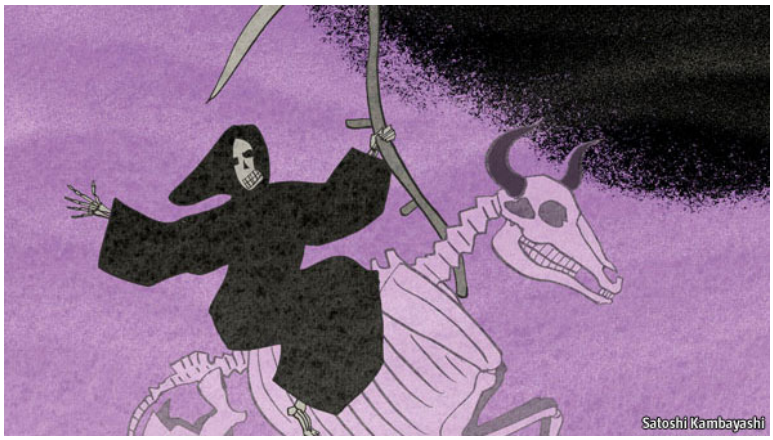
## A bull market in pessimism

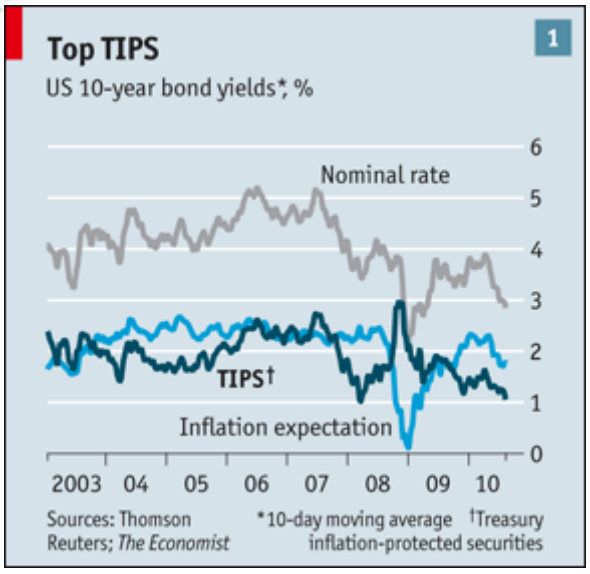
*A lot has to go wrong to justify today's rock-bottom bond yields.*




WHEN Japan slid into deflation in the mid-1990s bond investors were caught unawares. As late as 1995 yields on government bonds, a haven in times of deflation, were still approaching 5%. Investors today are not about to repeat that mistake. Inflation may be positive in America, Britain and Germany, but in all three countries government-bond yields have plunged to lows exceeded in recent times only by levels during the 2008 panic.

Since falling yields raise the value of bond principal, that has delivered bumper returns to investors. Government bonds have returned about 8% this year in local-currency terms in these three countries, according to Barclays Capital, outpacing equity returns. (Investors in weaker sovereign credits, such as Greece, have fared far worse). As go returns, so go investors. American equity mutual funds have seen net outflows this year of $7 billion, according to the Investment Company Institute, a trade group. Bond funds have had inflows of $191 billion.

The rush to bonds reflects both expectations of lower inflation and a longer period of rock-bottom central-bank lending rates. Of the 120-basis-point drop in the ten-year Treasury yield since January, about three-fifths can be attributed to a decline in the expected inflation rate over the next ten years, to 1.6% from 2.3%, as measured by the spread between nominal and inflation-linked bond yields (see chart 1). French and German yields reflect a similar drop in expected euro-zone inflation.



But actual inflationary expectations may not have declined as much as bond markets imply. Inflation-linked bonds are less liquid than their nominal cousins. When investors rush to government debt, they pile into nominal bonds: that is what happened after the Federal Reserve marked down its economic outlook on August 10th and said it would reinvest maturing mortgage bonds in its portfolio into Treasuries. That extra demand squeezes the spread over inflation-linked bonds, bringing down the implied inflation rate.

The principal on American inflation-linked bonds rises with the consumer-price index, but does not drop below its par value even if the CPI declines. This protects investors' principal in the event of deflation. Michael Gapen of Barclays Capital has calculated the value of this "deflation put option" and reckons it suggests a 10-15% probability of deflation over the next five years. That is down sharply from 70% in late 2008, though still up from zero before the crisis.

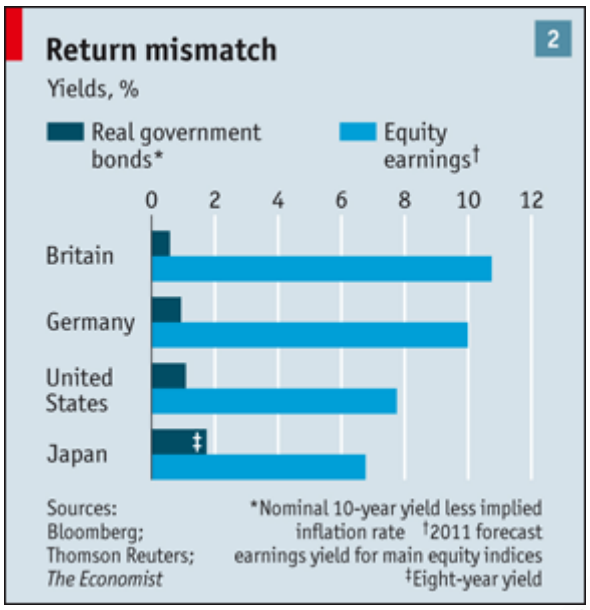
Bond investors expect a concerted effort by the Fed to ward off the risk of deflation, however small. Much of the decline in the real ten-year Treasury yield this year, from 1.5% to 1%, reflects investors' expectations that the Fed will now wait until late 2011 to start raising its interest-rate target of 0-0.25%. By reinvesting the proceeds of its maturing mortgage debt, the Fed will also be absorbing some 20% of net new Treasury debt, or $20 billion a month, reckon analysts at UBS. That leaves fewer long-term bonds for other investors to buy, adding to downward pressure on yields.

Low bond yields should comfort central banks: they are the main channel by which they hope to stimulate demand. They are also a boon to governments with yawning fiscal deficits. Whether investors should be similarly comforted is more questionable. Today's yields offer precious little cushion should inflation turn out higher, growth stronger or central banks less accommodating than current predictions. Some go so far as to call the market a bond bubble. John Richards of Royal Bank of Scotland says current yields imply that the Fed funds rate will rise at a snail's pace and level out at 3%, a scenario compatible only with a double-dip recession and Japanese-style malaise. "You'd have to argue that either US inflation or potential growth are permanently lower," he says.

Mr Richards recalls another occasion when investors in Japanese bonds were caught out. In 2003 ten-year government-bond yields shot from 0.5% to 1.5% in just three months, sparked by nothing more than fading fears of deflation and casual remarks by the Bank of Japan. Monetary policy did not change. Banks were all positioned the same way, he says. Once the selling began, it became "indiscriminate…it was a bloodbath." If the Fed raises rates to 4% by late 2013, as the consensus expects, bonds will sell off violently.

Could such a turnaround be in the offing? America's 12-month core-inflation rate, which excludes food and energy, has fallen from 2.7% in early 2007 to 0.9% in July, but it may be bottoming out. Most of that drop has been because of falling rents, and they now appear to be headed higher again as apartment vacancies start to drop. Core producer prices also rose faster than expected in July. The deep freeze in private borrowing has begun to thaw, too. On August 16th the Fed reported that banks had eased lending standards for small businesses; sales of junk bonds are rocketing.

Bonds also look pricey compared with shares. Analysts at JPMorgan calculate that the "equity-risk premium", the expected excess return of shares over government bonds, is at a record high in America, reflecting an 8% earnings yield on stocks and 1% real yield on bonds. In Germany, Japan and Britain the story is similar (see chart 2).




None of this, however, may be enough for investors to start bailing out of bonds. With economic growth painfully slow throughout the rich world it will be a long time before the threat of deflation can be written off. Central banks are not only likely to keep their policy rates on hold for the foreseeable future, they may, for good measure, buy more bonds themselves. Low yields could be here for a good while yet.

**Fonte: The Economist, Aug. 19th 2010. Disponível em: <www.economist.com>. Acesso em: 25 ago. 2010.**