OPINION

Economics focus

Down but not out

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Can bond yields fall further?

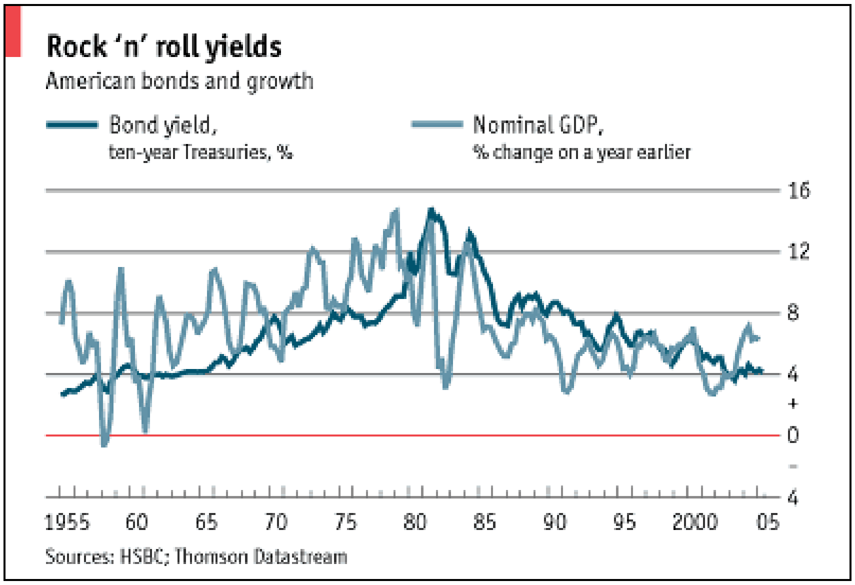
THINK the unthinkable: America's long-term bond yields may be heading down, not up. On May 31st, the yield on ten-year Treasuries dipped below 4% for the first time since early February. There are special circumstances, not least the fact that some investors are deserting Europe in this week of the *non* and the *nee*. But the debate over bond yields, unusually vociferous since February, when Alan Greenspan, chairman of the Federal Reserve, queried the refusal of long yields to rise when he pushed up short rates, has just increased a decibel or two. And the voices on the side of falling yields are getting louder.

At issue are two apparently strange phenomena. The first is the general level of bond yields. These are already low, by recent standards—in America, far less than the rate of economic growth that many think they should roughly reflect. The second is the yield curve, the gap between yields on long- and short-dated paper. The curve is flattening fast in America: less than half a percentage point separates the yield on ten-year Treasuries from that on two-years, down from more than two points a year ago. It is flat in Britain and Australia, and inverted in New Zealand.

Bond yields and the structure of interest rates matter both for what they do to economic performance and for what they tell us about it. It seems a shame, then, that their message is not unambiguous. Are rates low and curves flat because inflation has broadly been tamed? Is it because economic activity is expected to slump? Or has the link between growth and inflation been changed in some more or less permanent fashion, so that faster growth can take place with slower inflation than in the past?

Take the overall level of interest rates first. In a new paper*, Stephen King, chief economist at HSBC, a global bank, expresses his puzzlement at the failure of most economists to predict yields with anything near accuracy. Swayed by the concepts of “neutral” or “equilibrium” interest rates—sufficient to achieve price stability in the first instance and to balance savings and investment in the second—many have assumed that bond yields should approximate nominal GDP growth rates over time. They have exaggerated American bond yields for the past five years and got them wrong in Britain, too.

As the chart shows, however, the relationship between bond yields and GDP growth has been far from stable. In the 1950s and early 1960s, a time of relatively low inflation and robust economic activity, yields were well below nominal GDP growth rates. Through the 1970s, unexpected inflation pushed bondholders' real returns into the red. And from 1980, burnt by that experience, investors demanded a hefty premium for holding bonds. In the past two years, yields have fallen below GDP growth. Could we be moving back to that much earlier pattern?



Mr King thinks we are, even though the world looks very different now. He predicts that the yield on ten-year Treasuries will fall to 3.5% in 2006, and he is not alone. So does Stephen Roach, chief economist of Morgan Stanley, an investment bank, and until now a deep-dyed bond bear. But why, when America's economic growth still looks strong, its fiscal deficit supposes continued high borrowing, its trade deficit implies an eventual weakening of the dollar, and high oil prices suggest inflationary pressure—all of which normally push up bond yields? Globalisation, demography, cowed corporate executives and god-like central bankers all offer possible reasons why this time is different.

A lack of interest

Globalisation has been the most tramped over. Greater mobility of capital and labour, plus the new prominence of low-cost India and China in world trade, has dampened inflation. To support this new trading order, Asian central banks are content, for the moment, to buy dollar bonds with their savings. And interest rates in one country constrain those elsewhere more than before. Investors in Japan, for example—where yields on the ten-year government bond were this week the lowest since February 2004—take refuge in American assets, thus boosting their price.

The world's ageing workforce is another support for bonds. As baby boomers retire, they tend to switch from securities that eventually produce capital growth (most equities) into those that provide reliable income now (bonds). Stricter rules for matching assets and liabilities are pushing pension funds and life insurers in that direction, too. Company bosses bent on handing cash back to shareholders through share buy-backs and increased dividends imply that the corporate sector cannot supply growth and capital appreciation: this favours investment in assets other than most equities—including bonds.

The god-like central bankers have shaken off overt political control and are seen as invincible inflation-fighters. But this can have perverse side-effects. As the Fed puts up short rates, investors race out and buy more long-term bonds, safe in the knowledge that the dragon will be slain. For all the tightening of policy, monetary conditions are looser than a year ago.

Mr King reckons that a number of these changes are more or less permanent, and that interest rates around the world are likely to remain low for a long while. Will that be with or without economic growth? Is the flattening yield curve performing its traditional function of signalling an economic downturn or just indicating that inflation is no longer a threat?

Recent research on bond yields is bridging the old divide between financial economists and macroeconomists, bringing the latter's economic variables into the former's yield-curve models. A new study† by three American-based economists finds that while the yield curve was the better predictor of America's recession in the 1990s, over time lagged short rates (which are inversely correlated with GDP growth) are more reliable. Both indicators are pointing the same, worrying way now.

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* "From Bondage to the Promised Land". May 2005.

† "What Does the Yield Curve tell us about GDP Growth?", by Andrew Ang, Monika Piazzesi and Min Wei. *Journal of Econometrics*, forthcoming.