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> ***"As a bull market continues, almost anything you buy goes up. It makes you feel that investing in stocks is very easy and it's very safe and, most important of all, that you're a financial genius."*** *-Ron Chernow*

Never Say Never Again

Never is a long time.

Recent developments serve as a reminder to exercise caution before asserting that something will never happen.

It was not long ago that investors could hold AAA government bonds and comfortably earn a reasonable return – a return at least moderately in excess of inflation.

Then, a few years ago, central banks embarked on massive bond buying programs, ultimately causing bond yields to fall below the inflation rate and driving the "real" yield (or yield net of inflation) into negative territory.

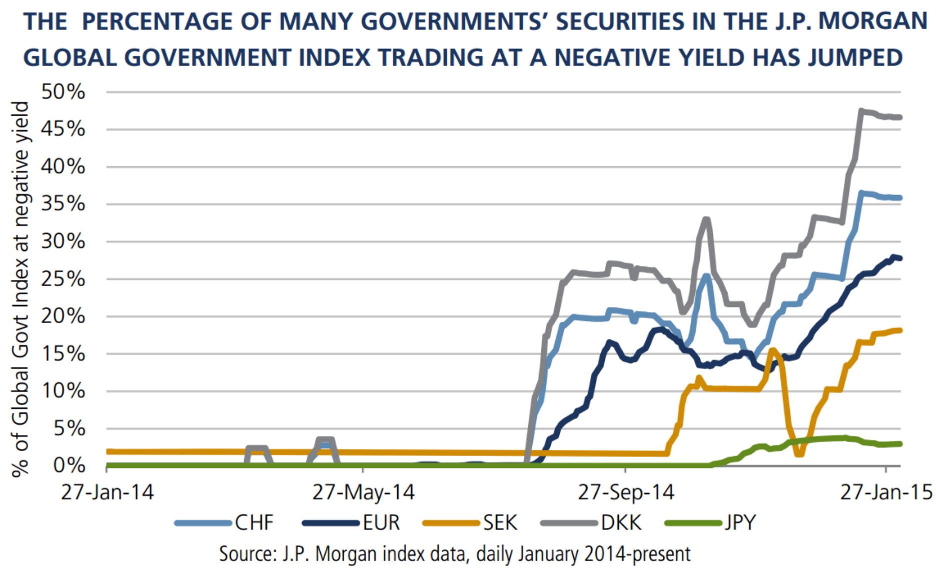
However, one principle seemed immutable: investors would never buy bonds with negative yields. After all, who would invest their funds with a guarantee to lose money? No one.

That is, until now.

On February 24th of this year, the German government auctioned €3.28 billion of five-year government bonds that carried a negative yield of 0.08%. This means that investors in such bonds are actually paying the German government for the privilege of lending them money (as the total proceeds upon maturity will be less than the original investment).

This situation is not unique to Germany, as negative yield bonds are starting to spread throughout the Eurozone. Swiss 10-year bonds also now offer a negative yield. Even Spain, which has struggled since the financial crisis, has shorter-term bonds that fall into this category.

The chart below helps tell the story.



Canada looks attractive by comparison, with 10-year government bonds yielding 1.4%. However, the real yield is still negative, given that the yield is well below the long-term inflation rate.

Why have bond yields turned negative?

Simply put: supply and demand.

As mentioned above, central banks, such as the European Central bank (ECB), have been aggressively buying bonds (a policy known as quantitative easing, or QE), in order to drive down yields and stimulate growth. So far the economy has remained moribund and inflation remains well below the ECB's target. The U.S. Federal Reserve Board was the first central bank to adopt QE on such a wide scale, and their economic recovery has prompted central bankers in Europe and Japan to emulate the strategy.

Central banks in the developed world now hold about $10 trillion of government bonds and are adding around $3 trillion per year to that total (source: PIMCO). At the same time, with government deficits declining, net government bond issuance has declined to $2.5 trillion. With demand for bonds outstripping supply, yields are falling. Putting things into perspective, roughly 15% of the entire outstanding government bond universe now trades at negative yields.

All of this suggests that, until economic growth begins to accelerate or inflation becomes an issue, negative yields may be more than just a short-term phenomenon.

Who would buy negative yield bonds?

As of April 14th, there were over €1.5 trillion (yes, trillion!) of eurozone government bonds with maturities greater than one year that were trading with negative yields (source: JP Morgan).

The ECB is not the only buyer of these bonds, as other investors in euro-denominated bonds do not have many options. Major pension funds and insurance companies, for example, are required to maintain a significant portion of their fixed-income investments in the highest-quality bonds and, therefore, compelled to buy these bonds despite their negative yields. That said, even those who can tolerate increased risk and stretch for yield, by investing in longer-term bonds from weaker credits, such as Portugal and Spain, are facing paltry yields of less than 2%.

What does this mean for investors?

One of the biggest risks of negative yields is that assets become overvalued.

At today's yields, bond investors cannot earn an adequate return. Retirees who are living off their investments, and pension funds that need regular cash flow, are feeling pressured to seek riskier investments, like equities and real estate, in order to enhance portfolio returns.

That is why steady, dividend paying companies, such as pipelines, are trading at valuations usually reserved for growth-stocks. Real estate prices are also impacted by low yields, and REITs, pension funds and other large investors, have been buying up properties at valuations that appear stretched.

However, as long as yields remain at current levels, we suspect that many investors will continue to chase equities and other assets in the quest for yield, while hoping that their capital is preserved.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly.

Final Thoughts

My parents bought their home in 1955 with a 25-year fixed-rate mortgage of 5%. For the next 50 years, mortgage rates remained well above that level and most believed they would never see a 5% fixed-rate mortgage rate again.

To home buyers today, a 5% mortgage sounds absurd, as rates have dipped below 3%. But buyer beware! Investors and borrowers have short memories. Home prices are at near-record levels in parts of the country, and many buyers who are taking on large mortgages today, run the risk of not being able to afford their mortgage payments in the future.

Negative yields exist because of central bank policy. As the global economy recovers, these QE policies will come to an end and yields will rise. Going "all in," as they say in the poker world, is not a sound bet that prudent investors should make.

Investors should always remember that capital preservation is of paramount concern. In the words of Chuck Noll (four-time Super Bowl winning coach): "in order to win, first you must not lose."

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely,

Lorne Steinberg
President