When do government bonds outperform credit?

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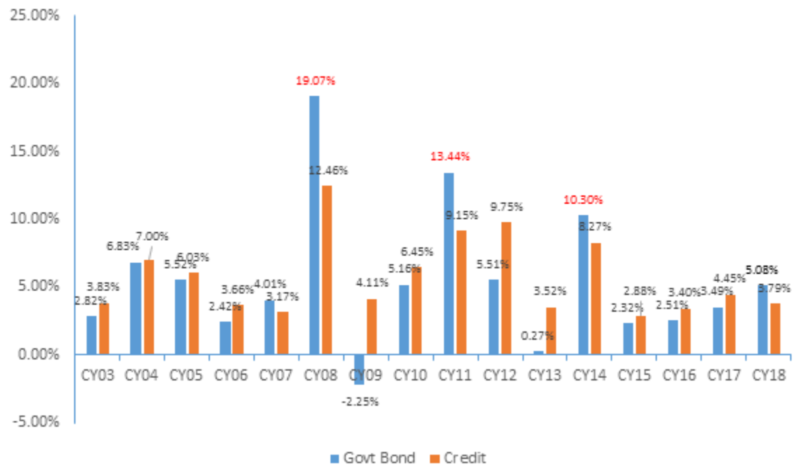
Within the fixed-income sector, government bonds are the safest of safe assets to hold. They are issued by sovereigns, which have minimal default risks due to their taxation and security powers.

Credit securities also have a risk of capital loss when issuers default, but this risk is higher than that of government bonds as issuers do not have the taxation powers of governments. Hence, credit securities usually offer investors returns which are higher than the returns of government bonds.

However, there were several periods in history when credit securities have delivered lower returns than government bonds.

Chart 1 below shows total returns of Government bonds and corporate bonds, often referred to as "credit " in professional circles, for the last 16 years. In this case, government bonds are represented by the Bloomberg AusBond Treasury Index and credit is represented by the Bloomberg AusBond Credit 0+ Yr Index.

Chart 1. Total Return of Bloomberg AusBond Treasury index and Bloomberg AusBond Credit 0+ Yr Index (2003 – 2018)



Source: Bloomberg, Atchison Consultants

As shown in Chart 1, in 5 out of 16 years from 2004 to 2018 government bonds outperformed credit. If insignificant outperformances are excluded, the frequency is down to 3 years. These figures are highlighted in red. The periods when the government bond index significantly outperformed credit are the years 2008, 2011 and 2014. What happened over these periods to make investors behave inconsistently with the "risk premium" rule of thumb?

These periods "coincided" with the Fed's timeline of quantitative easing programmes (QE1, QE2 and QE3). QE1 started in November 2008 when the Fed announced a USD 600 billion programme of purchasing MBS. 2 years later in November 2010, QE2 kicked off with USD 75 billion longer-dated treasuries to be purchased every month until June 2011. QE3 began from September 2012 to December 2013 with the Fed purchasing USD 40 billion MBS and longer-dated treasuries on a monthly basis.

The three rounds of quantitative easing certainly increased demand for US treasuries by a significant amount. However, increased demand for US treasuries has no direct impact on demand or supply of Australian government bonds and yet ACGB yields fell more than credit yields. Obviously, there were other second-order effects on other countries' risk-free bond markets.

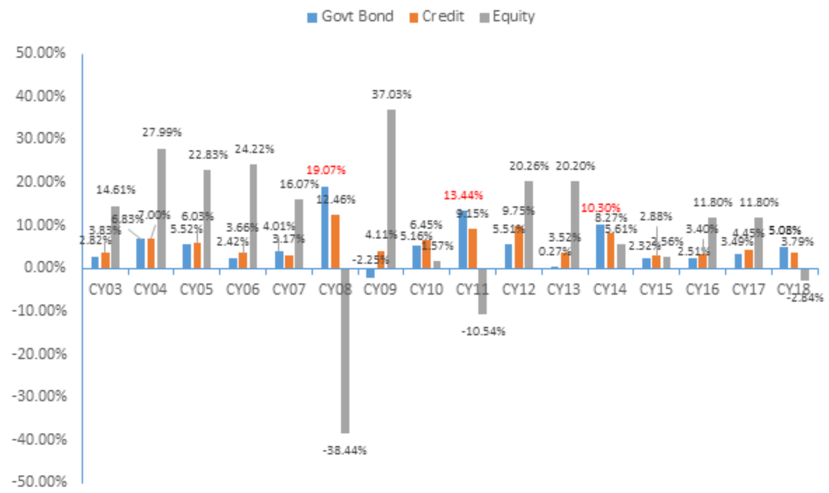
The rationale behind quantitative easing is that central banks inject additional liquidity into the market by purchasing government bonds or assets like MBS, in an attempt to incentivise business activities. The implementation of QE also implies that the economy is already in deep trouble; it cannot automatically recover in short term without external central bank involvement.

That also means, economic fundamentals have already deteriorated considerably and liquidity in the market has reduced significantly before QE arguably kicks in. Under the circumstances, any risk-taking opportunities may wipe out their capital. Therefore, government bonds become more favourable as they provide capital protection.

To further justify that government bond outperformances were driven by investors' risk profiles skewing toward conservativeness, we include another riskier asset class in the analysis. Chart 2 shows the total return of Australian equities (in addition to government bonds and credit) for the same period.

Chart 2. Total Return of Government Bond, Credit and Equity (2003-2018).

Note: Equity is represented by S&P/ASX 200 Accumulation Index.



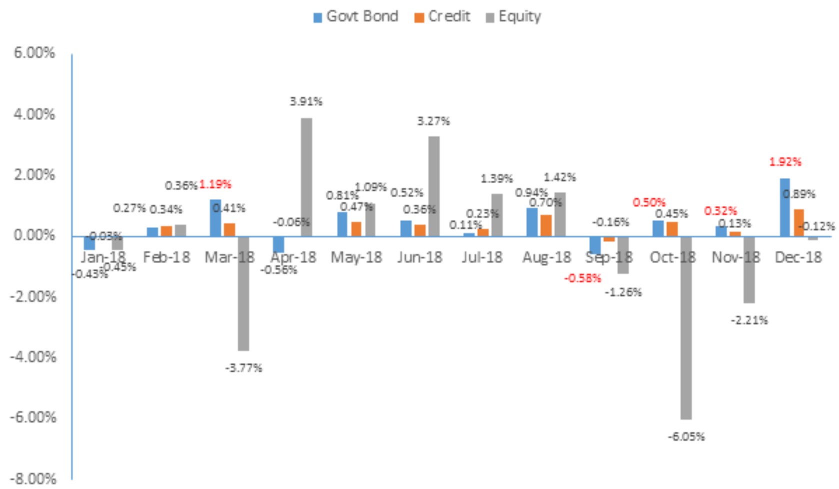
Source: Bloomberg, Atchison Consultants.

Chart 2 shows that when government bonds outperformed credit, they also significantly bettered the equity market. Equities' poor performances were pure reflections of significantly increased supply and plummeting demand as investors' confidence eroded. (It also illustrates the negative correlation of government bonds and equities in troubled times.)

2018 saw government bonds (as per the Bloomberg AusBond Treasury Index) outperform credit (Bloomberg AusBond Credit Index) and equities (S&P/ASX 200 Accumulation Index) significantly again. Similarly to 2008, 2011 and 2014, the strong performances of government bonds were attributed to investors' emphasis on capital preservation. The US economy grew strongly in the first half of 2018 but then deteriorated in the second half. This certainly increased investors' fear of a coming recession, further pushing up the price of government bonds globally.

Chart 3 shows government bonds outperformed equities and credit more than half of the time in the second half of 2018.

Chart 3. Trailing Return of Government Bonds, Credit and Equity in 2018.



Source: Bloomberg, Atchison Consultants

2019 continues to see fundamentals worsen on a global basis. The Australian economy has been experiencing low inflation and stagnant unemployment rate. The global picture has even more uncertainties arising from the intensified trade war tensions between US and China, the ongoing Brexit process and a slowing US economy.

Given all the deteriorating signals sent out from a global weakening economy, credit spreads are likely to widen further in the short to medium. Government bonds are likely to continue outperforming credit in the current environment.