SHOULD WE WORRY ABOUT BONDS CARRY WHEN THE FED CUTS RATES?

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Overview

In light of rising trade war risks and a marked slowdown in the global economy that has pushed inflation risks lower, major central banks have shifted recently from “normalisation mode” to “easing financial conditions” in order to avoid recession. As a result, global bond yields have declined significantly. In this new market environment, what can we expect from a bonds carry strategy, which aims to deliver positive returns in various economic regimes by being long sovereign bonds that offer high carry and short those offering low carry?

Bonds Carry: One of the Best-Performing ARP in the Recent Past

Alternative risk premia (ARP) solutions aim to deliver high risk-adjusted returns with a low correlation to traditional assets such as equities, sovereign bonds and commodities. To achieve that objective, we have identified a spectrum of individual ARP which make economic sense for why they should reward the investor, have been historically proven to produce positive long-term returns, and are liquid and easy to implement. In that framework, our investment universe consists of three types of ARP: Equity Factors, Macro Directional strategies, and Alternative Income/Carry strategies.

The bonds carry strategy we illustrate in this paper takes long positions in bonds with above-median carry and short ones in those with below-median carry in a duration-neutral manner. It aims to capture the carry premium within the G8 universe (excluding Japan and Italy). While the strategy is constructed to be duration neutral, it can still be exposed to shifting and/or diverging expectations on central bank monetary policies.

Since the launch of our ARP strategies, first within our flagship multi asset fund, then as a standalone fund, bonds carry has delivered impressive absolute returns across all market environments – equity bull, equity bear, bonds bull and bonds bear markets (Chart 1).

Key Points

1. Bonds carry has been one of the best-performing alternative risk premia strategies in recent years.
2. While the strategy has historically performed well when the Fed has cut rates, the current situation is unusual as bonds carry in the US is much lower than in other G8 countries.
3. Nonetheless, the strategy’s allocation, by design, will continue to adapt to changes in implied carry and we expect further robust returns in the future.

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1 Backtest period: 01/01/1990 to 25/06/2019, rebalanced monthly. We exclude Japanese bonds, as they possess significant negative skew given their near-zero interest rates, and Italian bonds, as their return pattern more closely tracks European peripheral debt than G8 bonds.
Chart 1: Bonds Carry in Different Market Conditions
(Average Weekly Bonds Carry Performance)

Source: Bloomberg, Unigestion, since 15/12/2014 (inception date of our flagship multi asset strategy)
Note: "Bull" is defined as a week where global equities or global bonds have had positive returns; "Bear" is defined as a week where global equities or global bonds have had negative returns.

Bonds carry has also been one of the best performers across individual ARPs on a risk-adjusted basis (Chart 2).

Chart 2: Risk-Adjusted Returns of Individual ARP Since Strategy Launch

Source: Bloomberg, Unigestion, since their respective launch dates in our flagship multi asset strategy. With the exception of Equity Factors (Equity Value, Equity Quality, Equity Size, Equity Low Risk, Equity Momentum – from 10/05/2016), FX Value and Dividends Carry from 13/12/2016, all remaining alternative risk premia listed were implemented from 15/12/2014.

“Bonds carry has been one of the best performers across individual ARPs on a risk-adjusted basis.”
Bonds Carry: The Slope Matters, Not Just the Bond Yield

Carry, the return earned should prices not change, is defined following Koijen et al (2016). For bonds, carry consists of two effects: (i) the bond's yield spread relative to the risk-free rate plus (ii) the "roll-down", which captures price changes as the bond rolls down the yield curve. It is important to note that the carry of a bond is not simply determined by the level of its yield, but also by its "roll-down".

To illustrate the effect of a "roll-down", consider a normal upward-sloping yield curve. As a five-year bond becomes a four-year bond after one year, the decrease in yield will naturally lead to a gain in the bond’s price, assuming that the level and shape of the yield curve remains unchanged. For a normal upward-sloping yield curve, the steeper the yield curve, the higher the "roll-down".

Historically, from 1990, this strategy was long US bonds due to a steeper US curve on average (Chart 3). However, as the US curve has flattened due to the Fed’s normalisation since 2015, despite European bonds offering negative or very low yields, the strategy has been long European bonds and short North American bonds since 2017. Currently, given the flat curves in the US, Canada and Australia, the positioning continues to be long European bonds and short North American and Australian bonds (Chart 4).

Chart 3: Historical Bonds Carry Strategy Capital Allocation

Source: Bloomberg, Unigestion, since 01/01/1990

2 "Carry", Koijen, Moskowitz, Pedersen, Vrugt, 2016
As markets expect monetary easing across most main developed markets in the coming years, and more so in the US than anywhere else (Chart 5), is this positioning at risk?

**Historically, Fed Cuts Have Been Favorable for Bonds Carry**

Since 1990, there have been five Fed easing cycles (1990/1992, 1995/1996, 1998, 2001/2003 and 2007/2008). As shown in Chart 6, during the months where the Fed cut rates, bonds carry delivered positive and higher returns on average than periods without rate cuts, and the spread in absolute performance is large. Furthermore, the proportion of positive monthly returns during periods of rate cuts is also higher (71%) than that during periods with no cuts (61%).
At first glance, based on its historical return behaviour, one may draw the conclusion that we need not be overly concerned about the future returns of the strategy.

**Does It Work Even If Recession Is Not on the Horizon?**

However, the current situation is unusual. The Fed has been more aggressive in its normalisation than other central banks. As a result, the yield curve in the US is flatter than in most other countries. This is illustrated in Chart 7, which compares the carry provided by the US versus the rest of G8 bonds (excluding Italy and Japan, as they are not in the strategy’s investment universe). Chart 7 shows that the current US bonds carry is much lower than the rest of the G8 countries, which is rare historically. In the past, there was only one occurrence similar to the current situation during periods of Fed cuts, particularly when recession risk is not high: 1995/1996. As a result, it was also the only historical Fed cut period where the strategy was also short US bonds (and short Canadian bonds for the first half of that period), as is the strategy’s position today (Chart 8).

**Chart 7: US Bonds Carry vs the Rest of G8 Bonds Carry**

“The current US bonds carry is much lower than the rest of the G8 countries, which is rare historically”
How did the strategy perform during this period, which was similar to today? During the first six months of 1995, ahead of Fed rate cuts, the strategy lost money (-8.5%), as it did in April and May of 2019. As shown in Chart 9, which presents performance contributions over the 1995/1996 period, the short position in US bonds was costly. However, the bulk of the negative contribution came from the short exposure to Canadian bonds, as the Bank of Canada had been aggressively easing during this period. Nevertheless, thanks to global easing from most of the G8 central banks, most sovereign curves steepened in 1995 and 1996, pushing the carry of the bond strategy much higher. In addition to the positive impact of yield changes, this increase in implied carry helped the strategy to recover sharply in the second half of 1995 (+5.2%) and in 1996 (+14.6%). Where short positions hurt performance as their respective central banks undertook substantial rate cuts, this was mostly offset by long positions posting large positive contributions.
Finally, it is worth highlighting that the strategy’s allocations change with each sovereign bond’s carry, which in turn is determined by the slopes of their respective yield curves. As an illustration, following significant monetary easing in Canada, the Canadian curve had steepened, increasing Canadian bonds’ carry. As a result, the strategy shifted from a short to a long position in Canadian bonds, which contributed positively to the performance in 1996, as shown in Chart 9.

This Time It’s Different?

We believe that history could repeat itself, protecting the strategy against a deep and prolonged drawdown arising from its large short position in US bonds. However, there is one important difference to note. Contrary to the current situation, US rates were lower than most other G8 countries back in 1995. Before the June 1995 Fed cut, US Fed fund rates were at 6% vs 6.6% for the UK, 8% for Canada, and 7.5% for Australia. Only German rates were lower at 4.85%, and even then, this is still much more elevated than G8 rates today. This means that every G8 central bank had room to carry out monetary easing, which led the strategy to benefit from an increase in implied carry (through the steepening of the curve), while losses from rate cuts on the short positions were largely offset by gains on the long positions. Today, the situation is very different as most non-US short-term rates are still low, even negative in some cases. As a result, the potential cushion delivered by curve steepening through global monetary easing and the gains on the long positions through yield cuts could be more limited this time. However, by design, the strategy’s allocation will adapt to the changes in implied carry, as it has done in the past. We believe that this should lead the strategy to continue to provide the robust returns it has done over recent decades.
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