



Buttonwood's notebook

Financial markets

Investing

Rates, growth and returns

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THE surprise of the year has been lower government bond yields. Despite a rise in recent days, the ten-year Treasury bond yields just 2.59%, compared with 3% at the start of the year. German ten year bond yields are 1.41%; the Swiss equivalent yields 0.73%.

Broadly speaking, one can view the nominal yield on a government bonds as being influenced by four things; the risk of outright default; the rate of economic growth; the rate of inflation; and the expected path of short-term rates, as directed by the central bank. Never say never but for economies like the US, Germany or Switzerland, default risk doesn't really come into it; they have borrowed in their own currencies. (Of course, they could inflate their debt away but that is one of our other three factors.)

So the fall in bond yields this year is down to one of the other three factors. Inflation has certainly dropped, most notably in the euro zone, where it was just 0.5% in May. Another possibility is that investors have become more pessimistic about growth, perhaps in the wake of the surprise fall in first quarter US GDP or because of worries about a Chinese slowdown. The third option is that investors have revised down their rate expectations, perhaps because they now expect the ECB to take action tomorrow to head off the deflationary threat.

As referred to in a [recent post](http://www.economist.com/blogs/buttonwood/2014/05/investing-2) (<http://www.economist.com/blogs/buttonwood/2014/05/investing-2>) , Pimco's outlook is for the "new neutral" in which real yields are low for longer. This seems plausible although it's not clear why investors should perceive all central banks as being more dovish since the start of this year; the Fed is continuing its tapering and the date of the first rate rise from the Bank of England seems to have edged closer.

A more fundamental challenge to the notion comes from Andrew Smithers of Smithers & Co. The idea that real yields and economic growth are linked is based on the notion that the return on capital should equal the cost of capital; in a slow-growth economy, returns will be low so businesses will not undertake projects if the cost of borrowing is high. But while that may be true in a closed economy (such as the world as a whole), it is not true of individual economies. Smithers says there is no correlation between changes in real rates and changes in growth, as the table shows.

	France	Germany	Japan	UK	US
1899-2013	0.02	0.00	0.07	0.03	0.03

Smithers argues that world growth is unlikely to slow, thanks to China's still impressive rise (although the annual rate of Chinese growth has slowed, it is now a much bigger part of the global economy, so its effect on global growth has not fallen. If China grows at 7% a year, the world economy will grow at 1.5%, even if all other economies are stagnant.) So at the global level, real rates have no need to fall. Fast-growing economies tend to see their real exchange rates rise (the Balassa-Samuelson effect); they tend as a result to have below-average real rates. (Capital will flow into an economy with an appreciating exchange rate, driving down real returns.) But if the emerging markets have below average real rates, Smithers points out that developed economies must have above average rates.

But back to lower bond yields. They have been accompanied, in recent weeks, by higher share prices. That, says Capital Economics, is perfectly reasonable.

the price of the stock market will rise if the Treasury yield falls, provided that the latter's decline is not more than offset by some combination of a rise in the equity risk premium or a drop in the expected growth rate of nominal EPS (earnings per share)

The logic is impeccable. But again we go back to why bond yields have fallen. If it is down to lower inflation expectations, then the expected rate of nominal earnings per share should fall; if it is down to lower growth expectations, then the expected real rate of eps growth should fall. Either effect should cancel out the discount rate benefit.

But perhaps it is down to central banks being more dovish? If central banks have changed attitude then that is because Draghi et al expect growth or inflation to be lower, in which case the objection in the previous paragraph still applies. Perhaps, however, equity markets think that central banks are wrong to be dovish. However, if they think central banks are wrongheaded, than that surely makes the outlook more cloudy, and should increase the risk premium they demand for holding equities.

Capital points out that risk premia on other assets (such as credit spreads) have fallen, which is a very sound practical point. But that doesn't

really resolve the central dilemma; one out of the bond markets, the equity markets or central banks must be wrong.

My best guess is that cognitive dissonance is at work. The lesson of the last five years for investors is that central banks will keep supplying cheap money and a "turn" can be earned by taking that money and investing in equities, credit, property and so on. The theoretical issues of discounted cashflows are neither here nor there in most investors' minds. Like Chuck Prince of Citibank once said, they will keep dancing till the music stops. And the band is still playing...