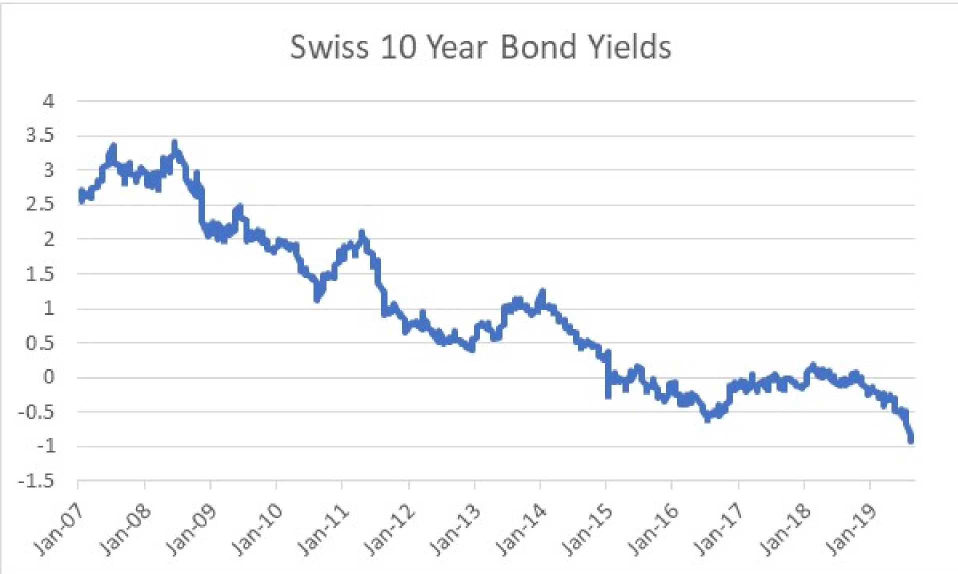
THINKING OF GOVERNMENT BONDS AS LONG TERM CURRENCY FUTURES

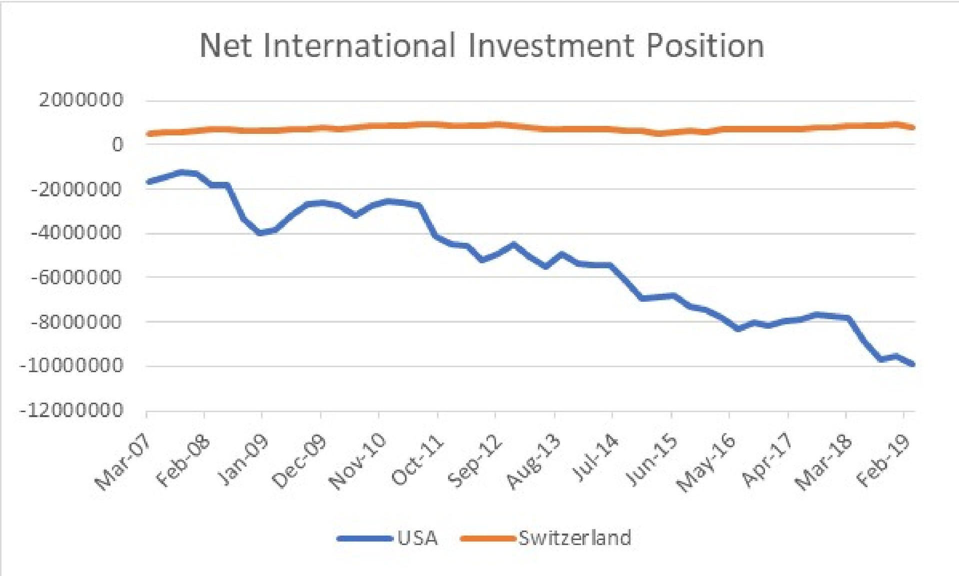
It is rare that anything in finance is genuinely new. However negative interest rates, and the huge amount of negative yielding bonds in the world are a new feature. The most extreme market would be the Swiss market, where 10 year bond yields are -1%, guaranteeing the holder a 10% capital loss if held to maturity.



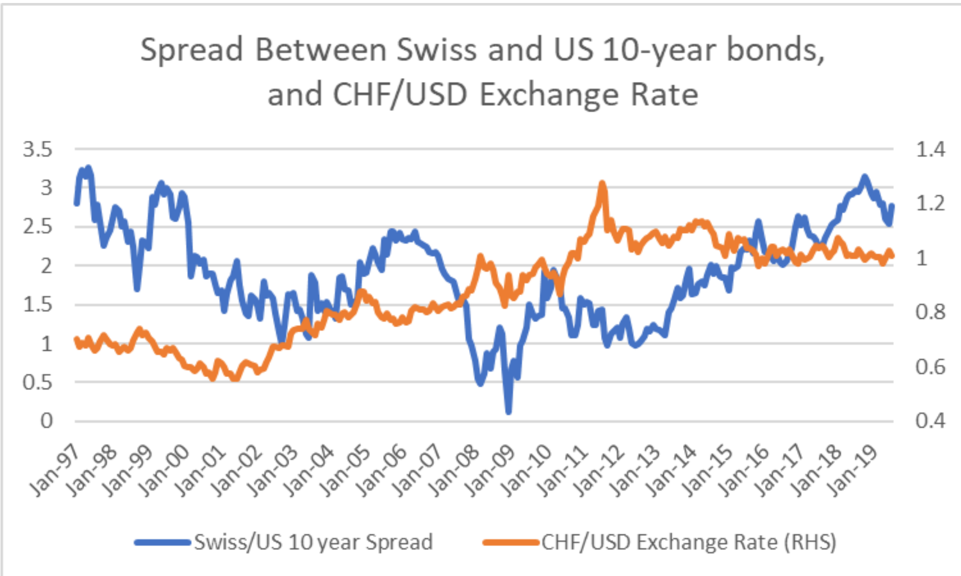
Of course, bond yields reflect the move into negative short-term interest rates by central banks, and hence negative longer term bond yields are merely the reflection of market estimates of where interest rates will be for the next 10 years in Switzerland.

I think bond yields can also reflect long term views on currencies. For example, a USD based investor may think that the 1.6% been offered by 10 year US treasuries is not enough to compensate you for the likely weakness of the US dollar, and hence they may be willing to take a 10% capital loss on bonds, to participate in the upside of the Swiss Franc versus the US dollar.

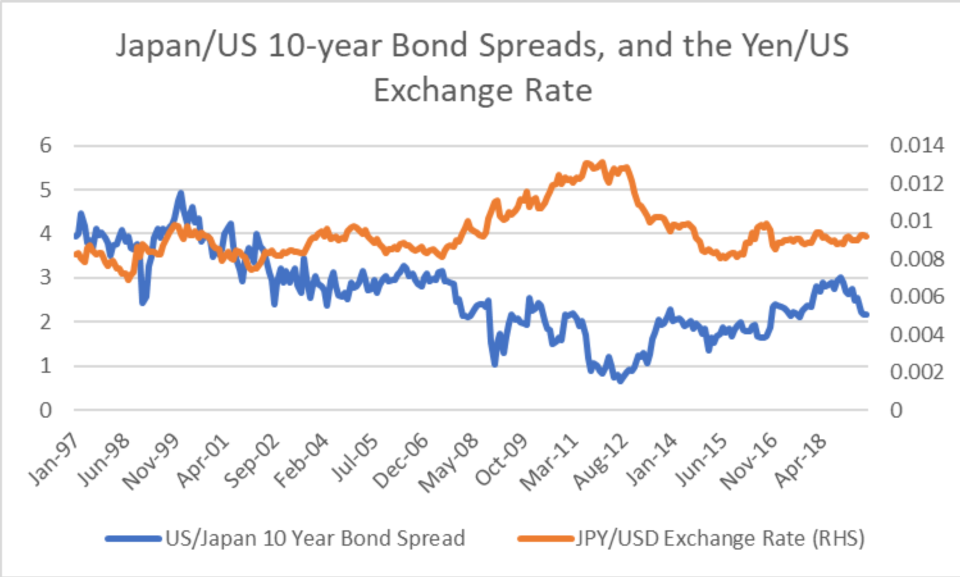
To simplify greatly, by ignoring reinvesting of coupons and compounding, a 10-year US bond yielding 1.6%, will pay a total of 16 USD over 10 years for every 100 USD invested. A 10-year Swiss Bond, held to maturity and yielding -1% over 10 years, will cost you 10 CHF for every 100 CHF invested. When looking at currencies, the Swiss Franc would need to appreciate by 26% versus the USD for this to be true. When we look at the respective net international investment positions, this would look to be a sound financial view.



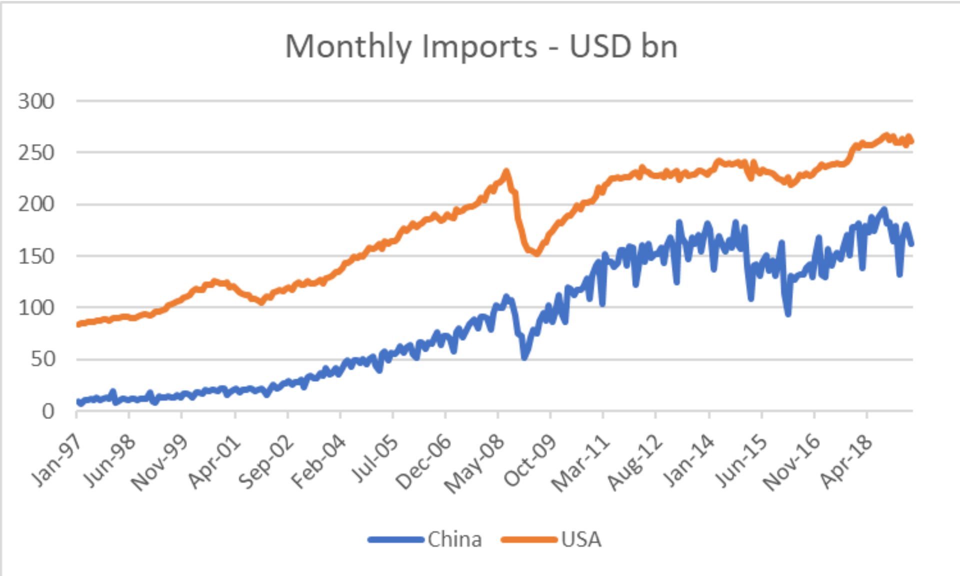
Extending this theory would then imply that if the US/Swiss bond spread is wide, the forward returns to being long Swiss Franc versus the US dollar will be high. There is some evidence to support this. Wide spreads in 1999/2000 then saw the Swiss Franc appreciate substantially over the next ten years.



We see a very similar relationship with the US and Japan. Relatively wide spreads in the 2004/5 period between the US and Japan foreshadowed a strong rise in the Yen from 2007 to 2011.



For markets over the last 20 years, worrying about the USD exchange rates has been a key factor as the US has been the dominant importer. However, since the financial crisis, China has also become a substantial consumer and importer. This means we need to factor in similar moves for the Chinese Yuan into bond yield as well.



Markets have been concerned with a possible Chinese devaluation. Chinese 10-year bonds currently yield 3%. If we use the above analysis, this would imply that the Swiss Franc could appreciate by 40% versus the Chinese Yuan, the Japanese Yen may appreciate by some 32%. If this analysis is correct, the current bond yields are implying that substantial currency volatility is about to re-emerge.

INFORMATION

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