Bond Market's Dumb Money Looks Clever in $350 Billion Shift

http://www.bloomberg.com/news/articles/2015-04-19/bond-market-s-dumb-money-looking-clever-with-350-billion-shift

by Alexandra Scaggs and Daniel Kruger

April 19, 2015 / 6:00 PM CDT

There are plenty of reasons to be bearish on U.S. government bonds. They pay almost nothing, the Federal Reserve wants to raise interest rates and money managers are largely convinced they're too expensive.

None of that really matters to Steven Kurashima.

Just last week, the 58-year-old accountant and his financial adviser shifted more money into U.S. debt. While he needs his assets to grow to pay college tuition for his two children, Kurashima decided to lock in gains from stocks after their dizzying ascent in the past six years.

And holding onto that capital is especially important now as he edges closer to retirement.

"I just want to preserve capital," Kurashima said from his office in Irvine, California. "It's time to put some money into so mething a little more stable."

He's hardly the only one. JPMorgan Chase & Co. says mom-and-pop investors like Kurashima may sink $350 billion into debt funds globally this year, adding to the $3 trillion they've already poured into bonds since 2008.

For the Treasury market, that source of demand is proving to be crucial in keeping a lid on yields that serve as the global benchmark for trillions of dollars of debt, especially as foreign central banks cut back their own buying and economists say the Fed wi ll end its near-zero rate policy in September.

In U.S. debt auctions this year, bond mutual funds have bought a record 43 percent of newly issued Treasuries, allotment data compiled by Bloomberg show. That compares with an average of 26 percent in the prior four years.

'Dumb Money'

It might be tempting for savvy Wall Street types to dismiss the demand as the "dumb money" marking an inevitable market peak. After all, a record 84 percent of professional investors in a Bank of America Corp. survey released this month said bonds were overvalued. And yields on Treasuries across all maturities -- from three months to 30 years -- have fallen in 2015.

For the benchmark 10-year note, they were at 1.88 percent as of 11:25 a.m. in New York, down from 2.17 percent at the end of last year and less than half the average of about 4.3 percent in the past two decades.

Yet there's little to suggest that individuals are blindly chasing gains. Even as U.S. investors have held more money in debt funds since the financial crisis, their allocations as a proportion of total mutual-fund assets has actually fallen in the past two years to 21 percent as the stock market more than tripled in value, data compiled by JPMorgan show.

Lesser Evil

That percentage is close to the historical average and still well below the quarter-century high of 31 percent in 1992, which suggests the shift into bonds can continue.

"It may be that they're sticking with bonds because they're the lesser of two evils," said Kathy Jones, a fixed-income strategist at Charles Schwab & Co., the San Francisco-based brokerage with $2.5 trillion of client assets.

Short-term government bonds are seeing the biggest pickup in demand from U.S. investors, according to the Treasury's auction allotment data. That's because the securities can serve as an alternative to cash for investors scarred by the two stock-market crashes since 1999.

"If you've gone through crashes, you get a little more gun-shy," Kurashima said.

Treasuries remain the deepest and most liquid government bond market in the world with $12.6 trillion outstanding. That's more than the combined amount from Japan and the U.K.

There are also fewer bargains in equities.

Demographic Shift

The Standard & Poor's 500 Index, which reached its peak in February, is trading at 18.2 times reported earnings, close to the highest valuation in five years.

Last month, the Nasdaq Composite Index came within a half-percentage point of eclipsing its dot-com bubble high.

"You can buy a risk-free asset with a low return, and that's your insurance policy against a drop in the equity markets," said Michael Lee, founder of Tiger Wealth Management, which caters to wealthy individuals and smaller institutions, and has been buying Treasuries on their behalf.

A growing number of retirees and pensions are buying bonds for steady, low-risk income in an enduring demographic shift that's set to underpin debt demand for years to come.

The number of Americans 65 years or older will increase 14.5 million this decade, the biggest jump on record versus the total population, data compiled by the Census Bureau show.

'Bit Older'

"You've got people who are growing a bit older, and their risk tolerance is different than it was," Schwab's Jones said.

Savers would still be vulnerable to steep short-term losses if higher U.S. interest rates do ultimately push up Treasury yields, which Wall Street prognosticators have been calling for since the start of last year.

While repeatedly scaling back their estimates over that time, they still anticipate that yields on the 10-year note will reach 2.7 percent in about a year, based on the median estimate in a Bloomberg survey.

If that forecast turned out to be accurate, it result in a loss of about 4.5 percent for holders today, the data show.

"You'll see yields rise," said Justin Lederer, a New York-based interest-rate strategist at Cantor Fitzgerald LP, one of 22 primary dealers that trade directly with the U.S. central bank. "The Fed is looking to do a rate hike."

Regardless of what happens with the Fed, Sebold Capital Management's Sean Sebold says overseas bond buyers faced with negative yields as a result of the European Central Bank's quantitative easing will help keep Treasuries in demand.

Average yields on 1.09 trillion euros ($1.18 trillion) of German bonds tracked by Bloomberg fell to minus 0.02 percent last week. That compares with 1.3 percent for Treasuries.

"The globally-minded people look at the Treasury market and say, 'These are the highest rates in the world,'" Sebold, who oversees $140 million for individuals, said from Naperville, Illinois. "That's going to give people some cover."