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# Repression on bonds heralds masochism

By Gillian Tett

Almost exactly a year ago, the economists Carmen Reinhart and Belén Sbrancia wrote a path-breaking International Monetary Fund paper about “financial repression”. It initially caused many western investors to blink. For while such “repression” has been extensively discussed in emerging markets in recent years, not many people in America knew what this dark-sounding phrase meant. (Answer: “financial repression” occurs when governments engineer a situation in which investors feel compelled to buy bonds at unfavourable rates, ie below the prevailing level of inflation, thus helping to reduce national debt.)

How times change. A year later, the word “repression” is being bandied about at investor conferences across the western world. No wonder. In the eurozone, there are growing signs that governments in places such as Spain and Ireland are “encouraging” – if not forcing – banks and state pension funds to buy public sector bonds, at potentially unfavourable prices.

Meanwhile, in America something just as remarkable is under way: investors are gobbling up government debt at unfavourable rates without needing to be “repressed” at all. This week, demand for 10-year Treasuries was so high – as fears exploded about the eurozone – that the US government sold debt with a record low coupon of 1.75 per cent. And while the nominal yields on 10-year Treasuries, of about 1.91 per cent, are above last year’s lows, in real terms they are in negative territory, given inflation over 2.5 per cent.

Anybody buying Treasuries, in other words, is essentially agreeing to subsidise the US government in coming years – unless you believe that deep deflation looms. Call it, if you like, a form of “voluntary” repression; either way, it will almost certainly end up helping the US state, to the detriment of investors.

So can it continue? If you ask US policy makers and financial officials that question, you are apt to hear an embarrassed cough. Last week, for example, I questioned a group of Federal Reserve presidents at a debate at the University of California, Santa Barbara. In public, none of those Fed leaders was willing to describe the picture as overt “repression”. After all, they said, monetary policy in America is independent, meaning that the raison d’être of the Fed’s super loose monetary policy is to boost economic demand, not support fiscal policy. If this helps cut debt, this is just a happy accident; or so the argument goes.

Nevertheless, what is crystal clear is that Fed and Treasury officials alike are determined to keep those Treasury yields ultra low, if not negative in real terms, for the foreseeable future. And they may well succeed. Never mind the fact that the Federal Reserve has been gobbling up Treasury bonds, as part of its loose monetary policy; or that private sector banks are raising their holdings of government debt to satisfy new regulations, such as the Basel liquidity coverage ratios. What is more fascinating is how investors are stealthily embracing a “voluntary repression” mindset too.

Consider what has happened with US pension funds. Five years ago, these typically had a 60 per cent equity allocation, with 30 per cent in bonds. But last month, according to the Milliman survey, the top 100 funds placed 41 per cent of their $1,300bn worth of assets in fixed income – topping the equities ratio for the first time. That shift might have looked rational a few years ago; after all, annualised returns for Treasuries in the past decade have been 6.8 per cent, versus 2.9 per cent for the S&P 500.

But the timing looks terrible, given that, as David Goerz, chief investment officer of HighMark Capital says, “a 2 per cent Treasury yield is equivalent to a price/earnings ratio of 50x compared to a forward earnings multiple of 13x for the S&P 500 today”. Or to put it another way, it would make more sense, Goerz says, for funds to switch back into equities.

Alternatively, managers such as Scott Minerd of Guggenheim, think investors should be looking to corporate bonds for decent returns. But the experience of 2007 and 2008 has left investors so scarred – and scared – they are more focused on capital preservation and liquidity, than returns. Or to put it another way, if everyone else (including the Fed and banks) is piling into Treasuries, many investors want to follow the crowd. Correlation of fear rules the day.

This creates big risks in the long run; if inflation suddenly surges, growth resumes, or there is another US fiscal row that creates default scares, prices could swing and many investors will get badly hurt. But, in a world awash with spare cash, it is a fool’s errand to predict exactly when this bubble might burst. I suspect we could see this voluntary repression prevail for some time; or call it, if you prefer, the era of mass market financial masochism.