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Global bond investments getting riskier

Investors in government bond markets like Germany, France, the UK and Japan, where bonds continue to rally and yields fall further into negative territory, are facing the increasing chance of large losses should these markets sell off. This is according to Marc Beckenstrater, portfolio manager of the Prudential Global Funds range at M&G Investments.

According to Beckenstrater, investors are facing a global bond bubble where there is limited potential upside and large potential downside should economic conditions change or the current bullish market sentiment toward bonds start to turn – for whatever reason. Government bonds from most developed markets around the world are offering negative yields, and trading at their most expensive levels in history (where prices are highest and yields lowest). People buying these bonds now are effectively guaranteed to receive negative nominal and after-inflation returns if they hold them to maturity.

For example, the German 10-year government bond is currently offering a nominal yield of -0.3%, which after 2.1% German inflation translates into a -2.41% real yield, guaranteed for 10 years. For more details on how this bubble has built up, see Prudential's earlier article "What's driving negative bond yields?".
Based on current yields, as M&G Investments research shows in the table below, if real bond yields rally by 1% (in other words bond yields fall by 1%), investors' returns could range between 1.7% for the UK 10-year government bond and 20.5% for the German 30-year government bond. However, if real bond yields sell off to reach a 0% real yield, the same bonds could face losses of 14.9% for the and a substantial 41.1%, respectively. Or, if the sell-off were to be as severe as that seen during the 2016-2018 Euro currency crisis, losses would range between 11.2% and 40.2% on those same bonds.

Returns of core government bonds if yields were to move to different levels

	Yields fall to -1%	Loss experienced from 2016 lows to Feb 2018	0% real yield
Germany 10-year	+3.0%	-14.1%	-21.2%
Germany 30-year	+20.5%	-40.2%	-41.1%
France 10-year	+5.8%	-12.1%	-13.9%
UK 10-year	+1.7%	-11.2%	-14.9%
Japan 10-year	+4.2%	-3.6%	-7.5%

Source: Bloomberg, 2 September 2019

"Investors considering putting funds into these government bonds now should think twice," said Beckenstrater. "They are facing a far larger potential downside than upside given the current levels of yields in negative territory. Also, if they hold to maturity they will be guaranteed a loss because of the negative yield – to avoid this loss they will need to sell these bonds on to other investors willing to pay even more than they have paid. And those new buyers will face the prospect of even bigger guaranteed losses."

What could trigger a reversal in the long global bond market rally? He believes upside surprises to the inflation or growth outlooks could cause a sell-off. So could changes in current regulations forcing financial institutions to buy bonds even at expensive prices. "If these bonds stop rallying for whatever reason, they could deliver negative returns over rolling 2, 3, 4 and 5-year periods. For investor portfolios, this could be painful. This is when investors will be reminded that bonds are not always low-risk instruments - they can lose money."

Beckenstrater believes investors should instead consider global equities, which are offering a far superior relative yield (MSCI ACWI Index earnings yield at around 6.5%) compared to global government bonds (Germany at a 10-year real yield of -2%, US at a 10-year real yield of 0%). The Prudential Global Balanced Fund is very underweight developed market government bonds and very overweight global equities at present. It also has exposure to higher-yielding investment-grade corporate bonds and select emerging market government bonds. For example, Mexican government 10-year bonds are offering a real yield of around 3.8%, attractive on a relative basis and amply compensating for the risk involved.

Prudential South Africa offers investors the Prudential Global Funds range of offshore funds managed by M&G Investments: four Irish-domiciled, US dollar-denominated funds, and four corresponding South African-domiciled, rand-based feeder funds.

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