

Bond buyers should be mindful of history

By Burton Malkiel

Equities entail less risk than 'haven' investments

Investors have been fleeing to "safety". US 10-year Treasury yields fell to less than 1.5 per cent earlier in June, a level not witnessed since 1946 when interest rates were pegged. German 10-year yields fell to an all-time low near 1 per cent. Some very short-term Federal rates were negative, implying that investors were willing to pay governments considered financially stable for the privilege of holding their money. Global equity markets have fallen sharply.

Investors appear to be far more concerned with the return of, rather than a return on, their money. Since 2008, more than \$1tn have been moved from equity funds to bond funds. Similar shifts from equities to bonds have characterised US pension fund allocations.

But does this [flight to so-called havens](#) really provide investors with the protection they desire? Or, are bond buyers making a huge mistake that is likely to guarantee them a period of negative real (after inflation) returns? The answer is almost certainly the latter. Bonds today in countries such as Japan, Germany, and the US are more expensive than at any time in history. Bond investors face virtually sure losses and equities are as attractive as they have been in a generation.

We can illustrate the fundamental unattractiveness of bonds with the US market. The buyer of a 10-year US Treasury bond at a 1.5 per cent yield to maturity will receive a nominal return well below the current rate of inflation and below the Federal Reserve's informal target rate of inflation of 2 per cent. Thus, even if inflation does not accelerate, long-term US Treasuries will provide a negative real rate of return. If inflation does accelerate, that real rate of return will be further reduced.

It is important to remember what happened to bond investors the last time that Treasury bond yields were at 1.5 per cent, in 1946. Bond yields remained pegged at low rates until the early 1950s to enable the government to more easily finance the debts from the second world war. Therefore, bond prices remained fairly stable. But moderate inflation reduced the real value of both coupon payments and the face value of the bonds, and bondholders lost considerable purchasing power. And that was only the beginning of the pain.

Interest rates began to rise to more normal levels and bond prices started to fall. Oil and food shocks then boosted inflation further and, by the end of the 1970s, bond yields had increased to double digit levels. Thus, bond owners not only earned negative real income returns but also suffered punishing capital losses. No wonder a "bond" came to be considered an unmentionable four letter word and bond investors came to believe they had in effect been slaughtered. Investors should be mindful of history. The current era of financial repression may well lead once again to the euthanasia of the bondholding class.

All the developed countries of the world are burdened with excessive amounts of debt. As in the US, governments around the world are having an extraordinarily difficult time reining in entitlement programmes in the face of ageing populations. The

easier path for the US government is to keep interest rates artificially low as the real burden of the debt is reduced and the debt is restructured on the backs of the bondholders. We reduced the debt to gross domestic product ratio in the US from 122 per cent in 1946 to 33 per cent in 1980. But it was achieved at the expense of bondholders.

Equities are reasonably priced and are downright cheap in comparison with bond alternatives. Price-to-earnings multiples and multiples of book values are below recent averages. Dividend yields on stocks are well above bond yields. The dividend yield on AT&T stock is double that on AT&T 10-year bonds, and AT&T has been increasing its dividend at about 5 per cent per year.

Emerging market equities are even cheaper. Prior to the world-wide recession that started in late 2007, developed-market P/E multiples were 10 per cent higher than those in emerging markets. Today emerging-market multiples are more than 10 per cent below those in developed markets. And emerging markets have better fiscal balances, lower debt to GDP ratios, and younger populations.

A generation ago there was widespread dissatisfaction with equities. We had lived through the 1970s when equities produced negative real rates of return. Business Week described the situation as “The Death of Equities”. Equities then produced spectacular double digit returns through the turn of the century. Today, “death of equities” talk is equally widespread. No one can tell when global equity markets will shake off the intractable pessimism that characterises investors. But I would submit that equity investments in today’s market environment entail less risk than the “safe haven” bond investments favoured by so many investors.

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