Have the years of plenty gone?
For some asset classes they certainly have.

Alexander Varyushkin
Partner,
Head of Asset Management

In 2015, it will be exactly seven years since the U.S. Federal Reserve (followed duly by other leading central banks) went on an unprecedented free money policy spree in an attempt to lend momentum to the faltering global economy. Most market participants expect the Fed in 2015 to start **normalising** rates (in the sense that today they are abnormally low). Interest rate futures point towards a 0.5% rise to 0.75% by the end of 2015, moving further up by another 1% to reach 1.75% in late 2016. Economists envisage a somewhat more aggressive scenario with interest rates reaching 1% by the end of 2015 to climb to 2.5% by the end of 2016 and to 3.5% by the end of 2017. Still, while market participants ostensibly expect interest rates to go up, yields on long-term debt securities seem to belie this forecast. Yields on 10-year U.S. Treasuries currently stand at about 2.5%. Supposing short-term yields reach 3.5% by the end of 2017, the current fair yield should be hovering within the 2.8-3.6% range (with lots of reservations regarding the shape of the yield curve). What is the reason for the prices to ignore economic forecasts, and do they really? In our view, there are two possible explanations:

1)The mismatch between investment horizons of most investors and the terms of the securities they invest in. We mean that several years up until early 2013 were extremely successful for investments in high-quality long-term bonds and some investors have «grown used to» low volatily and excellent yields while others cannot afford to invest in short-term securities due to the near-zero returns they offer.

The famous words by Chuck Prince, the former Citigroup CEO, on the mortgage bond market are extremely appropriate here: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

2) The market does not support the economists' view and expects the global economy to post slow growth which will prompt monetary authorities to keep in place their loose money policies for longer. Which is essentially sticking to the "Japanese" scenario as far as interest rates are concerned (because on the stock market performance and economic growth fronts it has already proved a failure). Yields on 10-year Japanese sovereign bonds are at 0.52% while inflation over the last 10 years has stuck at near-zero levels. The market for Japan's bonds has even earned itself the nickname «Widow maker» as many investors who in the last 10 years bet on higher interest rates and went short have since gone bust. To some extent, this view draws support from the major central banks with the exception of the U.S. Federal Reserve (the European Central Bank and the Bank of Japan), which are moving in the opposite direction and keep loosening their purse strings.

Another explanation could be that on the debt market «lean» years had begun as early as the start of 2013 and it is just that the adaptation to market expectations regarding future monetary policies does not happen instantly. At the beginning of 2013, we knew that over the next 7-10 years yields on investments in U.S. Treasuries (benchmark long-term quality debt securities) would not exceed 1.2-1.5%, translating into near-zero nominal and negative real returns.

Since the start of 2013 investments in long-term U.S. Treasuries have brought investor NIL in the way of return. Slightly riskier investments in quality corporate instruments have yielded about 3% over the last 18 months, which is exactly what one would expect in a «lean-year» period.

We tend to think that the secular bear bond market is already here, that in all likelihood it will not be over-aggressive and that the U.S. Federal Reserve will not be aggressive either in tightening its monetary policy. Which means that beta returns are a thing of the past and for the next few years assiduous selection of maturities along with thorough credit analysis should become second nature for investors operating on the debt market.