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Bonds are not yet due a reversal of fortunes

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By John Authers
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If we have learned anything in the past year, it is that a "buy-and-hold" strategy of buying stocks and holding them forever, confident that they will outperform in the long run, is not foolproof.

The most telling statistic to dispute the notion of "stocks for the long run" came from Rob Arnott, the head of Research Affiliates and a frequent contributor to the Financial Times, writing in the *Journal of Indexes* . He found that in the 40 years to the end of February, and again to the end of March, long-dated US Treasury bonds had slightly outperformed US stocks.

This statistic proved that the many Americans who will retire soon should be deeply unhappy with their equity investments. Beyond that, what does it tell us?

Mr Arnott himself was careful not to overstate the implications. "This is not to say that we expect stocks to underperform long Treasuries over the next 10, 20, 30, or 40 years," he said. "We don't."

But he said the "cult of equities" is dangerous. "The notion that stocks always win for the long-term investor is a dangerous fallacy. The notion that if we're willing to be patient, it doesn't matter what we pay for stocks [or any other asset class] is foolish."

These are valuable insights with which it is hard to disagree. But stocks certainly outperform most of the time.

When Robert Huebscher of Advisor Perspectives checked Mr Arnott's data, he confirmed his finding - but also found that there were only three months since 1929 in which bonds had outperformed stocks over the previous 40 years.

Thus Mr Arnott's statistic could show that this is a great time to buy stocks. It has always been popular among brokers to value stocks by comparing their earnings yields to bond yields. The validity of this approach is questionable. But if stocks yield more in dividends than bonds yield, as they do now for the first time in more than 50 years, it does look like a decent argument that stocks are cheap.

Another response is to shift the spotlight from stocks to bonds. Mr Arnott's remarkable statistic may show that the bull market for US government bonds, which has now lasted more than a quarter of a century, is becoming unsustainable.

That conclusion is particularly tempting after 10-year US Treasury yields yesterday briefly went above 3 per cent, for the first time since the Federal Reserve last month announced that it would buy bonds in an attempt to push down yields. Traders are in a mood to dare the Fed into action, and this suggests that bond prices have been driven too high.

But the long-term forces pushing yields down are durable. Ever since Paul Volcker, as chairman of the US Federal Reserve in the early 1980s, managed to slay the beast of inflation, bond yields have steadily fallen, and their prices have risen, generating strong returns for those holding them.

As the chart shows, the trend downwards in yields has been remarkably consistent, a pattern that is totally different from the stock market. There have been periodic corrections, often sparked by tighter money from the Federal Reserve, when yields have risen, but they have never broken the downward trend.

The peak in yields during each correction of the past 25 years can be joined by a straight line. That line has been breached once, for a few weeks early in the summer of 2007, in a sell-off that probably acted as the trigger for the credit crisis.

Long bond yields provide the "risk-free" rates that are used when pricing all kinds of finance across the world. The market for corporate and mortgage debt went into turmoil as the world of steadily lowering rates was called into question, and government bond yields shot down once more as investors headed for safety.

The greatest driver of bond prices has been inflation, which eats away at the value of the fixed income paid out by bonds. Yields fell as it became clearer that the inflation of the 1970s had been squeezed out of the system.

This driver remains in place. The UK's retail price index this week showed year-on-year deflation for the first time in 50 years.

If the developed world is truly "turning Japanese" and ready for a "lost decade" of deflation, then yields can fall further.

But how long can this possibly continue? Issuance by governments to fund deficits will push down on bond prices. And the aggressively reflationary economic policy in place around much of the world is designed to avert the risk of the Japanese scenario, at the cost of bringing back inflation. These factors will in time cause the bond market to go into reverse.

But this will not happen all at once. This financial and economic crash has played out over more than two years. The next stages will similarly take a while to play out. Extrapolating the trend line on a Bloomberg screen shows that 10-year Treasury yields need not hit 1 per cent for more than a decade. The trend will be broken by then. When this happens yields are likely to rise fast. But it could easily survive for several more years.

The Arnott research does not mean "Bonds for the long run". But "bonds for quite a long time yet", even though the bull market has already lasted a quarter of a century, could work.

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