

Negative real yields on inflation linked bonds

This short comment provides an explanation of why real yields are negative in the US, and whether they offer good value as an investment at current levels.

Bonds are loans, and we are used to the idea that in return for lending money we receive interest as compensation. This same logic applies to bonds – indeed with very little qualification we can say that on conventional ('nominal') bonds the 'yield' (i.e. the effective interest rate once the purchase price is accounted for) is never negative.

What about zero? Can the yield on a nominal bond be zero? Japan has had official interest rates close to zero for many years which has encouraged the practice of keeping cash at home in a safe – after bank fees, net interest rates on bank deposits have been negative.

Let's think for a moment about the relationship between interest rates and inflation. It is normal for interest rates to provide more than adequate compensation for inflation. That means that after earning interest, one has greater purchasing power and has therefore achieved a real return. It is normal for real returns to be positive, which of course creates an incentive to save.

Returning to the situation in Japan for a moment, the reason interest rates have been zero for so long is that Japan has not properly recovered from the bursting of its 1980s (!) housing bubble. Economic growth has been close to zero for the past 20 years. By keeping official interest rates close to zero the Bank of Japan (BoJ) has been trying to discourage saving and encourage spending. One of the reasons the BoJ's efforts have been in vain is that the rate of inflation has been, and is expected to remain negative. Deflation means that even cash held at home in a safe is actually appreciating in real terms because deflation of prices means the longer you wait the cheaper it gets!

Japan style deflation is a trap that central banks around the world dread, because it is a recession in which the central bank's ability to stimulate the economy is severely hampered.

In the US, official interest rates are close to zero but, unlike Japan, inflation is positive and (at least on the balance of probabilities) expected to remain so. The expectation of



continued inflation, as opposed to deflation, is far from certain; indeed there has been good demand from investors for 'inflation floors' which are a type of insurance policy against negative inflation.

Other than keeping official interest rates low, what else can the Federal Reserve in the US do to reduce the chance of the US slipping into a Japan-style deflation trap? So called quantitative easing (QE) means expanding its own balance sheet (with freshly 'printed' electronic money) to buy financial assets, in the first instance buying US Treasuries, and effectively reducing the supply of government bonds available for other investors. The effect of quantitative easing is to make bonds more expensive (prices go up) and reduces their yield in both real and nominal terms.

The fact that real yields are negative is a sign that, at least for the moment, the US quantitative easing is doing its job. Close to zero nominal yields together with inflation expectations of 1% to 1.5% translate to a negative real yield, and that is the disincentive to save that is the precise intention of the Federal Reserve – sending a message to investors to either spend or at least invest in something that will hopefully lead to economic activity.

The real problem with quantitative easing is that it can just amount to another way for the central bank to push on a string (when interest rates are zero). It is possible to point to three different types of QE:

1. Printing e-money and using it to buy government bonds – the Fed announced details of such a plan last night.
2. Printing e-money to accumulate foreign currency reserves – also referred to as 'unsterilised currency intervention'.
3. Printing e-money for fiscal expansion.

These variants are listed in order of increasing inflationary and economic stimulatory effectiveness.

Given that the US is only at stage 1, the question becomes: how determined is the US to avoid the deflation trap? Japan has only tried type 1 QE. Of course, the US is doing it more quickly than Japan did, but there are definitely no guarantees that it will work.

The recent mid-term election results make it hard to imagine all the necessary political stakeholders agreeing to type 3 QE. The difficulty with type 2 QE is that it could be viewed

as exporting deflationary problems to other countries and, after the public lectures to China on the evils of currency manipulation, it is probably fair to say that much in the way of currency intervention from the US would be a big step.

Much like a frustrated man pouring petrol on damp firewood and not seeing any flame, it seems most likely that the Fed will be increasingly aggressive with type 1 QE. The danger is that artificially low interest rates create imbalances in the form of misallocation of capital, which will lead to fresh problems down the track. Such problems could either end up being of either an inflationary or a deflationary nature.

It is hard to get too excited therefore about US Treasury Inflation Protected Securities (TIPS) as a defensive play in an investment portfolio (although this question definitely depends on what else you hold in your portfolio), simply because it is impossible to rule out the US falling into the deflation trap, despite their current determination to avoid it.

So what does this mean for investors holding Aussie inflation linked bonds or thinking about investing in the asset class? Australia may end up bending its inflation-fighting resolve in the face of global inflation, but the prospect of Australia falling into a deflation trap is a very remote possibility indeed. As a small economy, Australia is much more easily able to adjust to changing economic circumstances, helped greatly by the considerable flexibility in the Australian dollar, and this provides a natural buffer against deflation. Besides, it is hard to look past Australian linkers which, amongst other things, offer the highest real yield of the advanced economies. Breakeven inflation in Australia also remains at attractive levels, given the possibility of a further increase in inflation in future.

So negative real yields are not in themselves an indication that an extreme in pricing has been reached, and for this reason TIPS are not necessarily a screaming sell. QE is however designed to make Treasuries and TIPS expensive while encouraging US citizens to consume. From a portfolio construction point of view, it is prudent to look for better-value substitutes. In our minds, a much more palatable way to protect against the longer-term risks of the US's QE programme is to buy Australian linkers.

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