

Sovereign bond markets and financial repression

Government intervention in the bond markets is pressing yields below fair market prices, says **Shane Shepherd**.



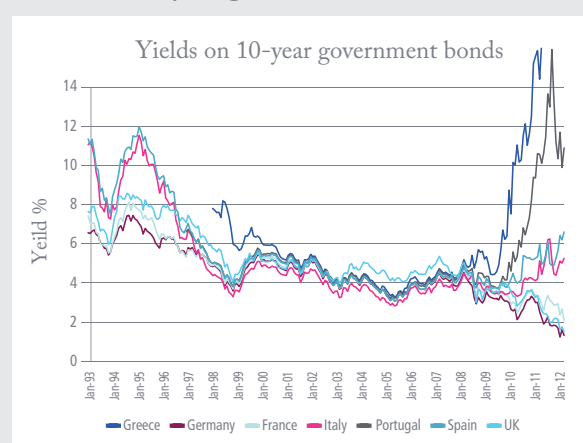
The European sovereign debt crisis is roiling global financial markets. This scenario may seem obvious in retrospect: profligate nations with high deficits and a history of devaluation committed themselves to issuing debt in a hard currency beyond their control – what other outcome should we have expected? Yet the economic events that made our arrival here possible are not unique to the European continent – an observation that should not be ignored by investors in the sovereign bond markets.

Looking a little deeper into the facts, we conclude that sovereign bond markets did not appropriately compensate investors for default risk. In academic terms, the sovereign bond markets were not efficiently priced. Very little attention was given to default risk – all sovereign debt was considered, more or less, risk free, which means that lenders did not receive adequate compensation for the risk they were taking on when buying many of these government bonds.

Executive summary

- Sovereign bond markets are not perfectly efficient and historically have not compensated investors appropriately for default risk. This is just as true today.
- Looking forward, the greatest risk for investors lies with large debtors paying exceptionally low interest rates – the United States, the United Kingdom, and Japan.
- Financial repression and quantitative easing create an environment of low and negative real interest rates that will likely persist for a long time, leading to low expected returns.

Figure 1:
Yields on 10-year government bonds



Source: *Bloomberg and Research Affiliates*

The default risk premium pattern can be seen in Figure 1, which shows the historical yield on constant maturity 10-year bonds from several European countries. Perhaps most telling is the stark narrowing in the variation of rates throughout much of the previous decade, when all bonds were given essentially the same default risk. Before joining the euro, the Greek 10-year note traded at a yield as high as twice that given to German 10-year Bunds (8.3% compared to 3.9% in September 1998). By the time Greece adopted the euro in January 2001, that spread had dropped to a mere 55bp (and hit an all-time low of 9bp in 2005).

This would seem to imply a drastic reduction in the probability of default for Greek bonds relative to German debt (either through outright abrogation or through the well-trodden path of inflation and devaluation). And yet, giving up the drachma and the ability to devalue their currency started Greece down that very path to outright default.

In hindsight, the yields on Greek bonds were not sufficiently high enough to compensate investors for taking on that default risk. A short examination of Greece's track record leads to a healthy dose of scepticism that these bonds never should have traded at such a skinny premium to German bonds. Greece has been in outright default or restructuring approximately 50% of the time over the past 200 years.

Furthermore, throughout the past decade Greece's debt burden has grown dramatically – increasing the likelihood of default – while its yield shrunk. Not only did buying these bonds start out as a bad proposition, but it got worse over time. Thinking about the incentives that were put in place, the debt explosion across many of the southern European nations should not be so surprising. Lowering the interest rate lowers the price of borrowing money and drives increased deficit spending. The lowered interest rates that coincided with joining the euro naturally led to higher debt burdens.

Nor was the problem solely tied to Greece. An examination of the yields paid by Portugal, Spain, and Italy shows the same pattern. In mid-1995, Spanish yields traded at a 5.1% premium to German bonds, and Italian bonds paid a 4.6% yield premium. The rates paid by all these government borrowers equalised as the introduction of the euro became imminent. Now, at mid-2012, we have arrived full circle, with Spanish bonds yielding a 5.4% premium and Italian debt a 4.1% premium. Even triple-A rated (but highly indebted) France has seen its cost of borrowing spike to over a 1% premium to Bunds – the highest premium in the last 20 years.

The sovereign debt crisis is now the foremost issue for most investors, and yield spreads have widened significantly, so surely the appropriate default risk must be priced in now, correct? Perhaps not, and the reason is that government intervention in the bond markets will likely continue to press yields below fair market prices.

The specific intent of quantitative easing is to push yields away from a fair market equilibrium point and thereby reduce the cost of borrowing. The success of quantitative easing means that yields are below where they would be based purely on a

Table 1:
Government Debt-to-GDP ratios, 2011

Country	Debt-to-GDP
France	85.5%
Germany	81.2%
Greece	165.3%
Italy	120.1%
Japan	207.6%
Portugal	107.8%
United Kingdom	85.7%
United States	100.8%

Source: *Eurostat and World Bank*

risk/reward trade-off – that is, investors in these bonds are still not receiving adequate compensation for the default risk they assume. Quantitative easing is no magic bullet but rather a zero-sum game. Reducing the cost to borrow money is a transfer of wealth from lenders to debtors. Savers are subsidising government borrowers and become decidedly worse off.

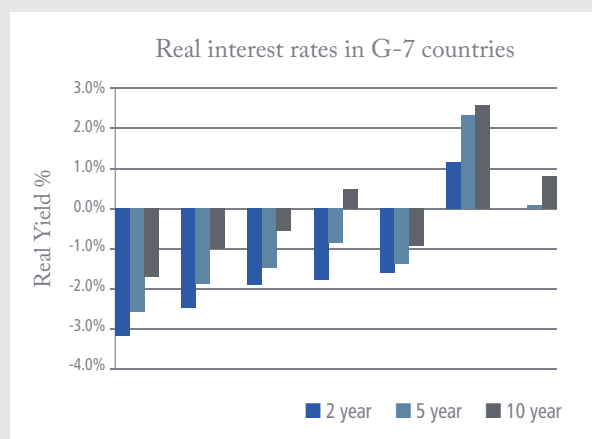
High debt burdens are not confined to the southern European nations, as seen in Table 1. The United States now boasts a debt/GDP ratio at 100%, Japan's debt has surpassed 200% of GDP, and the United Kingdom's government debt burden sits at 85% of GDP. These giant debt burdens create strong incentives for governments to keep their costs of borrowing low.

As a result, quantitative easing and related government tactics that suppress interest rates are widespread. Moving beyond the European periphery, massive quantitative easing in the US, the UK, and Japan has driven interest rates to historic lows. Government regulations that direct investor funds toward government debt obligations exert further downward pressure on interest rates.

These tactics, called “financial repression,” help keep interest rates low in these highly indebted countries. Such techniques include caps on savings rates, requirements on public pension plans to invest a certain percentage of assets in government debt (regardless of the yield paid), and requirements on banks to keep a percentage of their assets in “safe” treasuries or promoting such holdings through preferential treatment of these obligations on banks' balance sheets. These funds channeled toward government bonds, regardless of the yield they receive, exert sustained downward pressure on bond yields.

Just as in the troubled southern European nations, savers are being penalised in favour of government borrowers. History has taught us that the sovereign debt markets can be inefficient, particularly when accompanied by government intervention. Investors in government bonds have not received adequate compensation for default risk in the past – and with yields held artificially low, it seems likely this is again the case in the

Figure 2:
Real interest rates in G-7 countries



Source: Bloomberg and Research Affiliates

seemingly safer but still highly indebted countries such as the US, UK, and Japan.

While outright default is very unlikely in those countries that hold a printing press, investors have high exposure to a “stealth default” via a combination of steady inflation and artificially low interest rates – the very environment encouraged by financial repression.

As a result of quantitative easing and financial repression, we currently see negative real interest rates in most of the G-7 countries (see Figure 2). Negative real interest rates are a tremendous boon for government borrowers and will help liquidate government debt obligations and assuage the problem of unsustainably high debt-to-GDP ratios. However, negative real interest rates present a disastrous situation for savers as their purchasing power declines over time. We estimate real rates as low as -3.3% at the two-year horizon on UK Gilts, improving to only -1.7% for the 10-year maturity. Only in Italy, where rates include some pricing of default risk, and Japan, with near-zero inflation, do interest rates leak out to the positive side.

Those countries with the highest debt burdens are the ones most subject to financial repression and persistent low or negative real rates. It is not only the southern European countries that face a pressing need to reduce their debt ratios. Carmen Reinhart and Ken Rogoff (*Growth in a Time of Debt*, 2010) show that once government debt exceeds 90% of GDP, it creates a significant drag upon economic growth.

Many industrialised nations are at or well past this threshold. A negative real interest rate of 2% will erode the value of that debt obligation slowly – if all goes well, over a decade the debt-to-GDP ratio could decline by 20%. This route provides a feasible solution to the sovereign debt crisis, but not a rapid one. Low and negative real interest rates are likely to persist for a sustained period of time. The impact will be greatest in those countries with the highest debt burdens, and the risk is highest where yields are low. Where the borrower is large, let the buyer beware. ■



Profile



Shane Shepherd

Shane Shepherd is vice-president, head of fixed-income research, at Research Affiliates. He focuses on extending Research Affiliates' Fundamental Index strategy into fixed-income asset classes and bringing investment products based upon this research to the marketplace. In addition, he conducts quantitative research to forecast interest rates and inflation and supports the global tactical asset allocation model. His responsibilities include writing articles for publication in academic and industry journals and speaking at conferences and other events. Shane earned his PhD in finance from the University of California, Los Angeles. He holds a BA in political science and philosophy from Duke University.