The Economist

Buttonwood

Land of the falling yield

The return of an old relationship between asset prices

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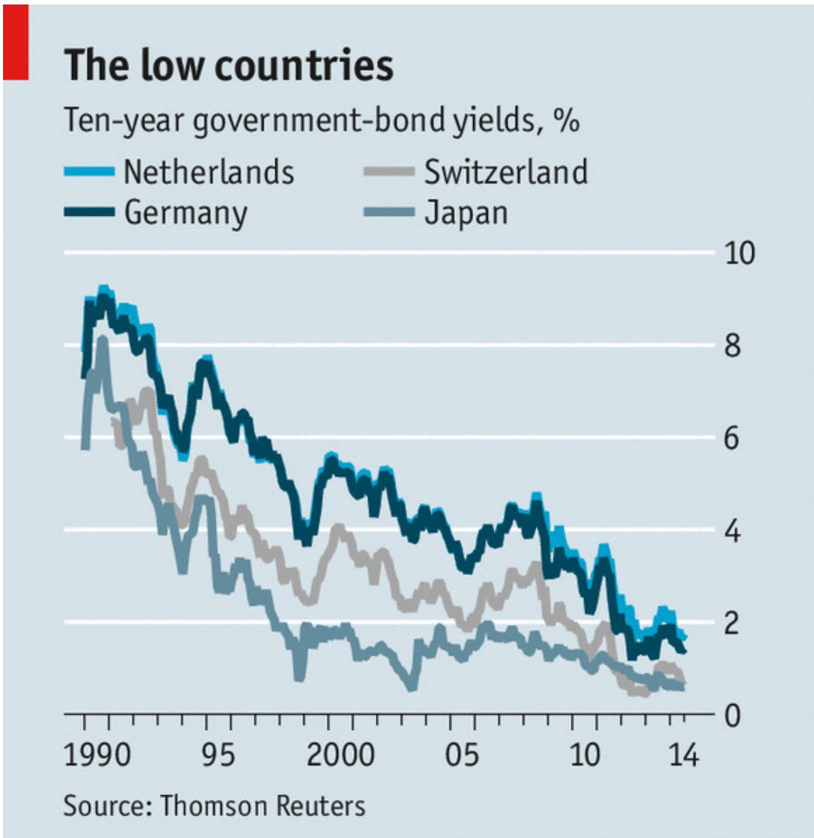
IS EUROPE succumbing to "Japanification", whereby poor demography and the legacy of a debt crisis lead to a long period of sluggish growth and low inflation (or even deflation)?

Some economists argue that the situation is not that desperate. Europe could do a lot to spice up its growth rate with a dose of reforms—making its labour markets more flexible and reducing the influence of cartel-like guilds, for example. But Japanification is starting to appear in one prominent area: the bond market.

For more than a decade, bears who bet against Japan's bonds, believing that the government's debts (currently 230% of GDP) would eventually overwhelm it, have been disappointed; yields have stayed very low. The trade has been so destructive of wealth that it has become known as the "widowmaker".



In the euro zone, all the focus in recent years has been on the sharp rise and subsequent fall in government-bond yields in "peripheral Europe". Less attention has been paid to the fall in yields in the countries considered Europe's core. German ten-year government-bond yields are more than a percentage point lower than the equivalent Treasury yields in America. Jim Reid of Deutsche Bank says that Dutch yields are close to their lowest levels in the nation's history (see chart).

Many investors started the year in the belief that global bond yields would rise as the economy recovered, and have been startled by the move in the opposite direction. Part of this may be down to disappointing economic numbers. America's GDP unexpectedly shrank in the first quarter. Fredrik Nerbrand of HSBC thinks the global economy may have already reached its peak for this cycle, which began back in 2009. The low level of euro-zone inflation is another factor: prices rose by just 0.5% in the year to May. That means most European bond yields are still positive in real terms, as they were in Japan until recently.

Events in Switzerland (which is not in the euro zone) may be a harbinger of Europe's future. Dhaval Joshi of BCA Research points to some startling Japanese parallels. Bond yields in the two countries are now very similar and the Swiss inflation rate, exactly zero, is now lower than that in Japan.

While the Japanese have had Abenomics, the Swiss National Bank (SNB) has not been inactive in the face of the deflationary threat. In September 2011 the SNB said it was willing to create unlimited amounts of money to cap the Swiss franc at 1.20 to the euro. It intervened extensively in 2012, but inflation and yields remain low.

An era of low bond yields has implications for other markets. In the 1990s it was fashionable to cite the "Fed model", which said that equities were cheap when the earnings yield (profits per share divided by the share price) was higher than the ten-year bond yield. The theory was that equities were the better deal since profits grew over the long term.

This was a huge change from the first half of the 20th century. Back then, it was common not only for the earnings yield to be higher than bond yields in most counties, but also for dividend yields to exceed bond yields (the dividend yield is lower than the earnings yield since companies do not pay out all their profits to shareholders). Equities were more risky, the reasoning went, since companies were more likely to cut or eliminate their dividends than to stop paying interest on their bonds. This was a particular worry for small investors, who might have a concentrated portfolio of a few stocks.

As the century wore on, the equity market came to be dominated by institutional investors. By owning a diversified portfolio of equities, they could reduce the risk of individual corporate disappointments. In addition, bonds were vulnerable to the inflation that appeared in the 1960s and 1970s, whereas equities could offer income growth. Dividend yields duly fell below bond yields and stayed there, right up until the 2008 crisis.

But now the situation has reversed again. Japan has been there for a while; its shares yield 2%, compared with a ten-year bond yield of 0.6%. Swiss shares yield 3%, more than two percentage points above its ten-year bond yields.

That relationship may last. PIMCO, a fund-management group, talks of a "new neutral" era in which real interest rates are zero. For regulatory reasons, pension funds and insurance companies have lost their appetite for equities and put a much bigger share of their portfolios in bonds than they used to. Bond yields may be low for a long time.

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