KNOWLEDGE SHARED

Investors need to think again about the role of government bonds

June 2020

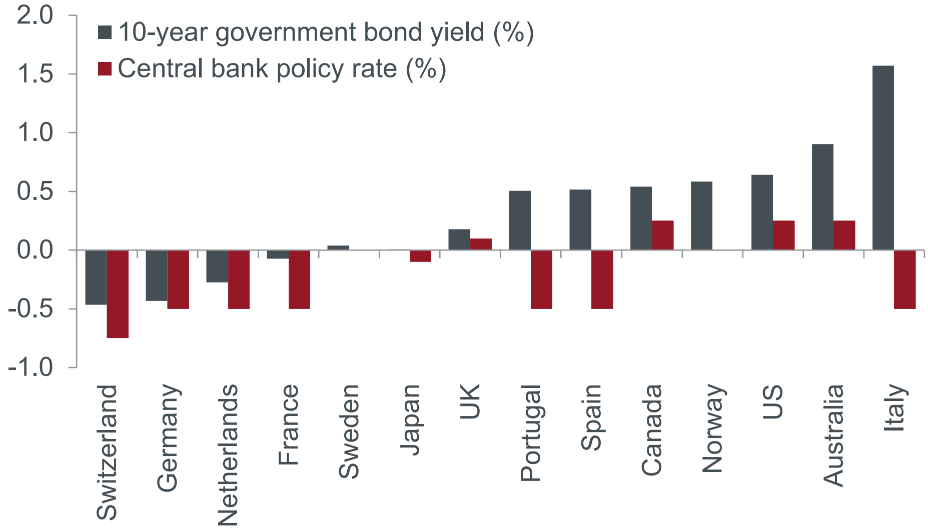
Oliver Blackbourn, Portfolio Manager on the UK-based Multi-Asset Team, considers the impact of monetary policy stimulus on government bond yields worldwide, and discusses what this may mean for investors looking to maintain risk and diversification in their portfolios.

Key takeaways:

- Investors are likely to have to work their investments harder after a decade in which loosening monetary policy has driven all asset prices, in aggregate, higher.
- The latest wave of monetary policy stimulus has seen ever more policy rates from central banks head towards negative territory, dragging government yields down with them.
- A more flexible approach may be required for those unwilling or unable to pay up for portfolio insurance, such as options.

The end of the multi-decade bond market rally has been called many times over the last 10 years but major sovereign bond yields are again below or approaching zero. The latest wave of monetary policy stimulus has seen ever more policy rates from central banks head towards negative territory, dragging government bond yields with them (see Exhibit 1). We ask what this means for multi-asset investors and whether bonds can provide the necessary diversification to risk assets going forward.

Exhibit 1: Major developed market government bond yields and central bank policy rates (%)



Source: Bloomberg, Janus Henderson Investors, as at 29 May 2020.
Past performance is not a guide to future performance.

Janus Henderson INVESTORS

The end of easy diversification

The economic halt caused by the virus outbreak has precipitated another wave of monetary policy easing from central banks, alongside large government spending packages. Monetary stimulus has been the standard post-2008 prescription of quantitative easing and, where possible, interest rate cuts. With many major central banks still at policy rates of zero or below from their dramatic moves over a decade ago, much of the easing has had to focus on asset purchases, both of sovereign debt and greater ventures into credit instruments

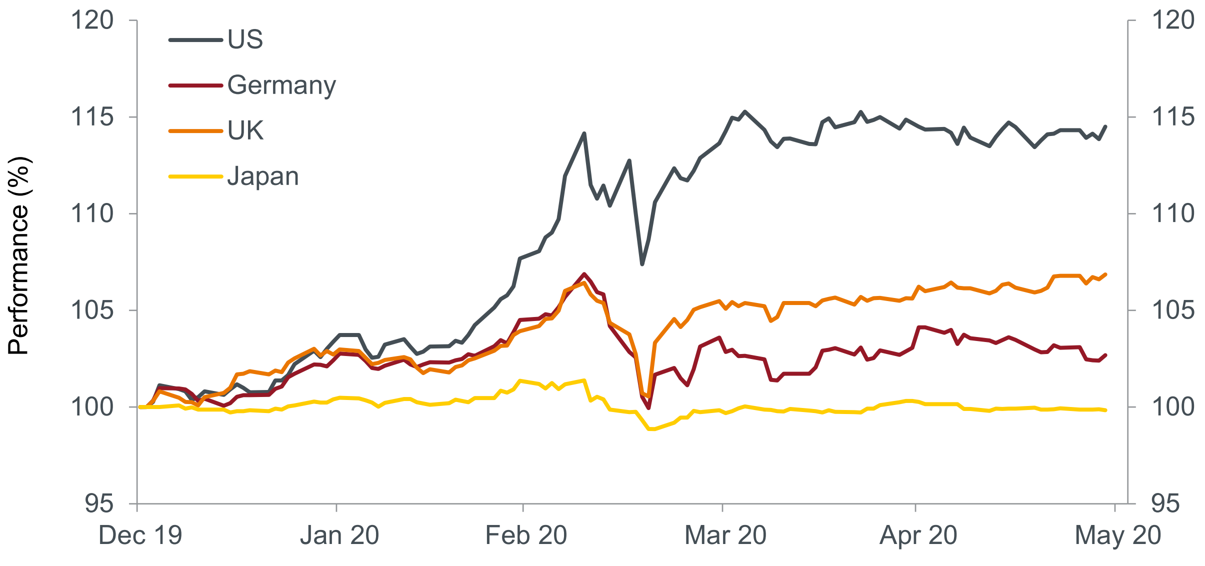
Economists are eagerly debating what new measures could be put in place by each central bank. How far down the credit spectrum will central banks eventually go? Will the US Federal Reserve (Fed) and the Bank of England (BoE) follow the European Central Bank (ECB) and others into negative interest rate experimentation? Will more central banks follow the lead of the Bank of Japan (BoJ) in taking control of or capping the yield curve? While the last two offer some potential upside for government bonds, it is now likely that we are in the final hurrah of the multi-decade government bond bull market. The effect of monetary policy on anything other than financial markets is becoming fairly marginal; fiscal policy needs to step up for a prolonged reflationary effort.

This is a very important development for investors as government bonds have tended to be the instrument that multi-asset investors hold in their portfolios for diversification against the growth shocks that upset economies and markets with regular frequency. They are not just hedges against the expansion-ending recessions but also against events such as the oil price collapse of 2014/15. The ability to earn a return, alongside the potential for capital upside in the event of an economic shock, has been an important building block when constructing a diversified multi-asset portfolio.

The end of meaningful protection from government bonds

US Treasuries remain one of the higher yielding, safe-haven government bond markets, yet only had a yield of 0.64% at the end of May 2020. That implies that a fall in the yield on the 10-year Treasury to the middle of the Fed's interest rate range of 0–0.25% would only see a roughly mid-single digit capital return. Of course, the returns could be higher if the Fed were to cut interest rates into negative territory at the same time but it would take a substantial reduction to drive a repetition of the double-digit returns seen so far in 2020 (Exhibit 2).

Exhibit 2: Performance of major 10-year sovereign bonds year-to-date

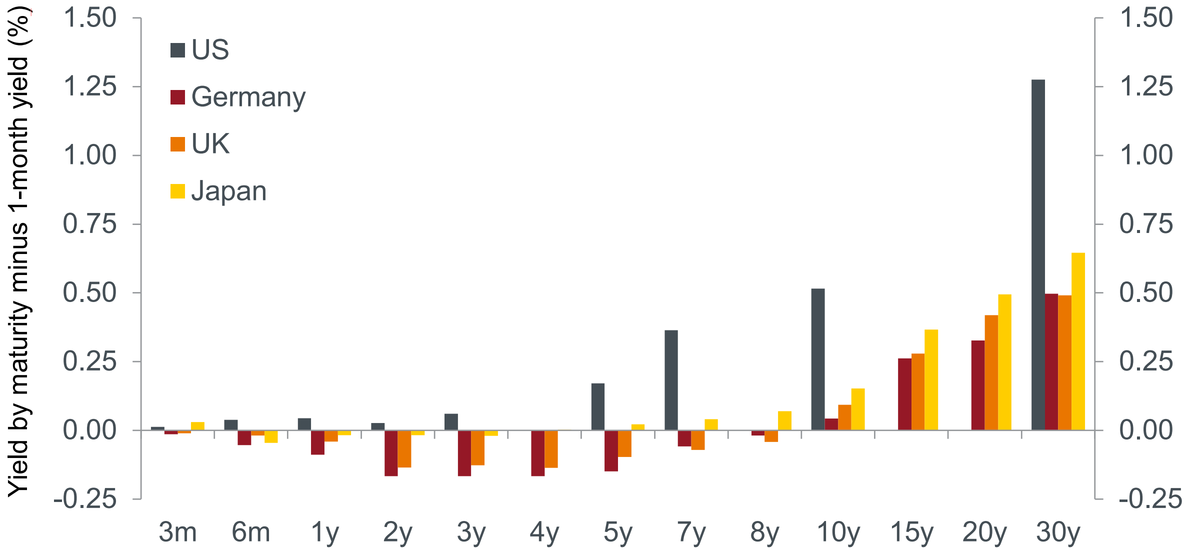


Source: Refinitiv Datastream, Janus Henderson Investors, 31 December 2019 to 29 May 2020. Rebased to 100 at start date.
Past performance is not a guide to future performance.

The impact of yield curve control in Japan — where the BoJ has sought to restrict the yield on 10-year government bond yields to a narrow range around 0% — has been to dramatically suppress the volatility of Japanese government bonds. In so doing, there was limited protection for Japanese investors when the virus outbreak brought the global economy to a halt and risk assets plunged in value. Similarly, German bunds could not deliver the same levels of return as US Treasuries, despite bund yields falling as low as -0.86% in early March.

Examining the shape of the US Treasury, German bund and UK gilt yield curves – the change in yields from short maturities to longer ones – we believe it is evident that without significant interest rate cuts there is now little upside for both German bunds and UK gilts. Both have yields that are less than their respective 1-month maturity debt out to those bonds that mature in almost 10 years' time. In fact, if we look back to where gilt yields were at the end of 2019, the majority of the performance of the 10-year gilt in 2020 so far has been driven by the fall in interest rates, rather than any compression in longer-term yields relative to shorter-dated debt, ie. the shape of the yield curve is little changed. This again places greater emphasis on the likelihood of interest rates cuts being the predominant driver of any further gains in UK gilts.

Exhibit 3: Shape of sovereign bond yield curves



Source: Refinitiv Datastream, Janus Henderson Investors, as at 29 May 2020
Notes: Yield by maturity minus the relevant 1-month yield, as a percentage.
Past performance is not a guide to future performance.

Yield curve control, yield capping or just consistently high levels of quantitative easing (effectively an implicit, but looser, form of yield capping) could mean that investors can still earn a small, but positive, return on certain government bonds. However, the protection that was taken for granted in many multi-asset portfolios has now been severely diminished, unless central banks are prepared to impose further, sizeable interest rate reductions into, or further into, negative territory. The impact on multi-asset investors is significant. Those with risk assets may have to accept that the total level of risk in their portfolios is being shifted higher, or they may have to look to reduce their exposure to bring overall portfolio risk back down, potentially hampering their ability to meet longer-term return targets.

A quick example

One way of examining the impact of lower bond yields is to model three multi-asset portfolios combining the S&P 500 and certain 7–10 year government bond indices, hedged into US dollars where appropriate (Exhibit 4). The first portfolio uses US Treasuries for the government bond exposure and in the others these have been switched for Japanese government bonds and German bunds respectively. If we consider the period from the end of 2016, when the BoJ had already introduced yield curve control and when interest rates were already negative in both Japan and the Eurozone, we can look at the impact on certain risk characteristics within the modelled portfolios over the past few years.

Exhibit 4: Model portfolios of 50% S&P 500 / 50% government bond exposure

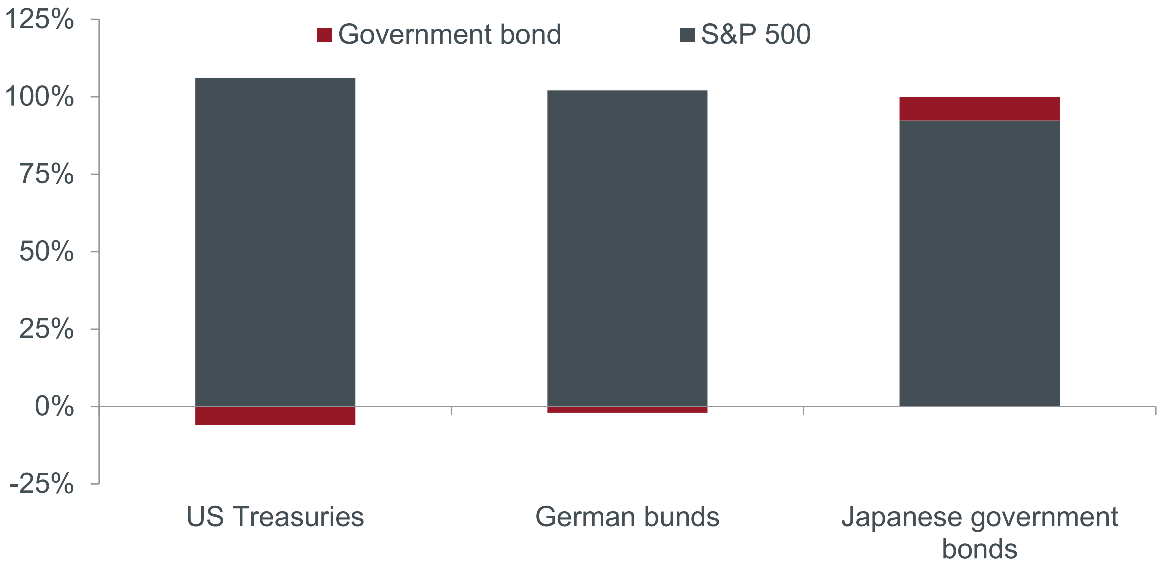
	US Treasuries	Japanese government bonds	German bunds	Cash with 0% return
Volatility	9.6%	10.3%	10.3%	10.3%
Maximum drawdown	-15.3%	-18.3%	-18.1%	-18.0%

Source: Janus Henderson Investors, Bloomberg, as at 10 June 2020.
Notes: Calculations used daily returns from 31 December 2016 to 29 May 2020, rebalanced daily to 50% S&P 500 and 50% government bond exposure. Bloomberg Barclays 7–10 year indices were used for US Treasuries, Japanese government bonds (US dollar hedged) and German bunds (US dollar hedged).
Past performance is not a guide to future performance.

As exhibit 4 shows, while volatility in the modelled portfolios was only marginally reduced by owning US Treasuries, there would have been a more meaningful reduction in the maximum drawdown of the modelled portfolios when US Treasuries were included, instead of Japanese government bonds or German bunds. Perhaps surprisingly, the maximum drawdowns for the models holding Japanese government bonds and German bunds would have been only marginally larger than holding cash that returned nothing.

By putting similarly modelled portfolios through our in-house risk systems for the market crash of February/March 2020, we can look at the contributions to risk, as defined by Value-at-Risk – a measure of the expected maximum loss each day with a high level of confidence. We get an even clearer picture of the benefit of owning US Treasuries throughout the period. While Japanese government bonds contributed positively to the overall level of risk and German bunds had little effect, the model incorporating US Treasuries showed a decent negative contribution to overall risk from government bonds – a clear diversifying effect as shown in Exhibit 5. While the contribution was small, this is to be expected given the far greater volatility of an asset such as equities.

Exhibit 5: Contributions to total risk by asset class

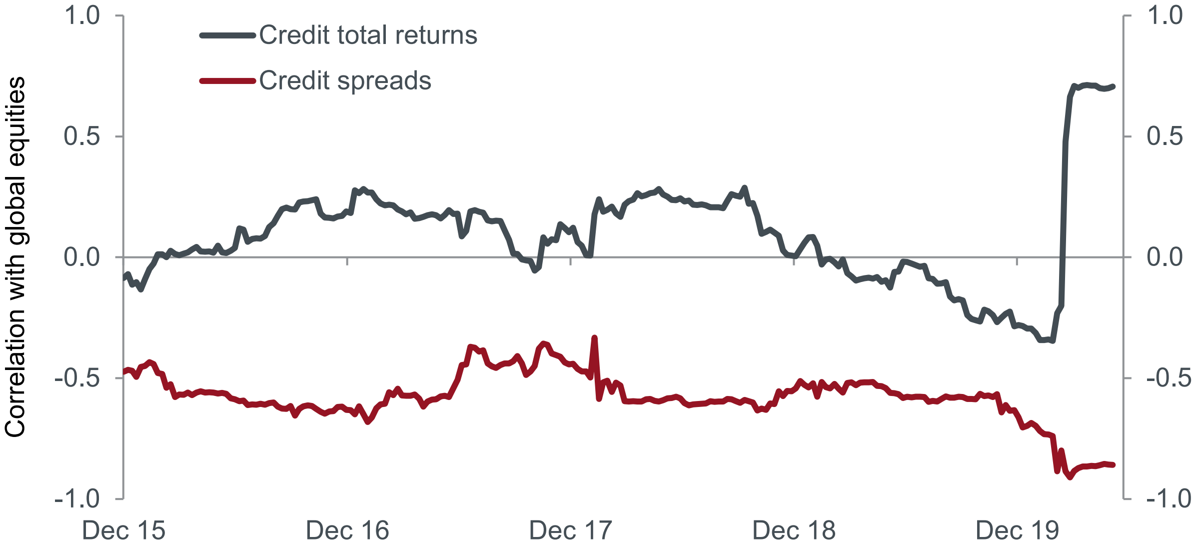


Source: Janus Henderson Investors, RiskMetrics, Bloomberg, from 20 February 2020 to 31 March 2020.
Notes: Risk measure is 99% Value-at-Risk, based on Monte Carlo simulations using daily returns between 20 February 2020 and 31 March 2020. Example portfolios are composed of 50% S&P 500 total return index and 50% of the relevant 10-year government bond future.
Past performance is not a guide to future performance.

Is it just government bonds?

Even within fixed income, those higher-quality assets that may have once offered diversification in many risk-off instances, such as investment grade corporate bonds, may now behave more like risk assets. With the underlying sovereign yield confined to much smaller movements, the impact of the changes in credit spreads will dominate price returns. Exhibit 6 shows that investment grade (IG) debt total returns often have little correlation with equity markets. However, credit spreads tend to have a persistent negative correlation with equity markets, i.e. credit spreads get wider when equity markets are falling. With credit spreads having a higher correlation to falls in risk assets, investment grade credit may no longer offer the same diversification that it once did and the recent higher correlation between investment grade bonds and equities may continue. That is not to say that higher-quality corporate bonds should be ejected from a multi-asset portfolio, instead the way that investors consider their role may need to be adjusted.

Exhibit 6: Correlation between IG debt total returns/credit spreads and global equities



Source: Janus Henderson Investors, Bloomberg, as at June 2020.
Notes: Correlation between investment grade debt total returns/credit spreads and global equities. 52-week rolling correlation between the total return or the credit spread of Bloomberg Barclays Global Corporate Index (US dollar hedged) and MSCI AC World Index (in USD).
Past performance is not a guide to future performance.

The outlook for portfolio construction

The final throes of monetary policy dominance are creating problems for multi-asset investors, as government bond yields are crushed, along with an easy source of diversification. It will be harder and more costly to own assets that can help to protect portfolios against a growth shock. The so-called 'Fed put' may be joined by a 'fiscal put' that helps to underpin risk assets in the medium term. However, fiscal spending is a political decision rather than one made by supposedly cooler-headed central bankers. Politicians can be fickle and are generally less likely to rush to support the stock market, leading to greater uncertainty about how sustained any fiscal put might be. Investors need to cast their net wider in search of diversification, as well as thinking about the levels and types of risks that their portfolios will face.

One option is to simply accept that holdings of riskier assets must now be reduced to keep the overall level of risk unchanged. This might go hand-in-hand with a preference for greater levels of cash over government bonds with lopsided return expectations. However, this may also lead to lower return expectations for a portfolio as a whole. The purchase of options to provide protection is a possibility but options are generally an expensive alternative that could further erode potential returns over the longer term. Investors may look to currencies to play a greater role in portfolio diversification. We have seen the US dollar perform strongly in the recent market crash as investors sought the safety of the world's major reserve currency and the greater depth of US funding markets at a time of crisis. The correlation of the US dollar changes through time, though, and the Japanese yen and Swiss franc may be preferred for their more stable behaviour in appreciating during less egregious market declines.

There is also the threat of a potential rise in inflation over the longer term. While nominal government bonds would do little to protect against such a scenario, we may yet see demand for protection against both a growth shock and rising inflation push real yields even lower on US Treasury Inflation-Protected Securities. This may also help the gold price continue its recent rally back towards the 2011 high of US$1,900, given the observed relationship between gold prices and US real yields. A weaker US dollar is likely to be an additional boost for the yellow metal. Lower real yields may also help to boost securities with inflation-linked return streams, such as infrastructure investments, that can offer diversification.

Finally, investors are likely to have to work harder after a decade in which loosening monetary policy has driven all asset prices higher. Ultimately, investors may just have to accept that a given level of return likely requires a higher level of risk. A more flexible approach may be required for those unwilling or unable to pay up for portfolio insurance, such as options. Investors may have to look to alternative assets and strategies to play a larger part in portfolio construction, even if they do not precisely mimic the characteristics that government bonds have provided for decades. Whatever happens, an ability to adapt quickly to changing market conditions across a range of asset classes is likely to be more important than ever.

Janus Henderson
INVESTORS