

COMMENT

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Bonds sell-offs, nice and nasty

Some sell-offs in bond markets are good for shares, but others are not

For years, investors have worried about a sell-off in global bonds. The last few weeks, however, have reminded us that for equity investors the danger is not so much of a sell-off in bonds but a rally in them. Yields on 10-year US Treasury bonds have fallen since early October while global stock markets have slumped. That reverses the pattern we saw from 2016 to this summer, which was for US bond yields to rise as share prices did well.

This reminds us of an important fact – that sell-offs in bonds can be good for equities and, by the same token, bond market rallies can be bad.

Good sell-offs are those that are triggered by increases in appetite for risky assets or by expectations of stronger economic growth – although the two often go together.

To put this formally, the dividend yield on equities is equal to a long-dated bond yield (the risk-free rate at which we discount future cash flows), plus an equity risk premium, minus expected dividend growth. If the risk premium falls and/or dividend expectations rise, a rise in bond yields is entirely consistent with a fall in the dividend yield and hence a re-rating of equities.

Of course, this is no mere possibility. Not only is it what we saw between 2016 and 2018, but we also saw poor returns on bonds and good returns on equities in 2003-04 and in 2013-14. Emerging markets in particular tend to do especially well when bonds sell off. That's because they are especially risky assets and so rise a lot when appetite for risk rises – which is when bonds sell off.

Such nice sell-offs of bonds, however, are not the only sort. One big fact tells us this. It is that since 1986 the correlation between annual returns on the All-Share index and gilts has been slightly positive, at 0.1. Historically, bad times for bonds have slightly more often than not been bad times for equities. This tells us that there can be nasty sell-offs in government bond markets – ones that see shares fall alongside bond prices.

But what might such nasty sell-offs be? Many of the triggers for them come from the US.

You might think that one such trigger is rising US government debt: the Congressional Budget Office has forecast that the ratio of debt to GDP will rise from 78 per cent this year to 86.3 per cent over the next 10 years. And this assumes reasonable economic growth, which is when government debt should fall.

This, however, is only a minor problem. Joseph Gruber and Steven Kamin, two economists at the Federal Reserve, have estimated that each percentage point rise in the ratio of government debt to GDP raises bond yields by only 0.02 percentage points. That's not nothing. But it suggests we have bigger things to fear.

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One is rising interest rates. Although the fall in the S&P 500 has caused a reduction in interest rate expectations, markets are still pricing in a half-point rise in the fed funds rate by next December. This could raise bond yields simply because higher returns on cash might cause investors to switch out of bonds.

Historically, rising rates haven't often hurt shares simply because they have usually been accompanied by stronger economic growth.

Two things, however, might overturn this pattern.

One is that rising rates might cause a reversal of the 'reach for yield' that has driven prices up so much since 2009.

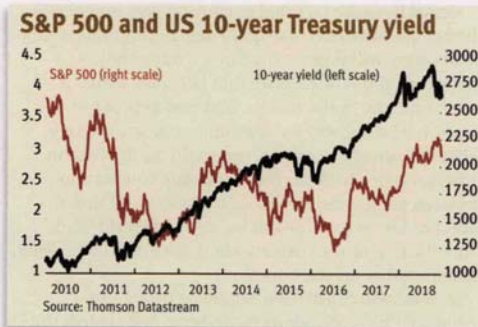
The other is that the US economy might be close to full capacity: the unemployment rate is at a 50-year low. If so, increases in aggregate demand might do more to raise inflation (and expectations thereof) than output. That would mean equities would not benefit much at all from faster growth, and might instead fear a recession as the Fed cools off the economy to reduce inflation.

In fact, there's another danger – that investors might come to doubt the Fed's independence. President Trump is leaning on it not to raise rates. He's said that he's "very unhappy" about recent rate rises and "not even a little bit happy" with his decision to appoint Jay Powell chairman. If markets were to fear that the Fed is holding rates below the level justified by the inflation outlook, this would raise inflation expectations, probably causing a rise in nominal bond yields. And it could hurt shares if it raises political uncertainty.

For what it's worth – which is not much – my hunch is that we might soon see a nice sell-off in bonds as investors recover their appetite for risk. But we cannot rule out the possibility of a nasty sell-off in coming months – of the sort that sees losses on shares as well as bonds. This is one reason to hold some cash despite negative real interest rates: doing so protects us from the danger of falls in both equities and bonds.

Equally, though, we should not overstate these risks. There's a lot that will continue to hold down





yields such as the global shortage of safe assets and the savings glut in many parts of the world. And of course there's continued slow trend growth in developed economies. Economists at the New York Fed estimate that this means that the "natural" real short-term interest rate is now under 1 per cent whereas it was over 3 per cent in the 1980s. Although such estimates are imprecise, they point to bond yields staying low by historic standards.

What we have to fear

What do investors have to be scared about? You might think the answer's obvious: losing money. In fact, it's not as simple as that.

Research by Christoph Merkle at Kuehne Logistics University shows why. Before the 2008 crisis he asked hundreds of UK clients of Barclays how they would feel if they were to see big falls in their equity portfolios. Obviously, they replied that they'd be unhappy. But here's the thing. When he surveyed them a few weeks later, when they had actually seen such losses, he found that they were much less upset than they anticipated. Losses don't hurt us as much as we fear.

A big reason for this, believes Professor Merkle, lies in what Harvard University's Matthew Rabin calls projection bias: we project our current tastes into the future and so fail to see that these will change, that we'll adapt to bad fortune. (This isn't just true of financial losses: Andrew Clark at the Paris School of Economics has shown that it's also true of other traumatic events such as divorce.)

How do we adapt? One way is that when the market falls we can comfort ourselves with the thought that everybody else is in the same boat. The cliché's right; a trouble shared is a trouble halved. And we can blame bankers and politicians rather than ourselves.

There's something else. For many of us, income and wealth are positional goods: we care not just about their absolute level but how we compare to others. "What matters to someone who lives in a rich country is his or her relative income," Warwick University's Andrew Oswald has said. Sara Solnick and David Hemenway, two US economists, have established this. Back in February 1995 they asked Harvard University students whether they'd prefer an income of \$50,000 a year when everybody else had \$25,000

a year or \$100,000 a year when everybody else got \$200,000. Most preferred the \$50,000.

A fall in equities generally leaves our wealth and future incomes intact relative to other investors. For many, this is a comfort.

But it has an important implication. If widespread losses don't hurt us but falling behind others does, then what hurts us are losses that are specific to ourselves – ones that result from our decisions to deviate from the average portfolio.

The pain such losses cause isn't just (or even I suspect mainly) a drop in relative wealth. It's also because we suffer a blow to our ego. If we lose money on a stock we've carefully researched and where we think we know something the market doesn't, we question our judgment: this is one reason

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why people hang onto losing stocks – they hate admitting they were wrong. It's one thing to be poorer; it's another to think ourselves stupid.

And then there's regret.

If we lose money on a tracker fund we won't regret it much, simply because a tracker fund is the default investment. But if we lose on an obscure Aim stock, we do.

It's not just what we do that we regret, however. Sometimes, we regret what we don't do: we can kick ourselves for not buying a share such as Amazon or Apple when it was much cheaper. This is one reason why there are sometimes bubbles in assets, such as we've seen in Bitcoin: the fear of missing out causes investors to pile into assets because others are doing so.

All this might help explain an otherwise strange fact – that, often, there is no trade-off between risk and return. Aim stocks, or high-beta stocks, for example, seem riskier than others but they have not on average delivered high returns to compensate. This puzzle disappears if the risk that really matters to us is that of relative loss. By definition, these losses are idiosyncratic and cancel out across investors: for everybody who's underweight in a stock, another is overweight. As Eric Falkenstein at Pine River Capital Management has said, if risks are idiosyncratic they cannot be priced and so there will be no risk-return trade-off.

There is, however, a nice counterpart to this. It means that equities in general have offered us something like a free lunch. We've been overcompensated for taking on market risk in the past because generalised stock market losses don't hurt us as much as we expect them to. This deepens the equity premium puzzle. But, for me, it is yet another argument for preferring tracker funds.

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