WITH INVESTORS REACHING FOR YIELD COULD THERE BE A RUDE AWAKENING?

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A headlong rush into higher-yielding, long-term bonds in recent years has created one of the most crowded trades in the financial markets. Investors seeking relief from central banks' zero-interest rate policies have poured into government debt due in a decade or more, swelling the amount worldwide by a record $733 billion this year. The amount of money going into longer-dated bonds has more than doubled since 2009 to about $6 trillion, data compiled by Bloomberg and Bank of America Corp. show. Money managers overseeing more than $1 trillion say the case for owning longer maturities, stellar performers for much of this decade, is crumbling. There's mounting evidence that inflation is starting to awake, just as some central banks hint that higher long-term interest rates may be the key to boosting stagnant growth. That's troubling because a key bond-market metric known as duration has reached historic levels, and the higher that gauge goes, the steeper the losses will be when rates rise. The lengthiest maturities have dominated the decades-long bull market run in bonds, precisely because of their higher duration. Investing in thirty-year Treasuries since the turn of the century has produced a 7.8 percent annualized return. Yet U.S. long bond are on pace for their worst month in October since June 2015, losing over three percent with only a few trading days left while yields have only climbed about 0.2 percentage points on the month.

Only the longest-dated principal strips, the most bullish bet an investor can make in Treasuries, have fared worse. These securities, which have an even higher duration the traditional coupon securities, are down almost five percent for 2016, cratering the performance of some of the year's best-performing mutual funds. In a sign of the demand for this segment, the strips market has swelled to the largest since 1998. Duration is at or near unprecedented levels across sovereign debt markets. The effective duration on Bank of America's global government bond index climbed to an all-time high of 8.23 in 2016, from 5 when it was created in 1997. Some components of this index set record duration numbers as well with a reading of 5.9 for U.S obligations, 7.2 across the euro area and 8.8 for Japan. That means the stakes are high due to the fact that a one-percentage point increase in interest rates equates to $2.1 trillion in losses for global investors, based on a Bloomberg Barclays sovereign-debt index. That magnitude of yield swing isn't necessarily a rare event. Benchmark ten-year Treasury yields have climbed by that amount over the course of a calendar year ten times in the past four decades, twice as frequent as a ten percent slide in the S&P 500 index.

Signals from policy makers are raising the prospect of a bond-market retreat. Federal Reserve Chair Janet Yellen recently made an argument for keeping policy accommodative, hinting at letting the economy run hot. Meanwhile, the European Central Bank has to consider how it wants to run its asset-purchase program. The Bank of Japan announced earlier in the fall its plan to control interest rates to steepen the country's yield curve in an effort to stimulate growth.

Even with some uneven speak from different members of the Federal Reserve; some bond bulls say they're staying the course. Lacy Hunt, who helps manage the $447 million Wasatch-Hoisington U.S. Treasury Fund, says he sees rates remaining low or even lower in the year ahead. The fund, which only holds Treasuries maturing from 2042 to 2046, has topped 99 percent of its peers this year and during the past three, according to data compiled by Bloomberg. He better hope interest rates stay low or continue lower, because the duration for that fund is a major risk to the share price of the fund should rates turn higher. But as October's small selloff shows, bond traders are getting nervous. Investors are no longer sure of benign inflation that they're willing to by Treasuries with real yields near the lowest since the 1980s. If you subtract the level of inflation based on the core consumer price index, investor's lock in a 0.11 percent yield on thirty-year Treasuries, based on interest rates at the end of October. Not a lot of return for an enormous amount of risk.

We shall see how this yield scenario plays out over the coming quarters but there may be a real reason to be slightly cautious when purchasing longer securities just for a small amount of excess yield.

S*tatistical data provided in this article provided by Bloomberg.*

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