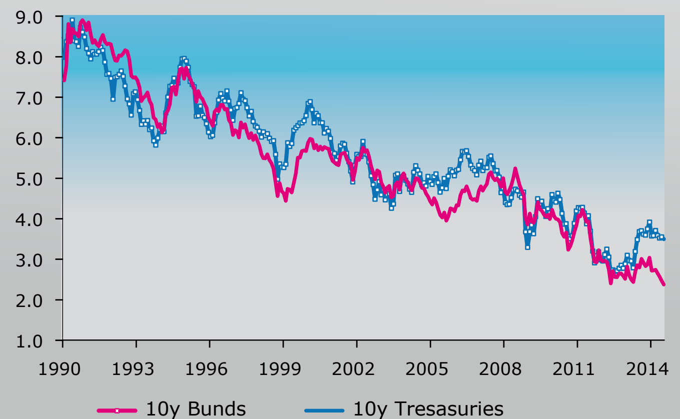
Turn in yields: waiting for Godot?

*Klaus Wiener, Head of Tactical Asset Allocation and Chief Economist of Generali Investments Europe, Generali Group's asset management branch, explains **why yield levels are still so low**, despite a strong reduction in systemic risks within the Euro area.*

Historically low yields

Long-term yields in core government bond markets have fallen to extreme lows. For instance, the yield on 10-year US Treasuries hit a record low of 1.4% in mid-2012. And while yields in the US have risen a bit since – they are now about 2.5% in the 10-year segment – the yield on Bunds fell to a fresh record low of 1.1% in July (see chart). At these extreme levels, real interest rates are often in negative territory, thus harming investors in inflation-adjusted terms. It is important to note, however, that this development was not a short-term phenomenon. In fact, long-term yields were in steady decline ever since the beginning of the 1990's (see chart). During the first years, the tendency



was driven by fundamentals like monetary policy (lower key rates), inflation (steady decline to levels in line with the price norm) and a secular downshift in growth trajectories in the advanced world (thereby depressing long-term yields). However, what came as a massive surprise was the drop from levels of about 4% in the last decade to the extreme lows now prevailing. Looking at Consensus expectations for these years, analysts have consistently underestimated the drop in yields. For Bunds, the annual average miss was as large as 90 bps. For Treasuries, it was even 120 bps. Such constant, but failed, predictions of higher yields resemble the situation in a play written by Samuel Beckett in 1953: there are two people waiting for a person called 'Godot'. They are sure that he is set to arrive any time soon – but he never shows up.

With the benefit of hindsight, it is now better understood what has driven yields to extreme lows. It was the series of **unprecedented events** which occurred during the last years. It started in 2007 with the Great Financial Crisis in the US. This led to a global banking crisis and, then, to a global economic slump in 2009, the biggest since the Great Depression. As fiscal levers were used to cushion the blow and long-term yields rose in some countries, sustainability of the public debt was called into question in parts of the euro area during 2011. Many government bond markets were downgraded. Some observers even cast doubts on the future existence of the euro so that capital flows into the remaining safe and liquid bond markets were extreme. This 'flight-to-quality' move was one factor responsible for the latest phase of strongly declining core yields. Equally important, however, was the fact that central banks have lowered key rates to the zero bound and that they have in addition adopted quantitative easing strategies.

Since mid-2012, however, matters took a turn for the better. For one, the **US economy** has made great progress in overcoming the crisis. The banking system has successfully been recapitalized and the deleveraging process is advanced so that credit growth is positive again. Most economists who are analysing the largest economy of the world now expect growth to move back to above-potential rates of more than 2.5%. In the **euro area**, signs of stress have eased substantially as well. Initially, this was triggered by the 2012 speech of ECB Presi-

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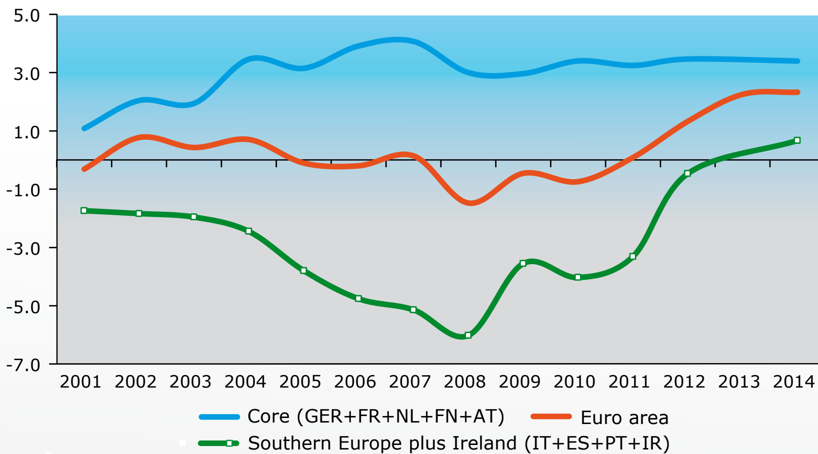
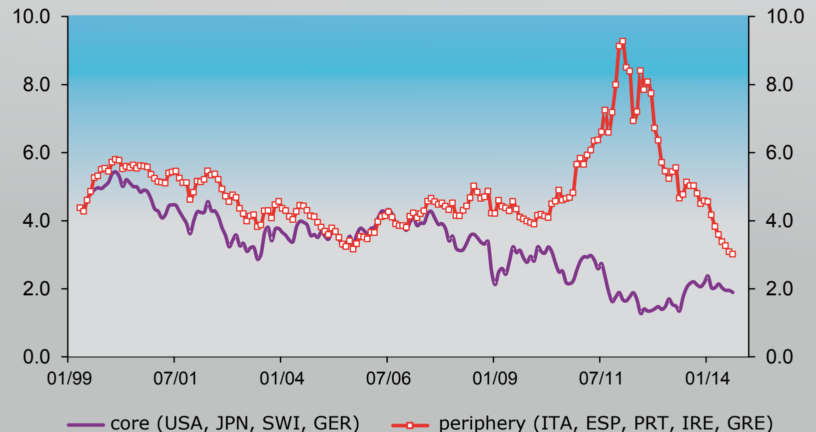
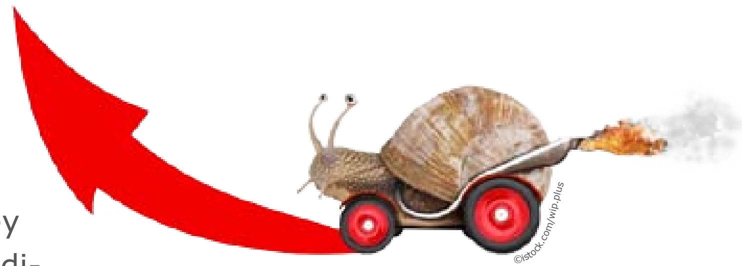


dent Mario Draghi in which he has promised to do 'whatever it takes' to save the euro. However, as time progressed this was underpinned by fundamental improvements. For instance, the current account deficits in Southern Europe and Ireland, one of the most pressing problems of the euro area on fundamental grounds, have successfully been eliminated (see chart). This has brought down the Target2 balances which had received so much attention by euro-skeptics during this crisis. Also, the banking system in the euro area was recapitalized strongly. In fact, Core Tier1 ratios are now twice the pre-crisis average.

All these factors have strongly brought down yields in the so-called peripheral bond markets. In fact, in Spain, Italy and Ireland yields have fallen to levels which could be hardly imagined at the height of the euro crisis. In the 1 to 3 year segment, yields in all three markets have fallen to all-time lows of less than 1%. The same is true for longer-dated paper where yields are now trading at less than 3%. In the high yield corporate bond market some companies are now even trading at lower yields than similar debt from the core. This is yet the strongest sign that **financial fragmentation** in the euro area is easing. What is noteworthy in the general yield picture is the fact that borrowing costs in the crisis-hit bond markets have fallen substantially (even Greek paper now trades at less than 7% in the 10-year segment, a landslide move from the high-double-digit figures reached at the peak of the crisis), yet core yields in the euro area have failed to move higher. This is in stark contrast to the market movements during the heydays of the crisis when a clear negative correlation between core and peripheral yields in Europe existed (see chart). What are the reasons that this correlation has turned pos-



itive, thereby failing to lift core government bond yields to more normal levels?

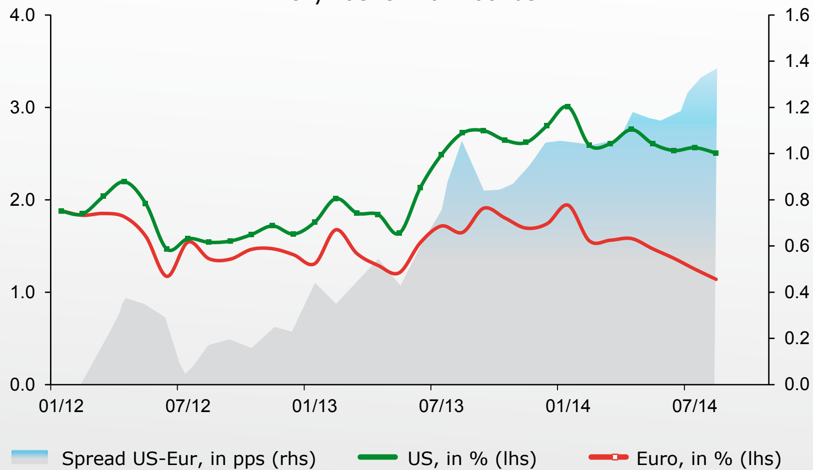


Above all, the main 'culprits' are **central banks**. With key rates so low, they pin long-term yields at levels where creditors get even harmed in real terms. Some market participants have argued that this is done deliberately to help governments bring down debt levels in real terms. In the economic literature, this has been dubbed 'financial repression'. We doubt, though, that this is the main reason. Above all, with inflation rates generally low, real yields are just not low enough to make a big difference for government debt levels. Historically, financial repression was successful when real rates were as low as minus 3 to minus 4 %. Today's levels are much higher as real rates are not much different from zero in the core and still decidedly positive in Southern Europe.

More importantly, we think that key rates are kept so low to help the economies get going again ('**credit easing**'). And this is unlikely to change any time soon. In the US, the Fed will spend year 2014 to unwind its quantitative easing program gradually, i.e. very cautiously. And only if labour market conditions have improved further, will a first rate hike be implemented. That said, even if a rate hike cycle is set in motion in mid-2015 as we expect, it will this time be much milder than in previous episodes. This has recently been highlighted by Fed Chairwoman Yellen who has argued that key rates will this time rise at a much slower pace than standard models of monetary policy would suggest (e.g. Taylor rule). Since inflation is likely to remain in check against the backdrop of stable energy prices (courtesy of the increased 'fracking' activities in the US), muted wage gains, and low credit growth, long-term yields will not rise too much as well. In our long-term projections for the coming three years, we envisage the upward move of the yield in 10-year Treasuries to stop at around 3.5%, a level still not high by historical standards.

For the euro area, the case for **meagre long-term yields** for longer is even stronger. For one, the growth trajectory of the euro area will remain extremely low given an ongoing need to restructure in some large euro area economies. In this respect, France and Italy stand out. If anything, we expect euro area growth

to move back just north of 1% for the coming three years. Second, since international price competitiveness is not sufficiently high yet internal devaluations will still be needed to improve external balances. In a monetary union, this can only be achieved if **inflation rates** are lower than abroad. Hence, we expect inflation rates in countries from Southern Europe to remain extremely low, thereby giving the ECB plenty of time to keep key rates at zero. And since core rates will remain low, demand for 'riskier' assets like peripheral bonds will also ensure that yields will stay low in the former crisis countries as well, possibly falling even more. Of course, higher Treasury yields are likely to exert a gravitational pull on yields in the euro area. We doubt, however, that there will be a one-to one relationship. The spread between Treasuries and Bunds is already very wide (see chart). We see a high chance for it to widen even more. As one high-ranking ECB official has put it recently: monetary conditions between the US and the euro are likely to diverge for a long period, 'which will be several years'.



Waiting for Godot?

Systemic risks for the Euro area have fallen greatly and the largest global economy, the US, looks set to grow more strongly. However, with monetary policy still biased towards caution following the unprecedented series and depth of crises and inflation rates so low as a result, we do not expect government bond yields to rise strongly from here. Since investors' hunger for yield will in this environment remain very large, this even applies for markets which were under intense pressure during the crisis. Emanating from the US, there may be mild push for euro area yields to move higher. That said, it will not be a large one. So while Godot may finally show up, he could turn out to be much smaller than many investors are hoping for.

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