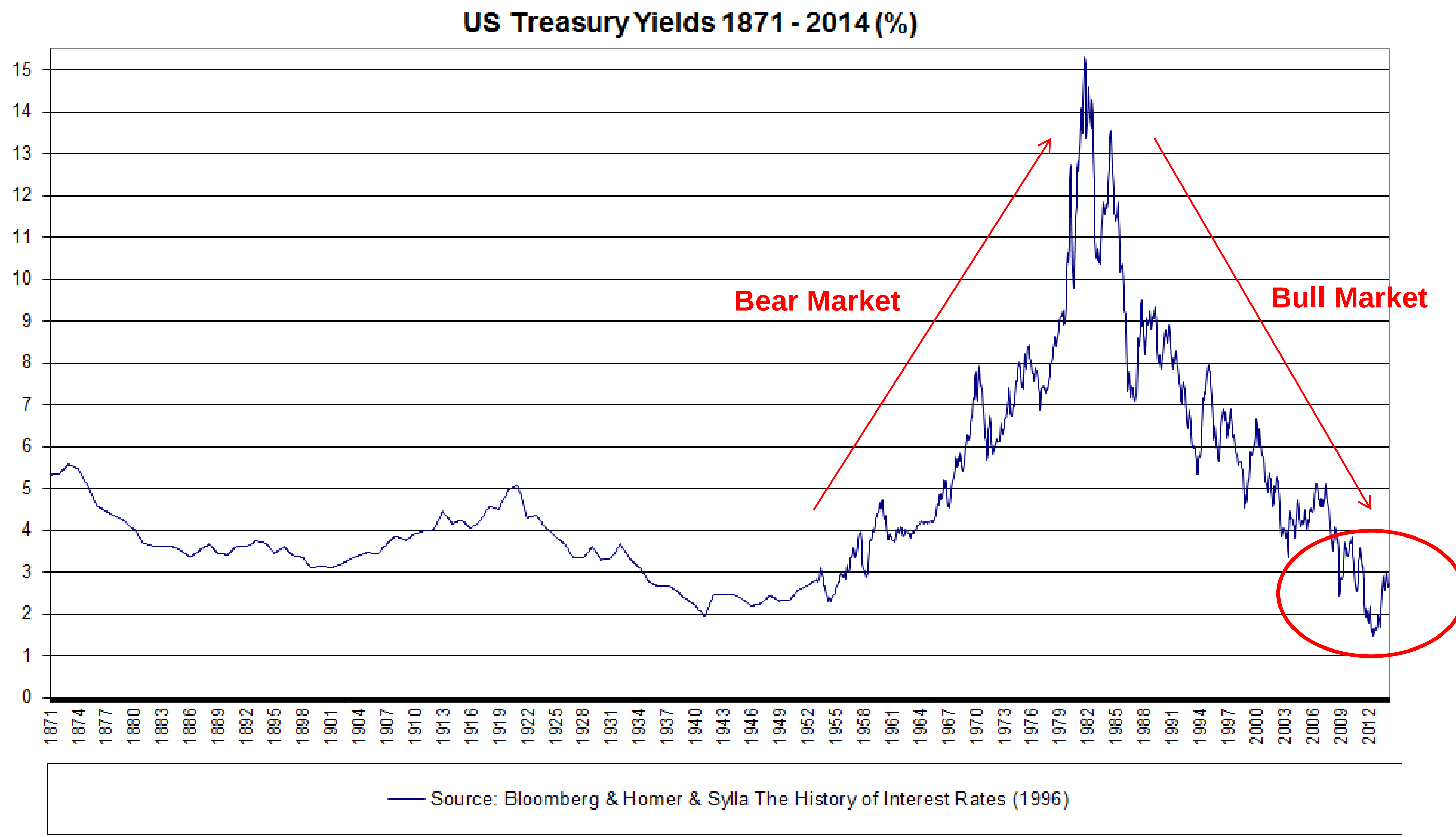


Expansion of Central Bank Balance Sheets and Quantitative Easing

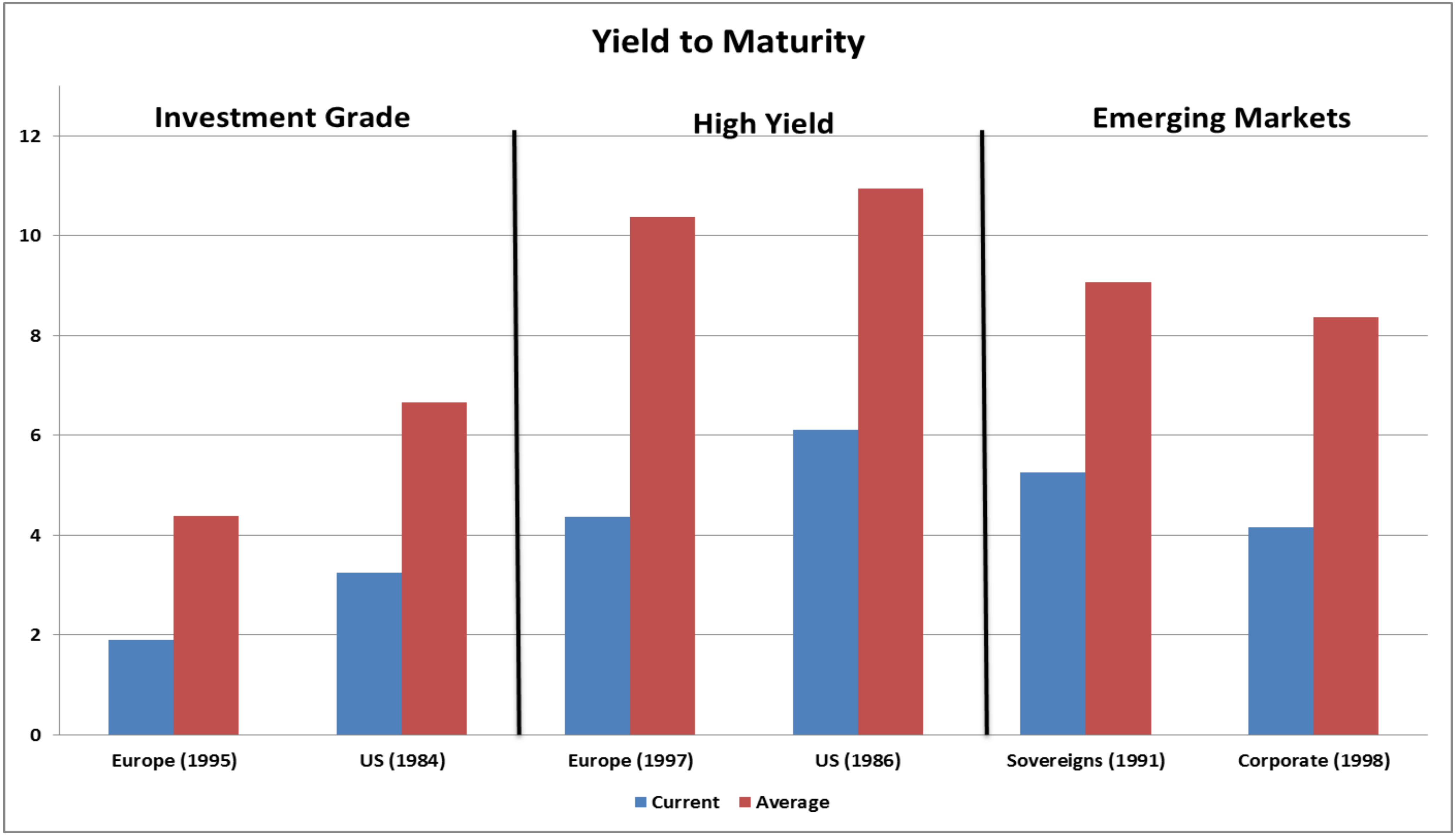


Source: BoE, Bloomberg, Davy

Bond Yields are at historic lows



Credit yields are also at historic lows

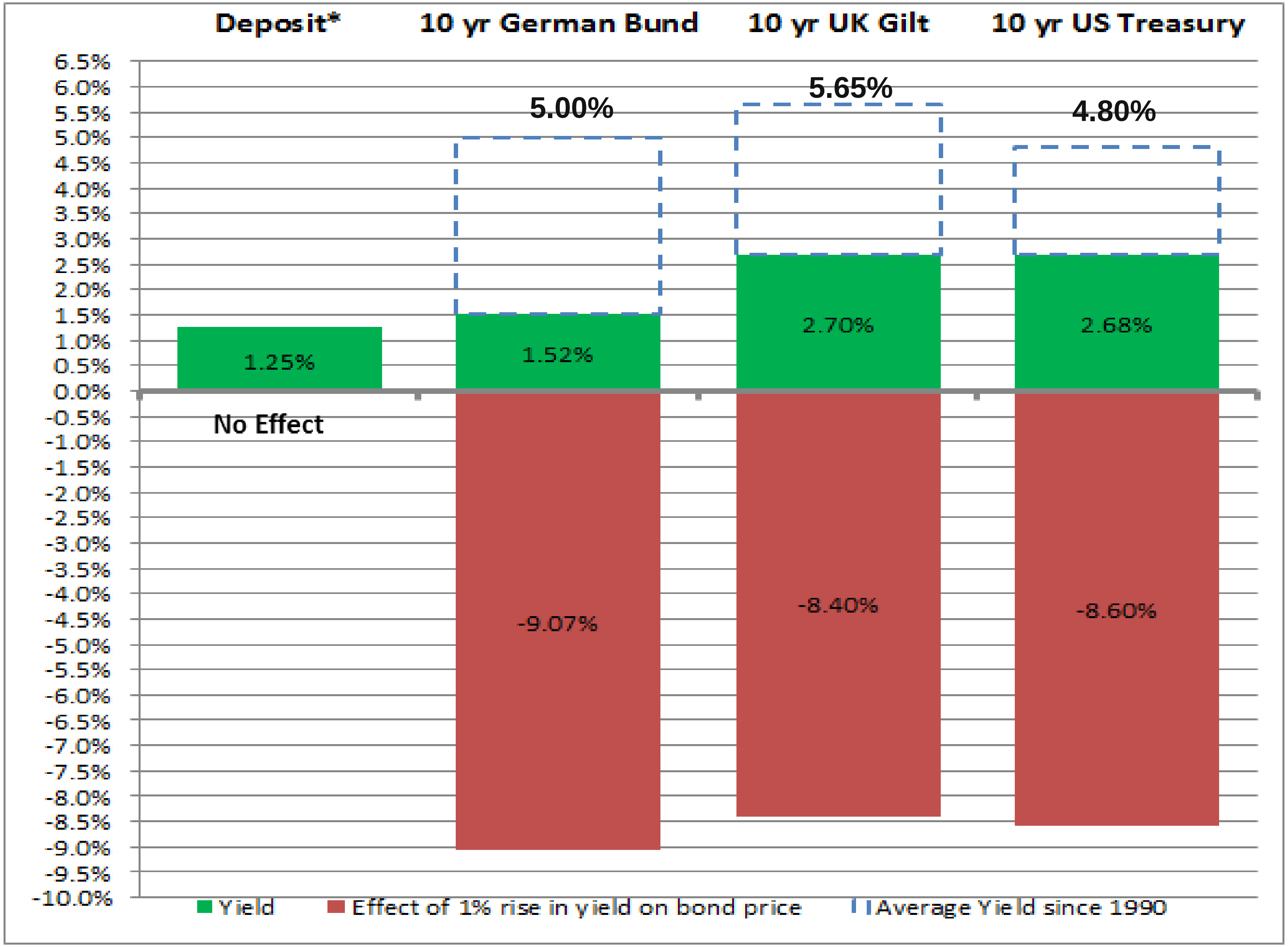


Source: BoAML, (Series Inception in Brackets), note the duration of each index will differ

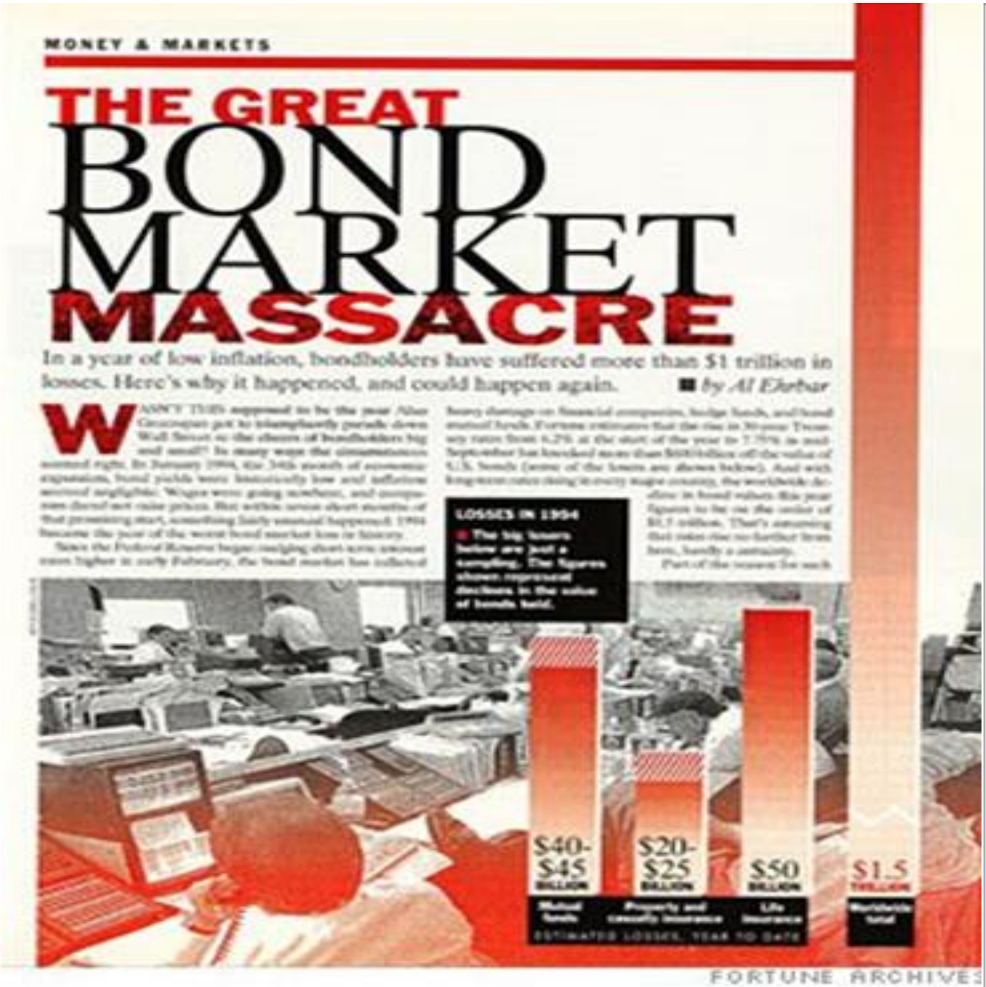
Implications of low yields – more risk taking

Bond investors are taking on more and more (duration and credit) risk in order to try and maintain income levels.

Duration risk at current low yield levels is particularly under appreciated by investors.

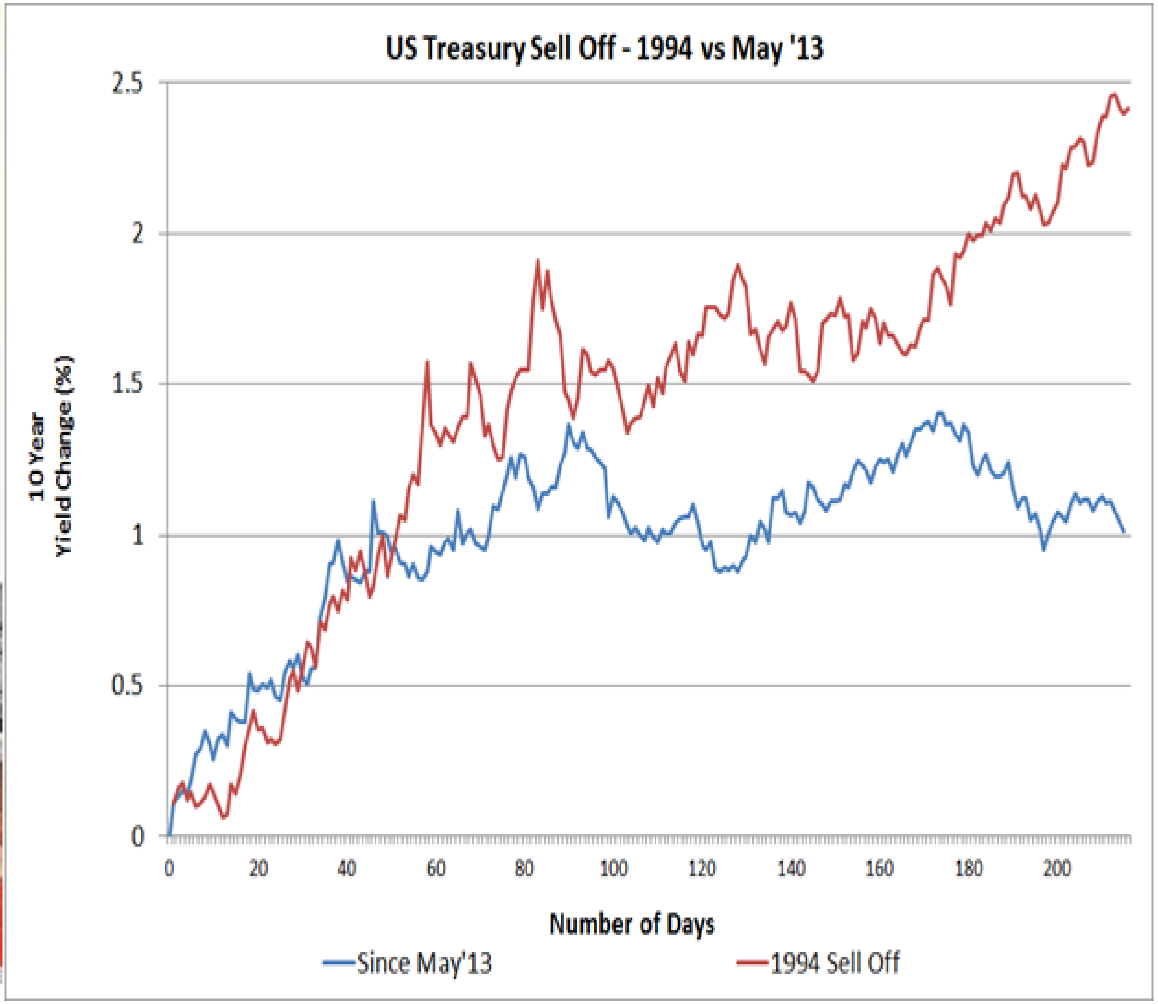


The May Sell-Off … A shot across the bows


MONEY & MARKETS

THE GREAT BOND MARKET MASSACRE

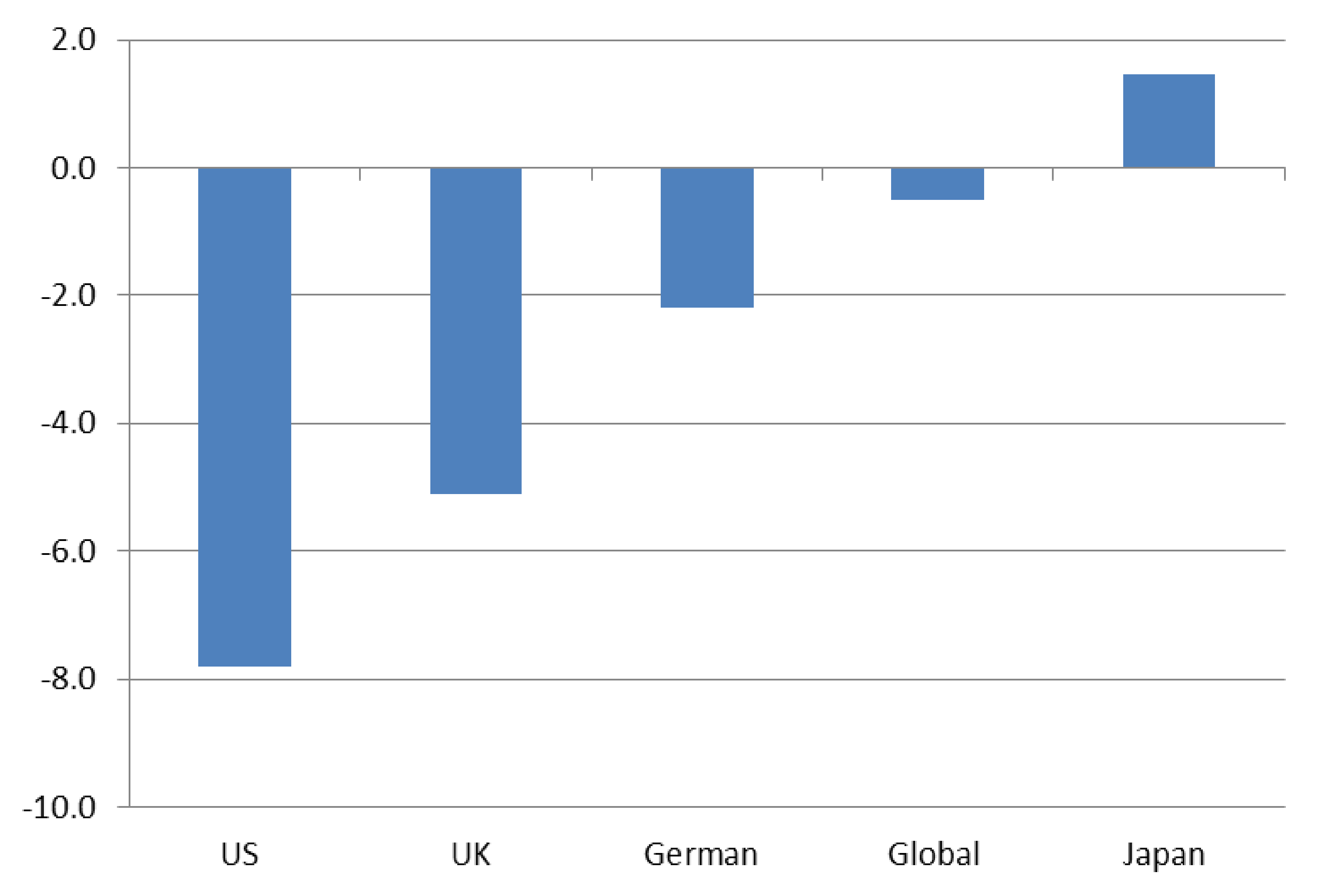
In a year of low inflation, bondholders have suffered more than $1 trillion in losses. Here's why it happened, and could happen again. ■ by Al Ehrbar



10 year Gov Bond Performance 2013

Last year, even "risk free" US Treasuries suffered significant losses.

Despite anaemic growth and inflation, German Bunds still lost 2% last year



Source: Bloomberg

Is this a “Bubble” and what does the future hold?

Real Yields are about 2% below their historical average

Real yields look through the cycle.

10 Year Real Yields *(using CPI)*

Bond	Current	Historical Average *	Difference
US	0.57	2.37	-1.80
German	0.11	2.52	-2.41
UK	-0.27	2.45	-2.72

Source: US Real Yields since 1871 - source Shiller

UK Real Yields since 1985 - source BoE

German Real Yields since 1992 - source Bloomberg

They suggest that yields have much further to rise before "value" emerges.

Real Yields *(using Inflation Linked Bonds)*

Bond	Current	Historical Average *	Difference
US	0.57	2.10	-1.53
UK	-0.27	1.91	-2.18

Source: US Inflation Linked Bonds since 1997

UK Inflation Linked Bonds since 1992

Note: European Inflation Linked bonds do not have a continuous history to make a comparison.

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Question: When do Bond Bear Market's End?

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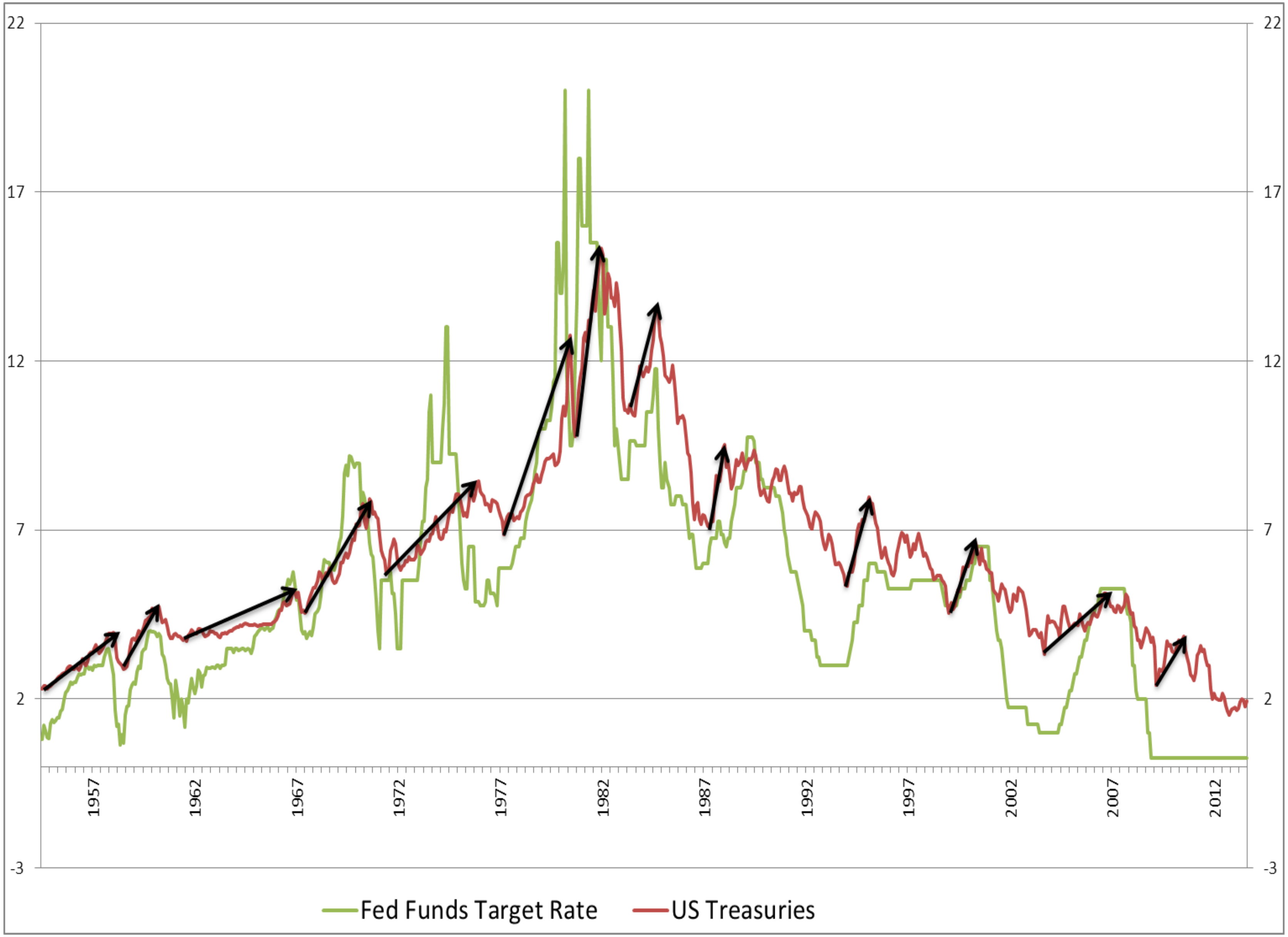
Answer: Typically when:

1) Value Emerges

- we are a long way from this

2) Central Banks are close to the Peak in the Rates cycle

- They have not even started raising rates yet



Near term outlook

If growth materialises it should be a negative for Benchmark Bonds

Euro curve normalisation should lag US and UK because of more anaemic growth and inflation outlook

GDP Forecasts			
Current US Economic Forecasts		**2014**	**2015**
Real GDP		2.70	3.00
CPI		1.70	2.00
Nominal GDP		4.40	5.00

Valuations: Golden Rule (GDP Bond Relationship)			
10 year bond	**Current**	**2014 Target**	**2015 Target**
US Treasury	2.72	3.48	4.08

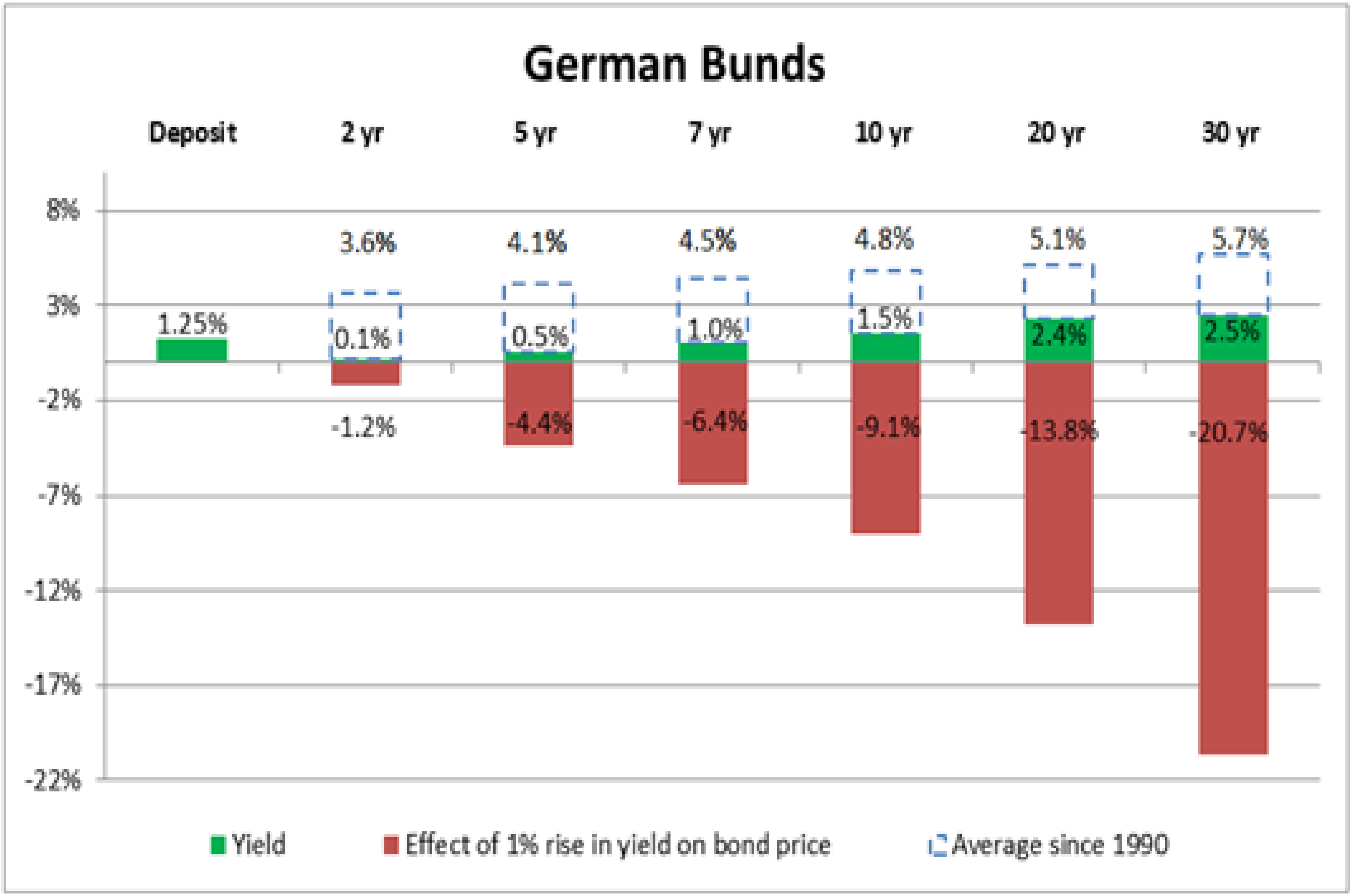
Applying same methodology for UK and Germany			
10 year bond	**Current**	**2014 Target**	**2015 Target**
UK 10 Year	2.69	3.78	3.58
German 10 Year	1.55	2.05	2.60

Europe – not as much upward pressure on yields

European yields are extremely low and yield/duration trade-off is unfavourable

Even though European bonds should lag rise in US and UK yields, it is difficult to see how they would not be affected.

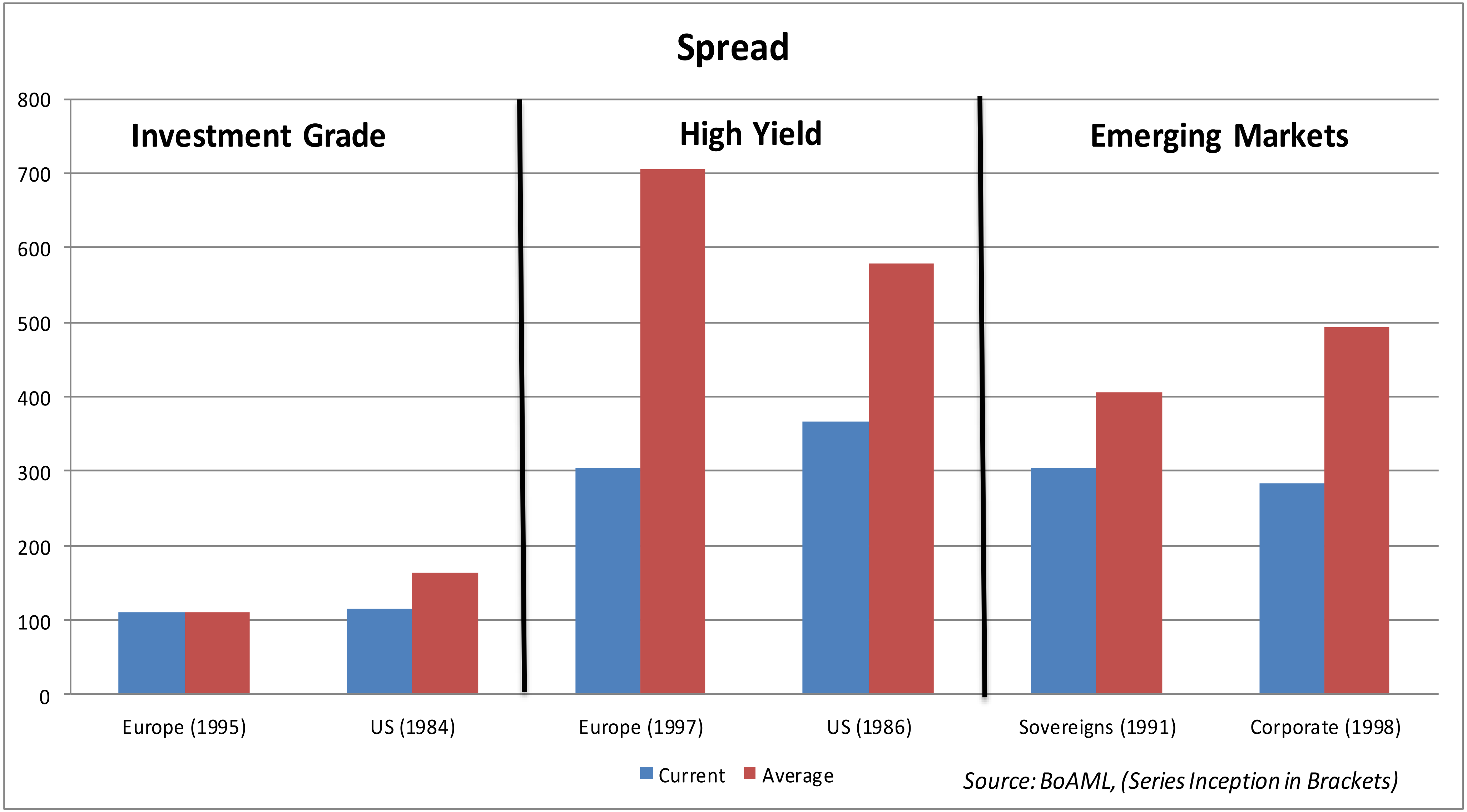
Rising yields is Good News for Pension Liabilities!



Bond Yields

Benchmark Bonds	2 Year	5 Year	10 Year	30 Year
USA	0.41	1.70	2.72	3.58
Germany	0.17	0.62	1.55	2.50
UK	0.65	1.90	2.69	3.47
Japan	0.09	0.19	0.65	1.66
Other European				
France	0.25	0.91	2.05	3.12
Netherlands	0.23	0.77	1.90	2.63
Finland	0.17	0.65	1.85	N/A
Austria	0.20	0.71	1.79	2.71
Switzerland	-0.07	0.16	0.92	1.47
Sweden	0.76	1.40	2.12	N/A
Norway	1.44	2.16	2.94	N/A
Denmark	0.19	0.78	1.59	2.45
Belgium	0.26	0.88	2.17	3.17
Peripherals				
Ireland	**0.49**	**1.24**	**2.92**	**N/A**
Portugal	1.20	2.64	3.86	5.78
Spain	0.59	1.72	3.19	4.17
Italy	0.70	1.77	3.19	4.26

Credit spreads



Source: BoAML, (Series Inception in Brackets), note the duration of each index will differ

Is this a “Bubble”?

Bonds are almost certainly the most overheated and overvalued asset class at the moment

No agreement on the **definition** of a Bubble

Unless the world is heading for recession/deflation, bonds are almost certainly the **most overheated and overvalued** asset class at the moment

However, the difference between bonds and risk assets important to note:

- Bonds are a **less volatile asset class**
  - Largest fall in 10 year US Treasury over the last 30 years was 13%
  - Largest fall in S&P 500 was 63% Tech Bubble and 55% Global Financial Crisis

- The **influence of authorities**:
  - Low yields have been manufactured by the authorities.
  - They control the short end and forward guidance and QE excerpt significant influence over the long end
  - An exit from extraordinary monetary policies is going to be tricky!

- Direct bond investors can **‘lock-in’ yields**

- **Regulation** – many investors required to hold bonds

Low yields creating potential bubbles elsewhere

The unintended consequences of QE

Potential Housing Bubbles in…

- Norway
- London
- Australia
- China
- Hong Kong
- Switzerland

EM & Commodity Currencies …

- Turkish Lira / South African Rand / Indonesia Rupiah
- Commodity producing nations: Aussie $/Norwegian Krone/Canadian $

Interest Rate Sensitive Assets

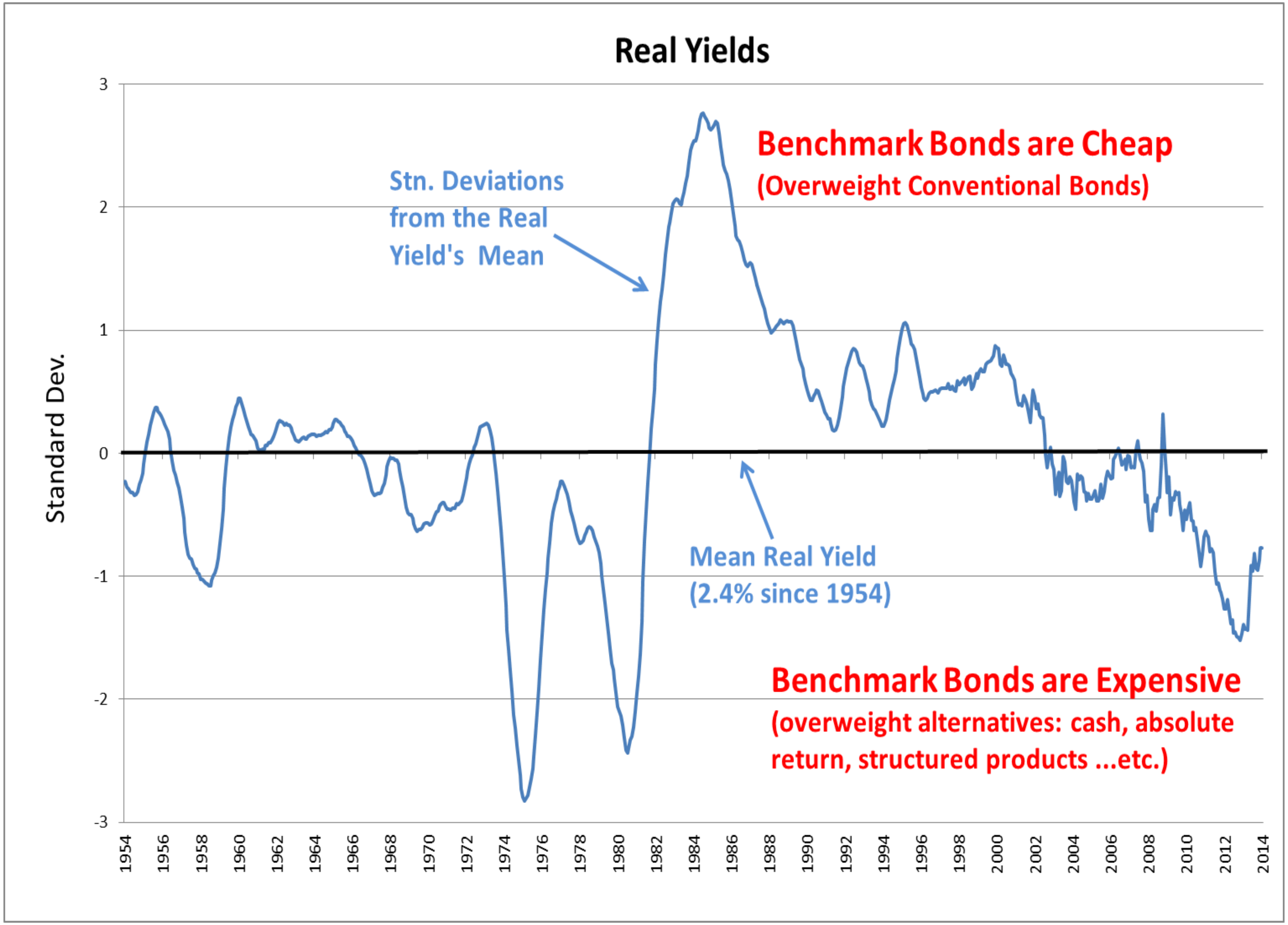
Source: Davy

The Multi Asset Approach

Underweight conventional bonds (and overweight alternatives) until value emerges

OR

A bear market in risks assets is close-at-hand



Conclusions

We believe that yields should normalise to higher levels as growth improves, which will be good news for pension liabilities

- In our opinion, bonds are the most expensive asset class at the moment.
- Most Investors underestimate the impact of rising yields on bond values (duration risk).
- Yields should normalise to higher levels as growth improves
- Given lower growth and inflation dynamics, the rise in European yields should lag US Treasuries and UK Gilts.
- Rising benchmark yields will be a drag on credit performance at current low spread levels.
- There is a risk that:
  - Exit from extraordinary monetary policy could lead to large sell-offs
  - Easy money has/will created problems elsewhere.
- Davy are managing these risks through multi-asset allocation:
  - Underweight bonds,
  - Overweight Cash, select property, absolute return, structured products.
  - Overweight equities vs Bonds

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