Market Insights

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Safe Haven Government Bond Investors Lulled into a False Sense of Security?

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Executive Summary
Standish Global Macro Strategist Tom Higgins worries that investors have been lulled into a false sense of security by safe haven government bond markets. He points out that Standish's econometric models suggest that U.S. Treasury and German Bund yields are well below where fundamental factors imply they should be. The bond manager's analysis indicates that fears of a eurozone break-up may be suppressing 10-year U.S. Treasury yields by as much as 100 basis points (bps). As such, there could be a sharp reversal of safe-haven inflows and a back up in U.S. Treasury yields if stresses in financial markets begin to ease.

Standish Global Macro Strategist Tom Higgins worries that investors have been lulled into a false sense of security by safe haven government bond markets.

"Always drink upstream from the herd." — Cowboy Proverb

Government bond yields in the United States, Germany, and several other advanced economies are near their lowest levels in history, as investors seek shelter from increased financial market volatility. Indeed, U.S. 10-year Treasury yields declined to 1.45%, while comparable German Bund yields dropped to 1.17% at the beginning of June before backing up modestly (Exhibit 1). Much of the influx of money into these safe haven markets has been driven by the worsening European sovereign debt and banking crisis. More recently, concerns about the strength of the global economy have also contributed to the downdraft in interest rates.

The question for us is just how safe are these so-called safe havens? From our perspective, there is probably little risk of principal loss for investors who plan to "buy and hold" Treasuries or Bunds to maturity, given the low probability of default in the U.S. or Germany. Yet if market expectations for inflation are correct, those investors may be locking in negative real yields for years to come. Indeed, the 10-year breakeven inflation rate implied by U.S. Treasury Inflation Protected Securities (TIPS) remains above 2%.[1]

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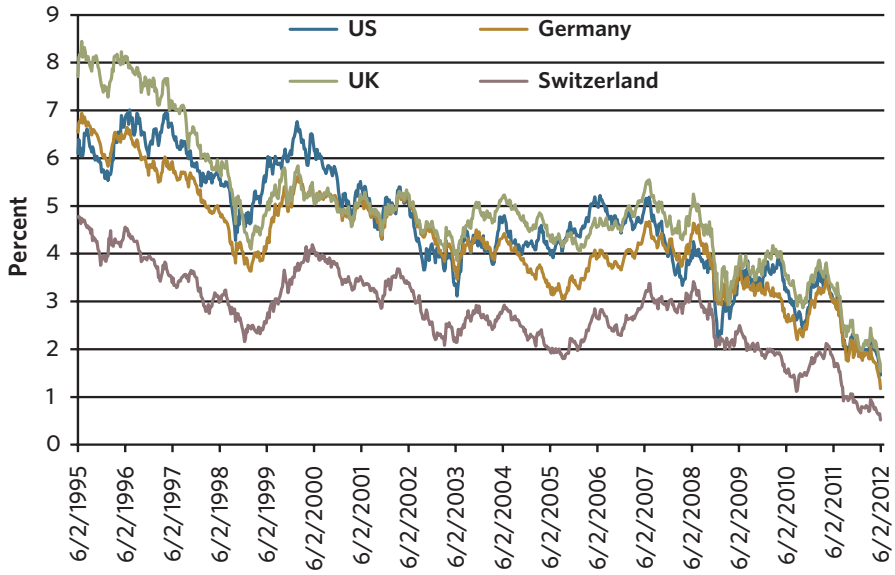
1 Bloomberg, as of June 5, 2012.

June 2012

Exhibit 1 – Unprecendented Low Levels of 10-Year Government Bond Yields



Source: Bloomberg as of June 5, 2012

Standish's econometric models suggest that U.S. Treasury and German Bund yields are well below where fundamental factors such as economic activity, inflation, money supply, central bank policy and foreign capital inflows would imply they should be.

For those investors simply seeking temporary shelter in long-term government bonds as a higher yielding alternative to cash, there are at least three reasons to be wary. First, the potential for interest rates to move lower is less than their potential to move higher given the zero bound. Second, economic fundamentals suggest that the fair value for U.S. and German bond yields is significantly higher than current levels. Third, the decline in U.S. and German interest rates since mid-March has been swift, raising the prospect of an abrupt reversal in rates *if* European policy makers take definitive actions to mitigate the risk of a eurozone break-up. The decision to provide a €100 billion bail-out to the Spanish banking sector and the victory by the more centrist pro-euro parties in the Greek election may indicate that we are getting closer to that point. Thus, we worry that investors have been lulled into a false sense of security by these safe haven government bond markets.

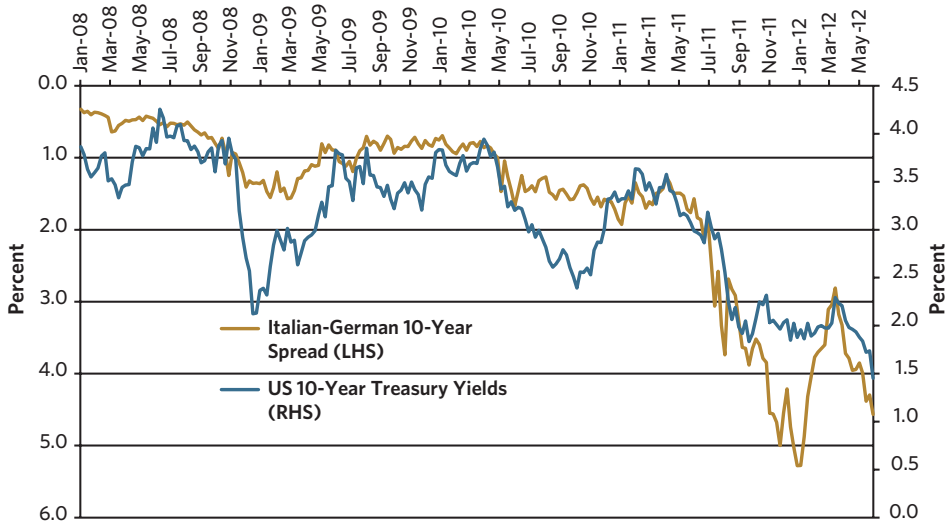
Fear Versus Fundamentals

Standish's econometric models suggest that U.S. Treasury and German Bund yields are well below where fundamental factors such as economic activity, inflation, money supply, central bank policy and foreign capital inflows would imply they should be. Indeed, according to our models, fair value for 10-year U.S. yields would be closer to 3.5% based on these fundamental factors, while 10-year German yields would be around to 2.4%. In both instances, fair value as measured by our models is roughly double where actual interest rates are today.

As mentioned, part of the large deviation between fair value and the current level of government bond yields is the flight to safety driven by the fear of a break-up of the eurozone. In order to capture this effect, we have incorporated the spread between German and Italian long-term bond yields into our analysis as a proxy for financial stress in the eurozone (Exhibit 2). We found that every 1 percentage point increase in this spread above 2% subtracts about 40 bps from 10-year U.S. Treasury yields. When the spread between German and Italian 10-year bond yields reached 4.5% in early June, our analysis suggests the flight to safety bid was reducing U.S. 10-year yields by 100 bps. Hence, all other things being equal, U.S. 10-year yields would have been closer to 2.5% than 1.5% in early June were it not for Europe's woes.

Part of the large deviation between fair value and the current level of government bond yields is the flight to safety driven by the fear of a break-up of the eurozone.

Exhibit 2 – Flight to Safety Driving Treasury Yields Lower



Source: Bloomberg as of June 5, 2012

Yet, even at 2.5% Treasury yields still appear overvalued based on fundamentals. Therefore, we think there must be other factors holding down Treasury yields. The most obvious candidate is quantitative easing (QE) by the Federal Reserve. Numerous academic studies have tried to quantify this effect. Our own internal analysis suggests each $1 billion in Treasury purchases by the Fed subtracts about 3 bps from U.S. 10-year yields, which is roughly in line with the Fed's own estimates. A recent Fed study on this topic suggests the first two rounds of QE combined with its maturity extension program, dubbed Operation Twist, reduced 10-year yields by approximately 100 bps.[2]

2 Canlin Li and Min Wei, "Term Structure Modeling with Supply Factors and the Federal Reserve's Large Scale Asset Purchase Programs," Finance and Economics Discussion Series (Washington: Board of Governors of the Federal Reserve System), May 30, 2012.

Demand for Safe Haven Assets May Be Greater Than Supply

We believe the remainder of the deviation between the fair value implied by fundamentals and the actual level of Treasury yields is the result of a combination of less quantifiable factors including: household deleveraging, a shortage of high quality assets, and increased regulation in the financial industry. From our perspective, the combined effect of these factors is probably worth at least another 50 to 75 bps off 10-year U.S. Treasury yields.

We believe the fundamentals and the actual level of Treasury yields is the result of a combination of less quantifiable factors including: household deleveraging, a shortage of high quality assets, and increased regulation in the financial industry.

American households have made significant progress repairing their balance sheets since the 2008 global financial crisis. Household debt to disposable income has fallen from 129% in Q2 2008 to 115% in Q1 2012.[3] This deleveraging has come at the cost of economic growth, as evidenced by the subpar pace of economic recovery in this business cycle versus prior expansions. Below-potential economic growth tends to be disinflationary, thereby suppressing interest rates.

At the same time, there has been a decline in the number of high quality assets available for investors to take refuge in during periods of financial market stress. Since the global financial crisis, the sovereign debt in many advanced economies has lost its luster as a consequence of deteriorating fiscal positions and credit ratings downgrades. According to the International Monetary Fund, gross government debt for the advanced economies has increased from an average of 74% of GDP in 2007 to 107% of GDP in 2012. Not surprisingly, 68% of the advanced economies had AAA credit ratings at the end of 2007 compared to just 52% at the beginning of 2012.[4]

One way of determining whether investors view the government debt of a particular country as a safe haven is to examine credit default swap (CDS) spreads on that debt. Sovereign CDS spreads measure the cost of insuring the bonds of a country against default. Five-year CDS for the United States currently stands at 50 bps whereas for Germany they are closer to 100 bps. Both countries have been recipients of safe haven inflows.

3 "Flow of Funds Accounts of the United States: First Quarter 2012," Federal Reserve Bank, June 7, 2012.
4 "Global Financial Stability Report: The Quest for Lasting Stability," International Monetary Fund, April 2012, p. 105.

By contrast, countries with 5-year CDS spreads above 200 bps are less likely to receive such inflows because they are classified as more risky. The CDS spreads for France, Belgium, Italy, and Spain are all above this threshold. Eliminating all countries with 5-year CDS spreads above 200 bps from the global pool of risk free assets would equate to a reduction in safe haven assets of $8.1 trillion, or approximately 16% of the 2012 total supply of advanced economy debt.[5]

We worry that U.S. Treasuries and German Bunds may be riskier than many investors realize, given the potential impact from a reversal in safe haven inflows.

Consequently, there is a shortage of high quality assets at a time when demand for such assets is increasing as a result of financial regulation. The requirements of the new Basel III Liquidity Coverage Ratio (LCR) alone could further increase the demand for safe assets by some $2 trillion to $4 trillion worldwide unless banks alter their liability structure to moderate their liquidity needs.[6] The LCR excludes lower quality assets because banks are unable to sell them or are forced to accept large haircuts, which can render them insolvent in times of market stress.

Calm Before the Storm

The interaction of all these factors affecting Treasury and Bund yields is such that it is difficult to distinguish the impact of one from another. For example, the Fed's purchases of Treasuries contribute to the shortage of high quality assets in global financial markets. Nevertheless, we believe it is important to try to quantify the effects of the flight to safety bid or Fed purchases of Treasuries, since these factors are overwhelming the economic fundamentals in the current market.

We worry that U.S. Treasuries and German Bunds may be riskier than many investors realize, given the potential impact from a reversal in safe haven inflows. Further progress on the European front could result in a back up in bond yields and mark-to-market losses for investors who are simply looking for a higher yielding alternative to cash. The risk of such a back up may be higher in Germany since the solution to the European crisis will likely involve some form of fiscal transfer from the core economies to the peripheral countries, whether in the form of joint and several issuance of euro bonds or further bailout money.

5 *Ibid.*, p. 108.
6 *Ibid.*, p. 100.

In our opinion, household deleveraging, increased regulation, and the shortage of high quality assets will keep a ceiling on how far government bond yields can rise for several more years.

That said, we do not believe that the current global environment warrants persistently higher interest rates in either the United States or Germany. Moreover, in our opinion, household deleveraging, increased regulation, and the shortage of high quality assets will keep a ceiling on how far government bond yields can rise for several more years. Thus, we do not expect to see the 3%-plus fair value level implied by the economic fundamentals for some time to come.

Thomas D. Higgins, PhD, Global Macro Strategist

Tom is the Global Macro Strategist for Standish. He is responsible for developing views on the global economy and making relative value recommendations among global bond markets, currencies, and sectors. Before joining Standish in 2010, Tom was employed as the Chief Economist for Payden & Rygel Investment Management in Los Angeles and served as International Economist at The Conference Board. Tom received his Ph.D. and M.A. degrees in Economics from Fordham University and holds a B.A. in Economics from Drew University. Tom has eighteen years of experience analyzing financial markets. He is a member of both the American Economics Association and the National Association of Business Economics (NABE). Tom was President of the Los Angeles Chapter of the NABE from 2006-2007. He is a past board member of the Los Angeles Economic Development Corporation and the California Council on Economic Education. Tom was the 2010 Recipient of the Robert T. Parry Award for Exemplary Contributions in the Field of Economics.

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