Lynx
Investment Advisory

What Should Investors Do When the World Needs More Bonds?

The world needs more long duration bonds as the current supply is not enough to satisfy the demand. Investors continue to rush into bonds, with yields hitting multi-year lows. The total amount of debt with negative yields has crossed the $11.5 trillion mark. This is sharply up from $6.9 trillion in early 2018 (see Chart 1). The problem is now more acute in Europe than in Japan, a country where bond yields have been under the 2% threshold for more than two decades. The yield on 10-year German bunds fell to a record negative 0.26% on June 7th, 2019. US 10-year bonds comparatively trade at around 2.08%, which is down from a November 2018 high of 3.25%.

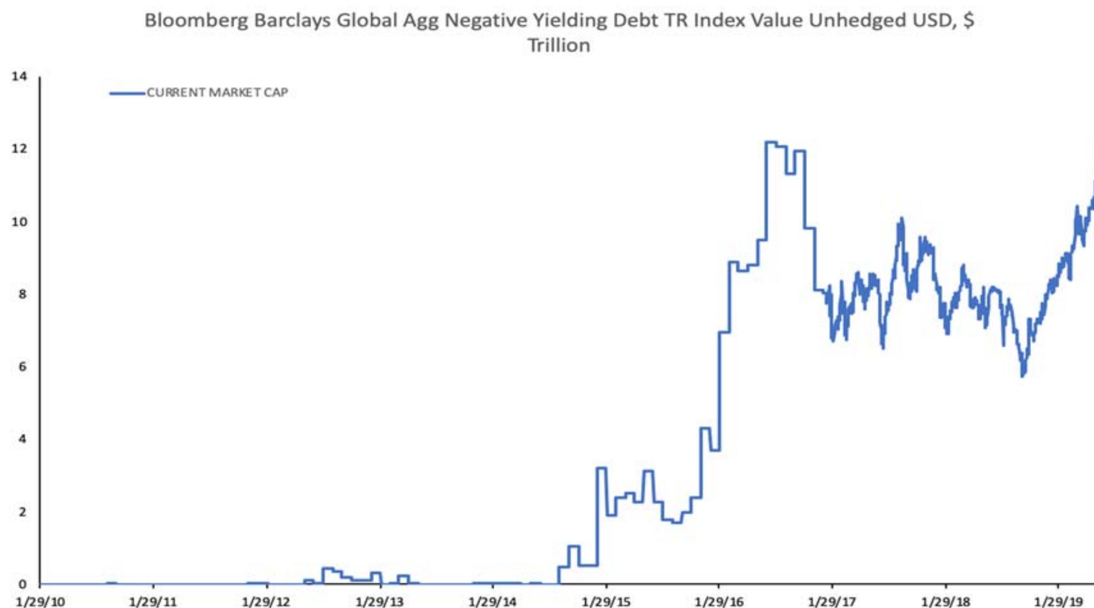

Chart 1: Source: Lynx Investment Advisory and Bloomberg data as of June 2019

While nations generally remain steadfastly opposed to issuing more longer dated debt, the flows into bond ETFs have recorded new highs (see Chart 2). To be fair, the world has struggled with negative debt before but what is remarkable this time around is that this comes as global short-term rates have increased, and

monetary accommodations have subsided. There are several reasons for this investor behavior, and we will focus on two of them. The first reason is structural, and the second is cyclical. Structurally, as the world continues to age, pension funds, insurance companies and individuals desire more bonds. This is because the population above the age of 60, which is the fastest growing demographic group, demands more exposure to fixed income securities in order to reduce volatility of their portfolios. The cyclical reason stems from investor belief that the recovery that started in 2009 is at its late stages of development and a recession is on the horizon. Let's examine the structural factor first.

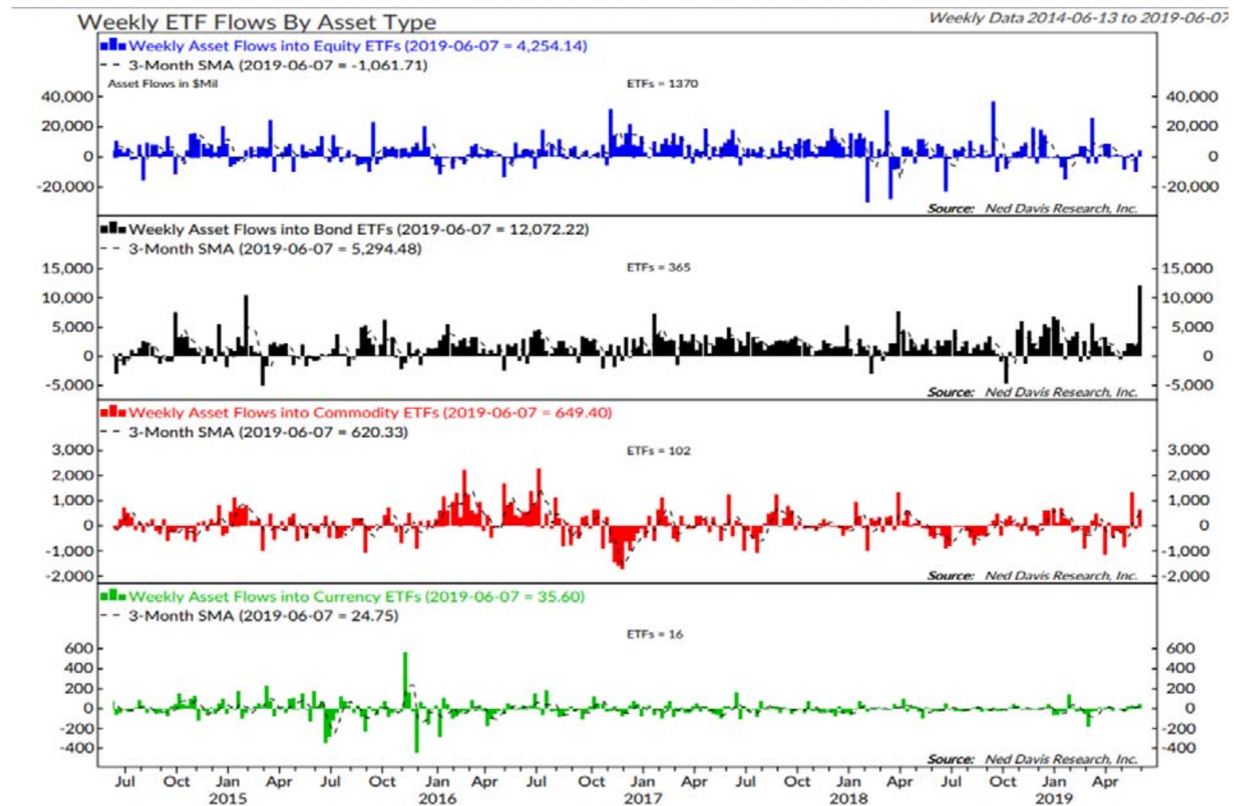

Chart 2: Source: Ned Davis Research

The demographic shift that we mentioned above is only going to worsen. The global population aged 60 years or more which numbered around 962 million in 2017 (double what it was in 1985), is expected to double again by 2050 according to UN report on Population, when it is projected to reach nearly 2.1 billion (see Chart 3). This shift will impact not only demand for bonds but has profound implications for labor productivity, global growth, health care costs, welfare benefits, retirement planning, etc. While radical policy changes may be needed to boost productivity, increase labor participation and boost immigration to help grow the GDP, the supply of long duration bonds must increase for normal functioning of the capital markets and to meet its ever-growing demand.

Percentage of population aged 60 years or over by region, from 1980 to 2050

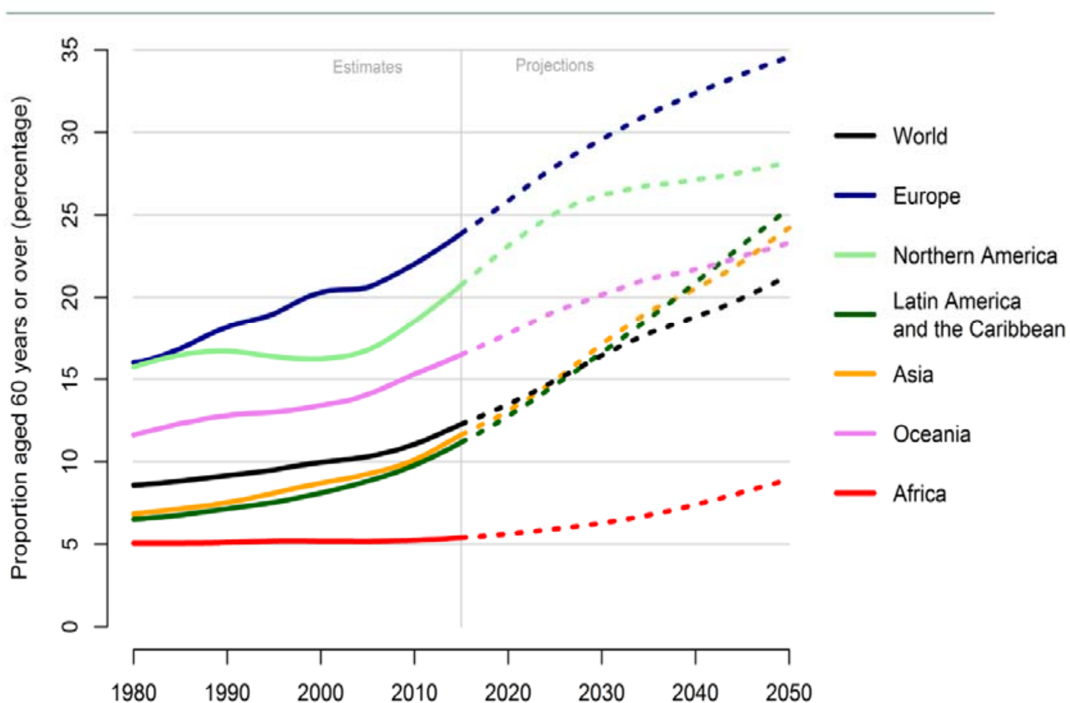

Chart 3: Source: UN report

While each business cycle presents a unique set of challenges, this one is different as it stems from trade and tariff disputes which have pressured the manufacturing sector globally. The severity and lingering nature of

these issues increase the level of uncertainty and pose a significant risk to global growth. A flat or inverted yield curve is not in anybody's interest. A positive sloping yield curve not only prices for term premium (difference between long term and short-term rates), it serves as a valuation check on spread products including equities. An increase in long-dated bonds issuance will prevent insurance companies and pension funds from crowding out the current limited issuance. This would steepen the curve, making the long-term rates higher and normalize the capital markets functioning.

So, what does an investor do in such markets? We looked at the past record of broad asset price returns during periods of recession and flat yield curves to suggest the following:

- Investing in fixed income when yields and spreads are at record lows is not advisable until the yield curve steepens.

- Equity investments, and spread products in general, that tend to benefit from flat yield curves might be a better way to invest. In the past, income driven investments such as real estate and utility stocks have done well while the financial sector, especially insurance and banking, has done the worst.

- While there are many forces at play and ascertaining investment implications for demographics change is hard, it is safe to assume that demand for senior housing and health care spending, especially for services that cater to the 80-year plus population, will continue to grow.

The policy implications to overcome the structural challenge of demographics are even bigger and warrant expert insights which we promise to bring to our clients in coming weeks. Please don't hesitate to call if you have any questions.

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