ARVEST
FUNDS AG

Monthly Report for September 2010

Fund manager's strategy report

When will the bond bubble burst?

One of the basic principles of capitalism is the free market, where prices for goods are determined by supply and demand. Rising prices for goods can be the result of either a rise in demand or a drop in supply. In the case of the bond markets, however, an increase in supply over the past several quarters as a result of new issues seems to be accompanied by an even sharper increase in the demand for this asset class. As a result, yields have fallen to levels so low that it no longer seems outlandish to speak of a bubble.

But what could be the reasons behind the run to bonds? Typically, bond yields fall when risk aversion among market participants rises and investors increasingly seek a safe haven for their assets. This would explain why government bonds, such as ten-year Swiss bonds with a current yield to maturity of 1.1%, have fallen to such low levels, leading one to ponder whether inflation will ever occur again. In the past, however, inflation has always been a trusty companion to economic growth. Therefore, those who fail to account for inflation in considering an investment must either expect no long-term economic growth or are simply underestimating the risk. The ARVEST Investment Committee has indeed been consistently quite critical in the last several years with regard to economic progress and the extent of the expected recovery. But we're certainly not as pessimistic as the bond market seems to be.

There is also no conclusive evidence that low yields on the bond markets are an expression of high risk aversion. If that were the case, then low yields for government bonds from financially solid nations would make sense. But it makes no sense that bonds from companies with junk ratings are having yields as low as those before the crisis erupted in 2007. After all, the risk averse are not likely to invest in companies with very low creditworthiness. Particularly since, in a pessimistic economic scenario, deflation would be expected, which would drive the real debt capital of these already highly indebted companies even higher and make it more difficult to refinance these debts. In any case, an intelligent and well-planned escape to security would look different than this.

Therefore, the simplified explanation provided by some market commentators, according to which optimists tend to scurry toward the stock markets while the pessimists tend to run to the bond markets, clearly falls short. But how else can we explain the obvious schizophrenia of the European and US capital markets?

The sharp increase in the federal reserve bank money supply could be one explanation for the sweeping increase in the demand for bonds. In fact, the US federal reserve money supply has increased since mid-2008 by an impressive 137%, from USD 840 billion to most recently USD 1,991 billion (see chart at right). USD 1.15 billion more in paper money is certainly nothing to sneeze at. However, it is important to note that in the same period the velocity of money, which also impacts the effective money supply, fell sharply. Taking the velocity of money into account, the effective increase in the money supply is "only" 25% or USD 340 billion.

Buyers who buy longer-term bonds for their somewhat higher yields but who lack liabilities of the same duration or a shorter investment horizon are breaking the golden balance sheet rule of matching the terms to maturity of assets with those of liabilities. This business model has only proven worthwhile in the past if, at the end of the day, a big brother, such as the government, is there to rescue you at others' expense.

Even if the ARVEST Investment Committee cannot conclusively cite the causes for unusually low bond yields, it remains clear that these yields are still much too low and in no way compensate for the risks incurred. Looking at it from this perspective suggests that the disproportionately low yields of many low-rated bonds are a clear indication of a bubble. This bubble is certain to burst if the related risks become more visible again in a more volatile market environment.

Only through truly active asset management, investors can enjoy the necessary freedom to avoid burdening their portfolios with every growing risk in the market.

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