The Telegraph

Elite funds prepare for reflation and a bloodbath for bonds

All the stars are aligned for an end to the deflationary supercycle, yet $6 trillion of bonds trade at yields below zero

Norway's vast petroleum fund is ditching bonds for London property

By Ambrose Evans-Pritchard

8:57PM GMT 24 Nov 2015

129 Comments

One by one, the giant investment funds are quietly switching out of government bonds, the most overpriced assets on the planet.

Nobody wants to be caught flat-footed if the latest surge in the global money supply finally catches fire and ignites reflation, closing the chapter on our strange Lost Decade of secular stagnation.

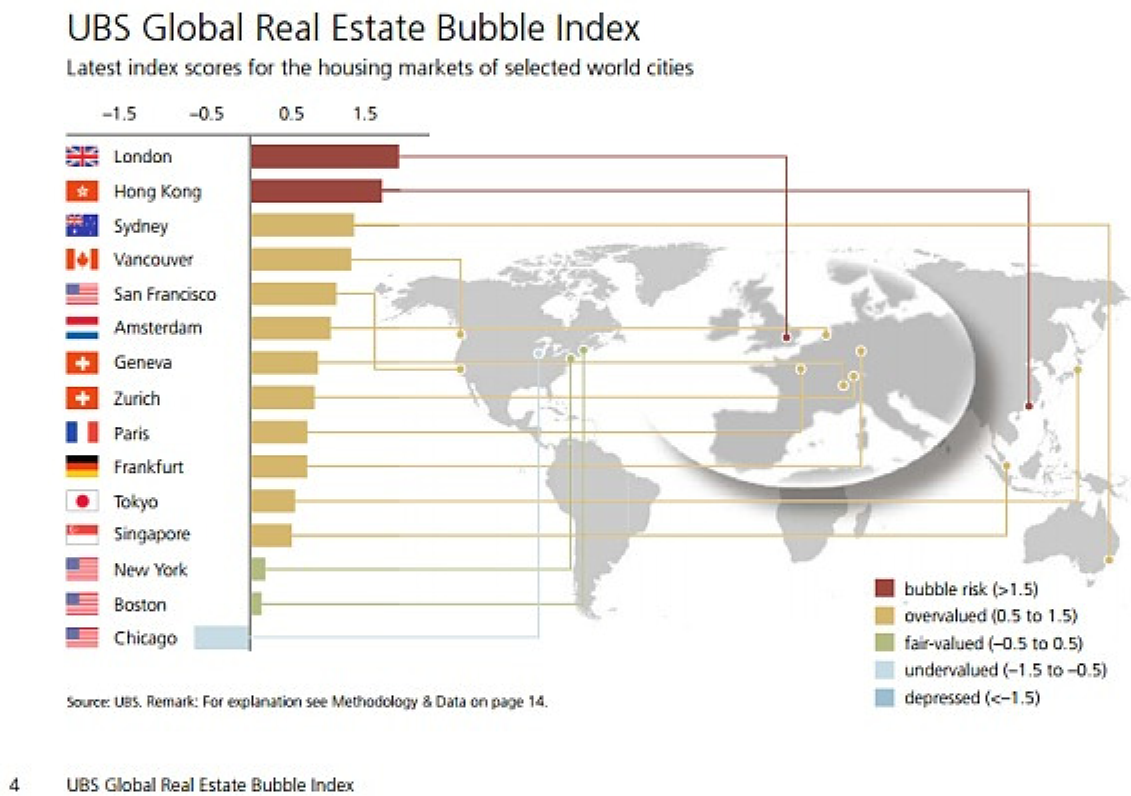
The **Norwegian Pension Fund**, the world's top sovereign wealth fund, is rotating a chunk of its $860bn of assets into property in London, Paris, Berlin, Milan, New York, San Francisco and now Tokyo and East Asia. "Every real estate investment deal we do is funded by sales of government bonds," says Yngve Slyngstad, the chief executive.

It already **owns** part of the Quadrant 3 building on Regent Street, and bought the Pollen Estate - along with Saville Row - from the Church Commissioners last year. But this is just a nibble. The fund is eyeing a 15pc weighting in property, an inflation-hedge if ever there was one.

The Swiss bank UBS - an even bigger player with $2 trillion under management - has issued its own gentle warning on bonds as the US Federal Reserve prepares to kick off the first global tightening cycle since 2004. UBS expects five rate rises by the end of next year, 60 points more than futures contracts, and enough to rattle debt markets still priced for an Ice Age.

Mark Haefele, the bank's investment guru, said his clients are growing wary of bonds but do not know where to park their money instead.

The UBS bubble index of global property is already flashing multiple alerts, with Hong Kong off the charts and London now so expensive that it takes a skilled worker 14 years to buy a broom cupboard of 60 square metres.

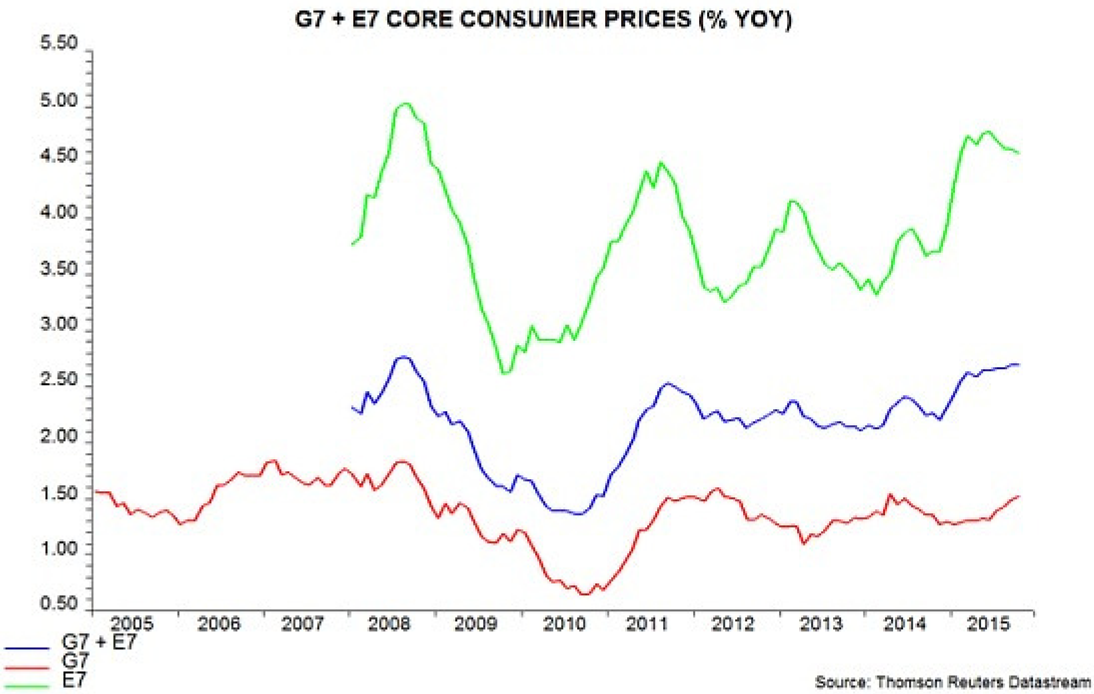


Mr Haefele says equities are the lesser risk, especially in Japan, where the central bank has bought 54pc of the entire market for exchange-traded funds (ETFs) and is itching to go further.

As of late November, roughly $6 trillion of government debt was trading at negative interest rates, led by the Swiss two-year bond at -1.046pc. The German two-year Bund is at -0.4pc.

The Germans and Czechs are negative all the way out to six years, the Dutch to five, the French to four and the Irish to three. Bank of America says $17 trillion of bonds are trading at yields below 1pc, including most of the Japanese sovereign debt market.

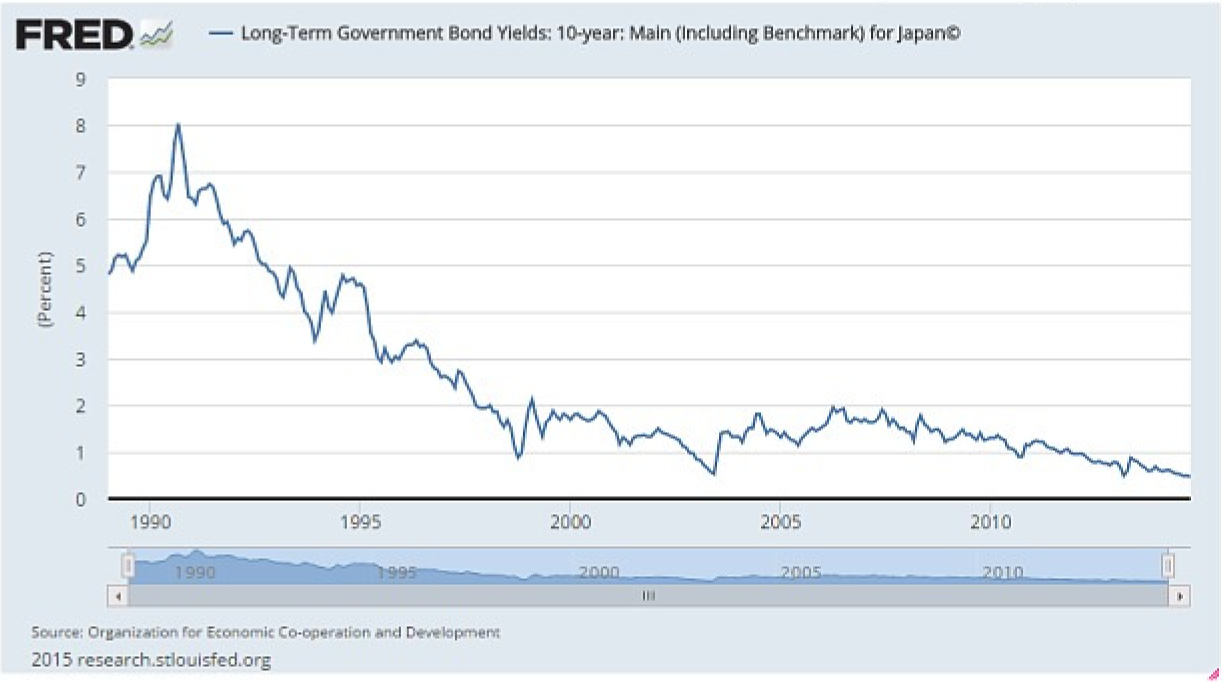
This is a remarkable phenomenon given that global core inflation - as**measured** by Henderson Global Investor's G7 and E7 composite - has been rising since late 2014 and is now at a seven-year high of 2.7pc.



can be made that the European Central Bank should go for broke, deliberately stoking a short-term monetary boom to achieve "escape velocity" once and for all. The risk of a Japanese trap is not to be taken lightly.

Yet even those who feared looming deflation in Europe two years ago are beginning to wonder whether the bank is losing the plot. If the ECB doubles down next week with more quantitative easing and a cut in the deposit rate to -0.3pc, as expected, it will validate the iron law that central banks are pro-cyclical recidivists, always and everywhere behind the curve.

Caution is in order. The investment graveyard is littered with the fund managers who bet against Japanese bonds, only to see the 10-year yield keep falling for two decades, plumbing new depths of 0.24pc this January.



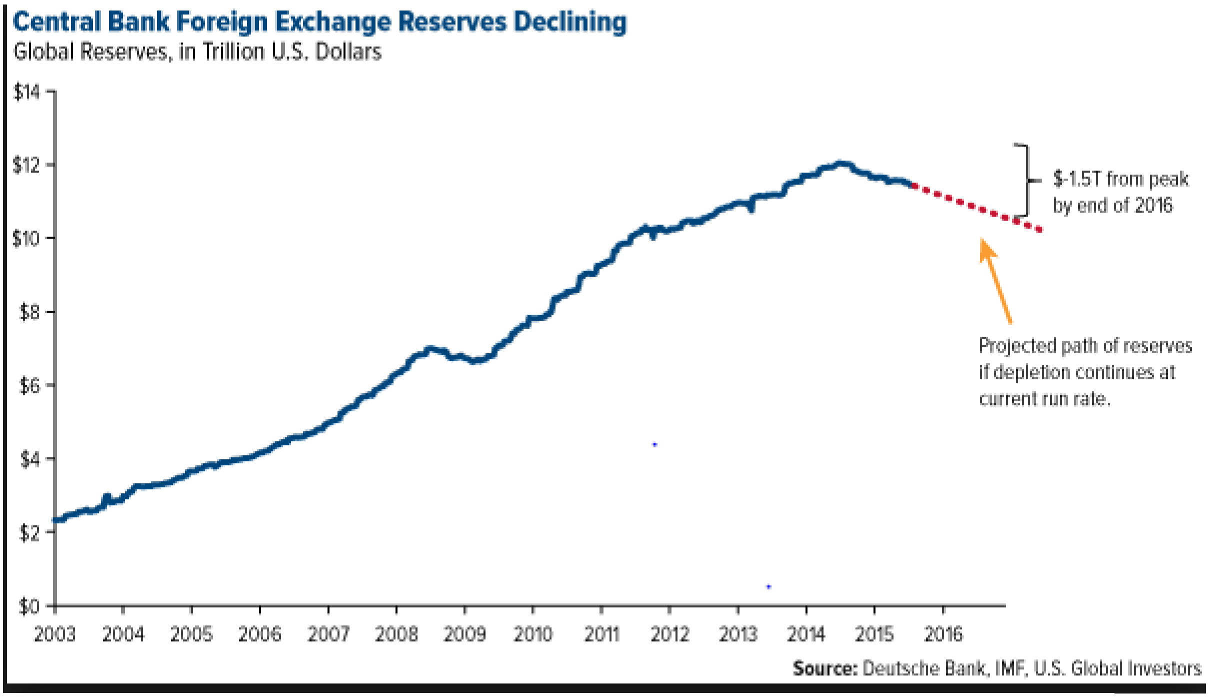
Inflacionistas in the West have been arguing for six years that the QE-fuelled monetary base is about to break out and take us straight to Weimar or Zimbabwe. They failed to do their homework on liquidity traps.

Yet their moment may soon be nigh. Catalysts are coming into place. Globalisation is mutating in crucial ways.

China, the petro-powers and Asian central banks led a sixfold increase in foreign reserves to $12 trillion between 2000 and mid-2014 (and trillions more in sovereign wealth funds). This flooded the global bond markets with capital and stoked asset bubbles everywhere.

The process has gone into reverse. Data from the International Monetary Fund show that these reserves dropped by $550bn in the year to June as capital flight and the commodity bust forced a string of countries to defend their currencies. Saudi Arabia is still burning through $12bn a month to cover its budget deficit.

This shift in reserve flows amounts to fiscal stimulus for the world. Less money is being hoarded as capital: more is going back into the real economy as spending - or it soon will do - exactly what the doctor ordered for a 1930s world, starved of demand.



It comes as China goes through a social revolution, moving through the gears towards affluence. Consumption was barely above 30pc of GDP in 2010, the lowest ever recorded in a major country in history. The Communist Party is trying to push it to 46pc by 2020.

Or, put another way, Ben Bernanke's "savings glut" is starting to dissipate. The global savings rate peaked at a record 25pc and is finally rolling over.

There is a further twist. Professor Charles Goodhart from the London School of Economics says the entry of China and eastern Europe into the world economy after 1990 doubled the work pool of the globalised market at a stroke. It lead to a surfeit of labour and a quarter century of wage compression. The rich got richer. Deflation became entrenched.

This episode is over. The old age dependency ratio is about to rocket. Labour will soon be scarce again. Wages will rebound. Prof Goodhart thinks it will push real interest rates back to their historic norm of 2.75pc to 3pc. "We are on the cusp of a complete reversal," he says.

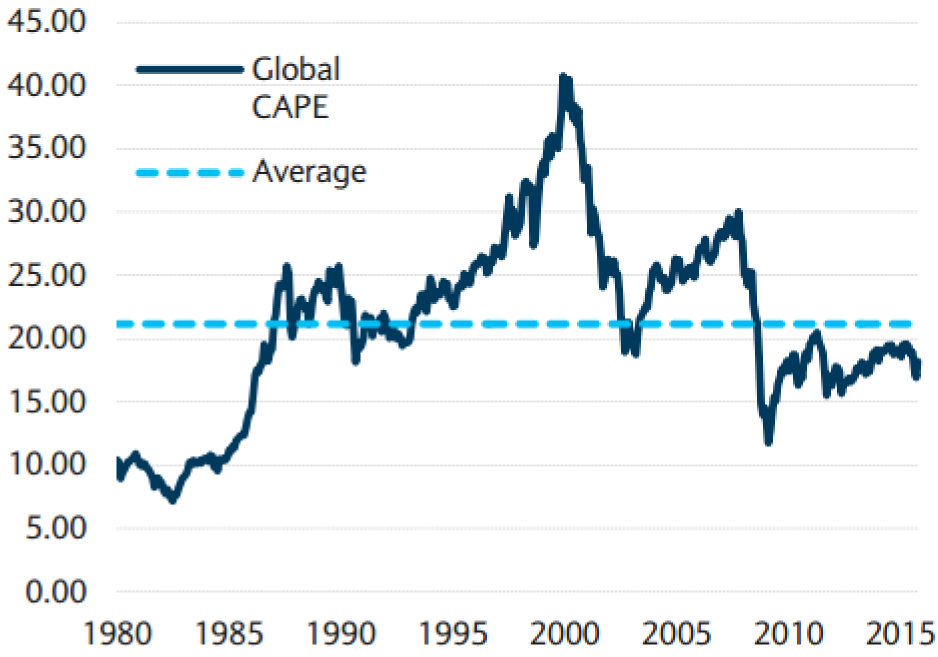
All the stars are aligned for an end to the deflationary supercycle, and therefore for an end to the 35-year bull market in government bonds.

With equities already at nose-bleed levels it is hard to know exactly where to seek refuge. Wall Street's S&P 500 has been on a blinder for nearly seven years, and is now hovering near an ominous double-top.

The MSCI index of world equities is trading at 18 on the CAPE price-to-earnings ratio. This is below its 40-year average of 22, but only if you believe the earnings.

FIGURE 8

Global CAPE below average at 18



Source: Barclays Research, DataStream, MSCI

Mr Haefele from UBS recommends niche plays in clean air, emerging market healthcare and, above all, oncology and immunotherapy, a sector currently running 300 clinical trials, with treatments costing $100,000 per patient.

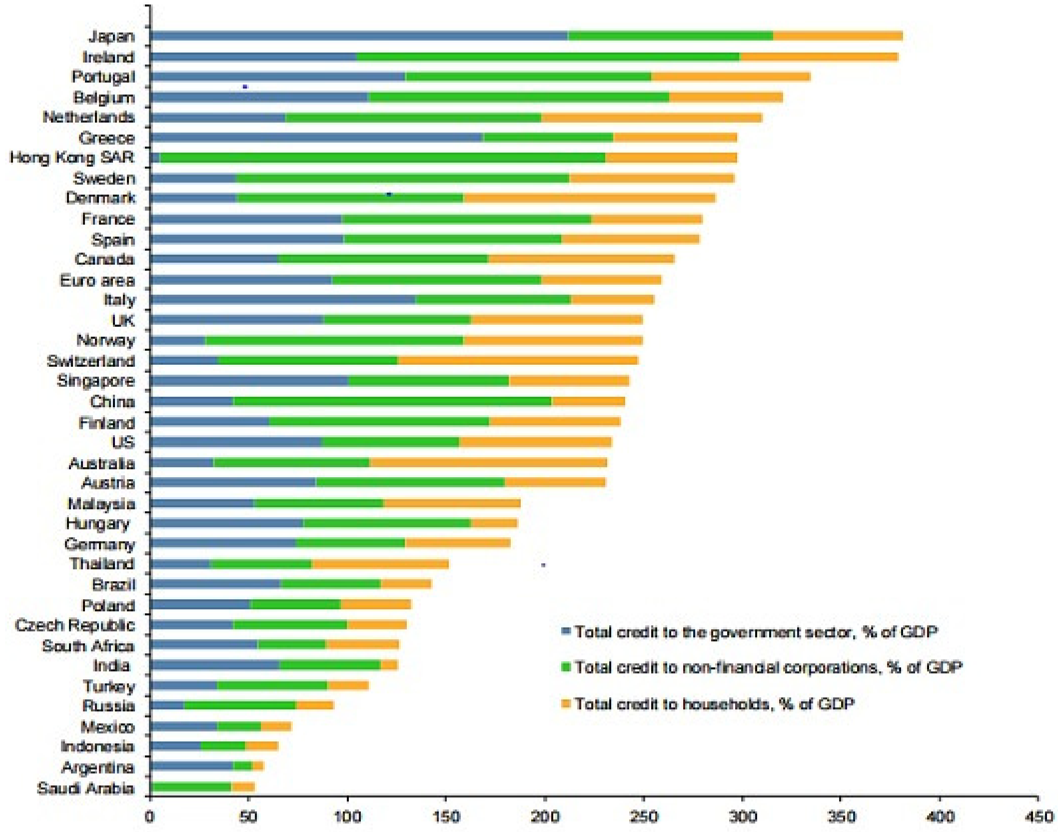
Spending per cancer patient jumped 60pc in the US, Canada and Germany from 2010 to 2014, a pattern likely to be repeated over time in China, east Asia and Latin America.

His colleague Bill O'Neill says equities are "not cheap" on the UBS proprietary gauge, but none of the bank's crash signals is flashing red, and you have to put money to work. "We think there is a good chance that the cycle will last another three years," he said.

Mr O'Neill said the "trillion dollar question" is whether the Fed and fellow central banks will wake up one day to find that the inflationary horse has already bolted.

My fear is that this is exactly what will happen. There will then be an almighty reckoning as global finance braces for a rush of staccato rate rises by the Fed, and a belated pirouette by the ECB.

The big, overriding balance sheet theme. Too much DEBT. China is too high on this chart for a developing economy



Source: RBS; BIS data as of Q1 2015

We will then find out whether the world can cope with public and private debt ratios hovering at all-time highs of 265pc of GDP in the OECD club and 185pc in emerging markets, up 35 percentage points since the top of the pre-Lehman credit bubble. Equities will not fare very well either when that moment comes.

It is a story for late-2016, perhaps, but not today. Until then, laissez les bon temps rouler.