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The Treasury-Bund Yield Puzzle

BY MICHAEL HEISE

Low Treasury and Bund yields are continuing to defy market forecasts. With the renewed escalation of the euro-zone debt crisis, 10-year maturities on both U.S. and German government bonds have again fallen well below 3%. They are reflecting neither the visible effects of lower output gaps due to economic recovery, nor somewhat higher inflation, nor these countries' surges in sovereign debt-issuance.

Treasury and Bund prices in light of extremely low interest rates and high public borrowing in the U.S., Japan and many European countries is particularly perplexing. Markets could interpret still-robust business activity and high commodity prices as temporary phenomena, but there is no getting around the reality of sovereign-debt problems. The U.S. financial predicament has become so precarious that the ratings agency Standard & Poor's recently downgraded its outlook for U.S. debt. But markets shrugged that off. Why?

One factor is that in the past two years savings have massively increased practically everywhere. In 2010 the financial balance of the private sector—basically the difference between the savings and investments of households and businesses—stood at 6.3% of GDP in the U.S., 5.2% in the euro zone and 7.6% in the U.K., after showing largely negative values in the years before the 2008 financial crisis. So at least some increase in government debt is being absorbed by the private sector. The same happened in Japan in the mid-1990s, when an increase in sovereign debt, eventually hitting about 200% of GDP, went along with interest rates of between 1% and 2%. Almost all Japanese government bonds are bought by Japanese investors, mainly in the financial sector. This includes the central bank, the still state-owned post office bank and government pension funds.

We can also compare aspects of the present situation with Europe's post-war years, when we also saw an extended period of low bond yields (even negative real yields) despite the fact that numerous countries were grappling with exorbitant levels of sovereign debt. In part this could be explained by the nature of the financial markets back in those days, when pervasive regulation and rigid interest-rate ceilings were the order of the day. In an informative and much-quoted paper this year, economists Carmen Reinhart and Belen Sbrancia show that it was this brand of financial repression that allowed countries to liquidate a substantial part of their sovereign debts after the war.

Why U.S. and German government bonds remain low—for now.

Today there are different, more sophisticated instruments to stoke demand and keep the yields on government paper low. Guided by the maxim of a stable financial system, the liquidity regulations under Basel III and the capital requirements of Solvency II are nudging banks and insurance companies towards secure investments—with government bonds deemed the most secure investments of all. Meanwhile, central banks' monetization of sovereign debt lost its taboo some time ago, and direct purchases of traded government bonds have since become a key tool in the monetary policy arsenal. What is more, extremely low short-term interest rates now serve as a sort of "interest-rate anchor" for the long end of the yield curve. While demand is rising, the financial crisis has depleted the supply of safe bonds: Fewer countries enjoy top-notch ratings and the markets for asset-backed securities have more or less collapsed. Higher demand and a smaller range of safe investments on offer spells rising prices and falling yields on safe-haven markets.

Against this backdrop, what can we expect for yields in the next year or so? First, assuming that eventually Europe's leaders contain their debt crises and overcome the market's fears of default, Treasury and Bund yields could rise by as much as 0.7 percentage points. This is our estimate of the crisis premium, a residual in the interest rate not explained by fundamental factors like growth, inflation and savings rates.

In the medium term there are other crucial factors for long-term interest rates. Will emerging markets and other surplus countries like Japan sustain their high demand for safe bonds? This seems very likely, as their currencies are strong vis-à-vis the U.S. dollar and therefore they have an incentive to keep buying Treasuries to avoid losing competitiveness. The disconcerting implication of this is that global imbalances will remain high. Will central banks will keep their rates low for some time to come, and thereby provide an anchor for bond yields? Yes, probably, despite small rate hikes by the European Central Bank and the abandonment of quantitative easing in the U.S. So for investors, the somewhat paradoxical conclusion is that, despite towering government debt and considerable capital requirements facing many countries, bond yields may rise only moderately.

So far so good. But what would happen if confidence in U.S. fiscal policies really crumbles and Washington takes no convincing steps to avoid a payments default? Presumably interest rates would shoot upward and the dollar would be pushed downward. That would be a test we can all hope to avoid.

Mr. Heise is chief economist and head of corporate development at Allianz.