BONDS AT BURSTING POINT

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Investment grade, junk, "munis" and treasuries. Whether it's an individual issue, an ETF or mutual fund, bond investors can't seem to get enough.

It's easy to appreciate why. For nearly 30 years, the bond market has been on an almost uninterrupted bull run, thanks to growing confidence that inflation was vanquished. Bonds' steady gains were a welcome refuge from the tech wreck in the decade past, and again more recently when the financial crisis cut global stock markets in half.

But now, with record-low interest rates poised to move higher, inflation looming and the sovereign debt crisis in Europe threatening to spill over, the great rally may be set to falter. It might not be an outright crash, but it could be just as ugly for investors as the recent stock-market carnage.

"I do think the bond market is highly vulnerable," said Alex Jurshevski, managing partner at Recovery Partners, a distressed-asset firm in Toronto. "Whether it is going to pop next week, next month or in six months, it's hard to tell, but there is significant pressure building in pretty much all the developed world bond markets."

George Athanassakos, a professor of finance at the Richard Ivey School of Business, says it took some time for investors to trust bonds again after prices collapsed in the 1970s as inflation soared in the wake of the oil embargo crisis.

Eventually, those concerns diminished and bonds became the go-to-investment for an aging population hungry for fixed income and a low-risk alternative to stocks.

As of last year, the global bond market had nearly tripled in value to US$82-trillion from US$33-trillion in 2001, according to the Bank of International Settlements. The U.S. bond market is worth US$31-trillion, or 38% of the total global value. Canada's bond market is valued at US$1.5-trillion, representing 1.8% of the total pie.

By comparison, the total value of the global equity market is just US$44-trillion.

In 2009 alone, total assets under management for Canadian fixed-income mutual funds grew 29% to $129-billion, while the assets invested in the ever-growing supply of bond ETFs jumped 134% to $5.8-billion.

Investors who have poured money into bond mutual funds and ETFs are at particular risk from a swoon in bond markets. While holders of individual bonds are guaranteed their principal back at maturity -- unless the entity goes bankrupt -- funds and ETFs do not have a fixed maturity. That means investors face outright capital losses if prices drop.

"Now, investors may trust bonds too much," Mr. Athanassakos said. "Once the economy starts to recover, and people start to believe it is recovering, the only way for interest rates to go is up and that means bond prices will go down."

With the United Sates and other countries still facing high unemployment and huge spare capacity in factories and businesses, the global economic recovery remains fragile. That has many economists predicting the near-term risk of inflation to be small.

Nonetheless, the expectation that consumer prices will rise in the longer term looms large. With interest rates already near zero, even the most gradual increase in rates is bound to put pressure on bonds.

As inflation and interest rates rise, they eat into the purchasing power of bonds issued in the past. A bond issued at a 3.75% interest rate, for example, will not be as attractive as newer bonds issued at higher rates. The price of the bond will have to fall, and yields will have to rise, to compensate.

Yields have already been rising. In Canada, two-year government bonds are yielding 1.57%, compared with 0.94% for comparable U.S. treasuries. It is the widest spread in five months as traders bet the Bank of Canada will raise interest rates before the U.S. Federal Reserve. Currently, the bank's benchmark rate stands at just 0.25%.

Avery Shenfeld, chief economist at Canadian Imperial Bank of Commerce, expects the first interest-rate hike in July and forecasts an increase in the overnight lending rate of 75 basis points by September.

"Once one hike is in the books, investors are likely to tack on many more to existing expectations, whether justified or not. At that point, two-year yields will be substantially higher than they are today," he said.

In the United States and elsewhere, central banks are expected to be much more cautious about raising rates as the debate between deflation and inflation continues to rage.

Even Mr. Jurshevski, who views the cuts to interest rates over the past 18 months as undeniably inflationary, admits global economic recovery is tenuous. He said it could take 12 to 18 months before higher prices materialize. For him, the more imminent threat to bond yields is the alarming escalation of government deficits around the world.

"There is a lot of pressure in the bond market right now because the financing requirements at the governmental level, not only in the various sovereigns cited as being in trouble, but pretty much across the board. There is tremendous supply pressure."

Just like in any market, an excess of money supply --in this case the surge of government bonds to fund stimulus spending in the face of the recession -- may eventually cause downward pressure on prices.

Greece's well-documented debt woes have already prompted a string of downgrades from credit-rating agencies and a dramatic rise in the country's bond yields over the past few months.

Credit ratings for Portugal and Spain have also been downgraded in recent weeks, causing yields to rise. Also, Standard & Poor's credit-rating agency has warned the U.K. and the United States their AAA ratings may come under pressure.

Based on projections from the International Monetary Fund, the average ratio of Group of 20 government debt-to-GDP will reach 118% by 2014. The United States' debt will exceed 100% of GDP in two years. Its federal deficit already adds up to 10% of GDP.

Mr. Bond said a 1% shift in the U.S. deficit-to-GDP ratio has historically raised long-term interest rates by 35 basis points. That points to an upward risk of as much as 336 basis points for long-term U.S. yields. That would take the yield on the benchmark 10-year note to about 7%. For G20 economies in aggregate, rising deficits point to a rise in yields of 200 basis points.

"For investors, the point here is that the historical odds do very much weigh on the side of this rise in yields occurring, which tends to suggest that we should determine our investments with the view that a large rise in government bond yields is not so much a risk as an absolute inevitability," Mr. Bond said.

In the United States, yields on 10-year treasuries have remained relatively benign in the face of its growing debt, climbing only slightly in the past year. Milton Ezrahi, chief economist and market strategist at Lord Abbet, a U.S. fund company, says U.S. investors are distracted from Europe's credit problems and ongoing doubts about the economy. But they will soon turn their attention back to fiscal issues.

"Projected deficits remain too large for too long into the future to avoid raising serious concerns about inflation, the dollar's value and the economy's fundamental growth potential," he wrote in a note to clients this week. "When investors return to these questions, chances are markets will also see a return of the bond vigilantes that so roiled pricing some 15 to 20 years ago when Bill Clinton occupied the White House."

In 1994, as the U.S. economy moved out of recession, the so-called vigilantes raised their concerns over excessive government spending and pushed bond yields up more than 300 basis points in the run-up to mid-term elections, forcing the Clinton administration to change policy course.

"I used to think if there was reincarnation, I wanted to come back as the president or the Pope or a .400 baseball hitter," said James Carville, a Clinton advisor at the time. "But now I want to come back as the bond market. You can intimidate everybody."

Sixteen years later, Mr. Carville's words continue to ring true and investors are reminded to never underestimate the power of the bond market.

"The broad picture is that many, if not most, G20 economies are in a fiscal mess," said Tim Bond, head of global asset allocation at Barclays Capital Markets, in a research note.

One of the biggest worries for bond markets is that governments will intentionally allow inflation to rise to make their deficits seem smaller in the future.

As the next cycle for bonds begins to unfold, fixed-income investors, who have run to the bond market for cover from the slump in stocks, need to be cautious once again. The outsized returns of the past decade are unlikely to be repeated and there could be stiff losses ahead.