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Laketon Canadian Fixed Income

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Brent: Billionaire speculator Jim Rogers told a CNBC interviewer. "Government bonds may be the last bubble. …" Another billionaire speculator, George Soros, told a financial interviewer that the "moment this fear of deflation turns into a fear of inflation, you'll find interest rates rising in the long end." And to paraphrase Warren Buffett from his latest letter to shareholders: "The U.S. Treasury bond bubble … may be regarded as almost equally extraordinary as the Internet and housing bubble"

So the question we'll pose today to Gary Morris, Director of Fixed Income at Laketon is "are we in a bond bubble?". For certain, there is a pitched battle being played out in the bond market; a crisscross affair where competing views on inflation vs. deflation; supply vs. demand and fear vs. greed all collide.

In order to digest this complex question we'll break it into manageable pieces. We'll cover off Laketon's view on each of the battles that I mentioned and how the outcome of each of will affect bond investors.

Let's begin with the fear vs. greed. Bond prices ran up dramatically during the "flight to quality" sparked by the financial crisis – so much so, that yields were pushed down to levels not seen in decades. As investors' appetite for risk returns, what impact is this having on government yields?

Are we wise to give in to this renewed appetite for risk and reduce our exposure to gov't bonds in favour of more risky choices?

Gary: Well Brent, let me begin by giving a kind of "Bonds 101" lesson. Government bond yields are generally speaking made up of two components: real yields and inflation expectations. Now, real yields address the supply/demand factors, the risk or perceived risk of owning government bonds, and of course some compensation relating to the term of the investment. Inflation expectations is simply the part of the yield that relates to inflation expectation for the life of the bond. For simplicity sake we can think of the nominal yields or yields-to-maturity as just the sum of real yields and inflation expectations. One more point, the main difference between the yield on a government bond and a non-government bond is essentially the additional yield premium that investors seek for investing in a more risky asset. OK, with that out of the way…

Looking back over the last 18 months, most of us know by now that investors have fled risky assets in droves. The exodus reached its peak last fall, marked by a corresponding flight to treasury bills and bonds. In the U.S. 90-day T-Bills hit bottom at virtually 0% and are still there and 10-year bonds hit 2.1%. In Canada 91-day T-bills have bottomed out at just under 20 basis points and 10-year bonds have reached as low as 2.5% in Q1 this year. One has to look back to the Great Depression to find a similar kind of exodus from risky assets. For example, the last time corporate yield spreads, (that is essentially the difference between a corporate bond yield and a sovereign government bond yield of similar term to maturity) anyway, the last time they were as wide as they were in Q1 was during the 1930's. The investment community likes to point to the wide TED spread as an example of the risk aversion that plagued the market – this spreads reached around 10 times its normal level, late last year. Anyways, I think you now you get the picture.

Well, Brent as you point out, investor risk appetite has returned, albeit not of the kind seen back in the first half of 2006. While the appetite for risk is real, I would say one has to be careful how one sees it. First of all, I think the massive "Flight to safety" which for many meant Treasuries and for some meant gold, has somewhat dissipated. It doesn't mean that the bid for Treasuries has disappeared, but it does mean that speculative investors are not willing to bid up Treasuries with the expectation that scared investors will follow. I think that much of the retracement that we have seen in Treasury yields is really a lot of that froth going away.

One has to remember that a lot of the so-called safe money was fleeing into T-bills and shorter-term bonds rather than further up the yield curve (and basically the yield curve of short term interest rates and longer term bond yields). For the time being no matter how much money goes in and comes out of short term government assets, we have gotten clear signals from central banks that short term interest rates are well anchored. In fact, Governor Carney of the Bank of Canada, has even given us a 12-month timeframe for stable rates. Of course, central banks don't control longer term bond yields, but there is a limit as to how steep the yield curve can get.

I know I have taken a kind of long way around answering your question, but to the point, we are not really ready to throw the towel in on government yields.

Brent: Battle number 2 is one of supply vs. demand. Governments globally are issuing and will continue to issue mountains of new bonds, as already tight budgets are being tapped for gargantuan stimulus packages and bailouts.

Basic economics dictates that as supply increases, prices will fall; unless of course there is an equal increase in demand.

So how is the bond market digesting this influx of government bond issuance, are we seeing an increase in demand? And if so, from where and why?

Gary: . Going back to "Bonds 101", the real yield component of a government bond yield is heavily influenced by the balance of supply and demand. Of course we are seeing supply like we have never seen before. The U.S. Treasury has issued over $200 Billion in Q1 and this is likely to double in Q2, which is well up from levels a year ago. Government of Canada issuance is also up but not as dramatically. And the pattern has been repeated elsewhere, globally.

On the other hand there is still deep demand for government securities. In the case of the U.S. Treasury market where the supply is most dramatic, trusted Treasury buyers such as China and Japan still have demand for Treasuries. Admittedly, Middle Eastern demand has waned, with the reduction in OPEC revenues due to lower oil prices. But these sources of demand, ultimately are not going to really make up the big increase in supply. We see most of the new demand for government bonds coming from U.S. investor for a variety of reasons. We have already mentioned the risk aversion of investors which we believe, will remain in place for some time. But, more importantly we see a general shift in attitude away from consumerism over to savings, which will find its way to government bonds. Savings rates have moved off their generational lows of zero, and are moving rapidly higher to historical averages closer to 10%. The situation will not be much different in Canada.

Finally, there is also a bond market specific shift taking place. We believe that this is a secular trend that is a consequence of the deleveraging of the private sector, with a corresponding leveraging of the government sector. The private sector is essentially being crowded out by the government sector. By way of comparison, 15 years ago, the Canadian public debt markets were less than 10% corporate bonds (according to the then McLeod Young Weir Universe Bond Index). At the peak of corporate issuance, the corporate bond market was just under 30% of the DEX Universe Index. We see the corporate weight heading towards 20% over time - it is now at 27.5%, which is down about 2.5% from a year ago.

To summarize, we believe the demand for government bonds will increase and soak up additional supply. Yields will, however, be volatile as the market adjusts to more and varied issuance. However, we do believe there is a point where we can see too much government supply. Obviously getting to such a point would be dangerous for government yields and just about every other asset class as well. We are certainly very far away from that point in Canada, but a little closer in the U.S. but for the meantime U.S. debt/GDP are still far from crisis point.

Brent: The last battle being waged in the fixed income markets today is potentially the most contentious one. The public has a general fear of inflation and certainly we all have a natural distaste for higher prices (except in our investment portfolios!)

When the economy begins to revive, should we be concerned with inflation?

Gary: Brent, before I answer this question, let me just say that by putting Jim Rogers, George Soros and Warren Buffet all in one camp certainly makes it hard for me to choose a different one.

It seems to me that since the 80's, most bond investors have been fearful of inflation at one time or another. It is certainly the question I get asked about most, and seems to be the area I have been challenged the most over the last five years. I don't believe that I am always an inflation optimist, but at least for the time being I remain so. Inflation will likely return at some point, not just now! In fact, I believe governments, with the tacit help of central banks, will probably try and engineer some level of higher inflation to help make their overgrown debt burdens shrink.

For the time being, we believe that the economic recovery will be disappointing and prolonged. The large amount of over-capacity in plant, equipment, commercial property and most importantly labour will take a long time to work off. This will be the underpinning of low inflation and eventually lower inflation expectations. Economies will have periods of outright disinflation and may even flirt with deflation. In our view this environment will persist for at least two or three years.

Brent: You mentioned that central banks don't control longer term bond yields. There is some suggestion that they are trying to. They're concerned the economy is too weak to handle higher borrowing costs and some jurisdictions are proceeding with "so-called" quantitative easing. These quantitative easing tools have been described by some as outright printing of money - adding further unknown amounts of fuel to an inflation problem. What is your take on those views and where do you see it leading?

Gary: Well the quantitative and credit easing debate continues. And for those listeners who are not really the familiar with the concepts let me just give a quick definition, as we see it. I should point out that it is our definition, primarily because there doesn't really seem to be any universally accepted definition out there. Anyways, both "easings" are a non-traditional monetary policy tools generally effected by central banks, although not necessarily. You know Governments can also actually exercise QE and CE policies directly. Basically, through QE and CE policies, as they are commonly referred to, central banks purchase securities in the market place from investors to put on the balance sheets of the central banks using newly printed money. It is assumed/hoped that in the process, government and credit yields will be prevented from rising and maybe even fall. The first experience with QE was in Japan in the 90's with mixed success. The most recent example in the U.K. has also been met with very much mixed success. For its' part, the Bank of Canada has discussed QE in theory, but with no specific game plan at this point.

My feeling is that in an isolated case, QE would likely ensure a devaluation of the countries currency and perhaps lead to higher inflation. However, in an environment where there are many QE and CE "easers", or many countries effecting QE and CE policies, I think it is hard to predict what the outcome will be. In the case of the U.S. though, because the US dollar is the reserve currency, I don't think that QE and CE policies will lead to a weaker greenback and higher inflation. On the other hand, if Canada were to aggressively implement QE and CE policies, the Canadian dollar would likely suffer with the potential consequence of higher inflation – but for now I think it is a scenario not worth worrying about.

Brent: We've talked mainly about the gov't bond market, the Laketon core strategies are universe bond mandates; as such, they have exposure to the investment grade corporate bonds. You mentioned that the main difference between the yield on a government bond and a non-government bond is essentially the additional yield premium that investors seek for investing in a more risky asset. What impact are we seeing in corporate bonds from this renewed risk appetite we have been discussing?

Gary: Yes, we did mostly talk about government bonds and didn't really say anything about the opportunities for risk in the bond market. Well last time I was on this call, we pointed out that the corporate bond market offered some good opportunities. We still believe corporate bonds are the place to be, but perhaps the recent narrowing in yield spreads has been a tad too aggressive. Never-the-less, corporate yield spreads are still wide and offer both good pick-up and good protection from further widening, so for us to want to remain overweight the sector.

Brent: Well thank you very much Gary that concludes our discussion for today. Our question was, Are we in a bond bubble? And we covered a variety of concepts and opinions. Till we talk to you next time, take care

Gary: Thank you Brent