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A 1994-style bond sell-off: the other view

Suggestions that the world will see a 1994-style sell-off in the bond market are strenuously disputed by Alliance Bernstein's head of global credit who said the biggest mistake investors can make is to try to time an interest-rate rise or to sell their bonds just as yields start to move higher.

Doing so will only lock in losses - losses that will likely be shallow and short-lived, Ashish Shah said.

Weighing into the bond crash debate, Shah said even if the US Federal Reserve hikes rates - for the first time in more than half a decade - the yield on cash will be only slightly above zero.

"That makes bond investors nervous even though it shouldn't. Those who keep their cool and stay put may find that higher rates can work to their advantage.

"There's another reason why hitting the sell button at the first sign of rising yields could be costly: everyone else might be doing the same thing. Regulatory changes have drained liquidity from global bond markets. With fewer willing buyers, a mass investor exodus could mean a sharp decline in prices and outsized losses for sellers," he said.

"The good news is that these liquidity-driven sell-offs tend to be short-lived. US high yield has recovered most big drawdowns — losses of more than 5 per cent — in less than a year. This goes even for periods that include 2008, the year the global financial crisis hit markets hardest."

Sell off improbable?

Shah also said bonds may not lose as much ground as many fear when the Fed finally pulls the trigger since markets have been expecting a quarter of percentage point interst rate hike for quite some time.

Corporate bond prices have adjusted to reflect this. While a more aggressive move could rattle the market, Shah believes that is unlikely.

This view is supported by comments by Fed Chairwoman Janet Yellen who, in March, stressed that the central bank intended to move slowly.

Robert Camilleri from Realm Investment House also sees a 1994 style sell off in the bond markets as improbable given low inflation and the fact that many of the hikes are already priced into the bond curve.

"Barring a European taper unwind, bond markets traditionally flatten in shape once tightening of rates start, limiting the losses in long term bonds. The unwinding of low rates, will probably takes as long on the way up as it did on the way down," he said.

Offsetting short-term losses

Bonds are highly sensitive to interest-rate movements—when rates rise, prices fall. But as bonds

mature, their prices drift back toward par.

“That means investors who sit tight will soon be able to reinvest the coupon income that their portfolios pay in newer—and higher-yielding—bonds. This typically offsets any short-term losses and increases total return,” said Shah.

Andrew Murray, managing director of Curve Securities, agreed that in this situation, rising rates are not necessarily a big problem especially for portfolios with shorter durations.

Neither does he see the real threat to a US bond portfolio coming from the Fed lifting rates especially if it is successful at keeping the economy in check.

Where the real problem materializes is if inflation starts to build pace and the Fed (or in Australia, the central bank) is unable or unsuccessful at controlling it.

"In this situation you'll see aggressive selling in the bond market lifting yields and, if you need to sell prior to maturity capital losses will mount significantly," said Murray.

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