



Global bonds: How low can they go?

BY VINCENT LÉPINE

Given that the level and direction of long-term bond yields significantly impact the value of pension plan liabilities and assets, it is not surprising that plan sponsors are closely monitoring global bond markets.

Around the world, bond yields have been trending lower for the past 25 years, dropping from more than 12% in the mid-1980s to less than 3% in the mid-2000s. This is due to one crucial development: the world's central bankers' victory against inflation in the late 1980s.

Following that victory, and during the ensuing decade, central banks remained vigilant and successfully kept inflation at bay, resulting in a gradual decline in interest rates. As

inflation stabilized, investors stopped demanding inflation premiums, allowing bond yields to move even lower. Now that bond yields are flirt-

ing with their cyclical lows, one can't help wondering if a trend reversal is around the corner.

INFLATION VS. DEFLATION

The future direction for bond markets could depend on which threat central bankers believe is the greatest threat for the world economy — inflation or deflation.

For the past quarter century, inflation has been their top concern. However, now that inflation in the industrialized world is well-contained and relatively low by historical standards, the answer to this crucial question is not as clear.

At first glance, there seems to be very little reason to believe that central banks could stop worrying about inflation anytime soon. The problem is that central bankers could now become victims of their own success. The continued decline in interest rates has done wonders to consumers' wallets. Since the early 1980s, the net worth of North American households has almost quadrupled.

Unfortunately, declining interest rates also encouraged consumers to take on a lot more debt. According to statistics from the U.S. Federal Reserve, mortgage debt now represents an unprecedented nearly 50% of total real estate equity.

This increase in consumer debt loads has been more than offset by the rapid value appreciation of their tangible and financial assets. Since 1985, home prices climbed by more than 200% in the United States (U.S. Census Bureau), and by 120% in

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Canada (Statistics Canada.) However, given current debt levels, the prospect of Japanese-style deflation is downright terrifying.

THE WORSE OF TWO EVILS

Japan's experience with mild deflation since the early 1990s is a constant reminder of how painful deflation can be. A decline in consumer

prices of less than 1% per year has been associated with years of painfully slow growth, rising unemployment, a multi-year decline in the value of tangible assets, and a very long bear market in equities due to intractable financial problems in the banking and corporate sectors.

How did Japan get into this predicament? It all started in the late 1980s with deeply overvalued equity and real estate markets. Both home and equity prices started falling, lethally hitting consumers' wealth. As the economy plunged into recession, the Bank of Japan reacted too slowly, allowing deflation to set in. The result was a prolonged period of anemic economic growth, persistent deflation and a very long and strong bull market in Japanese bonds.

If deflation starts outside Japan, the long-term downtrend in bond yields will remain in place. However, central banks have learned from the Japanese experience. To prevent deflation from occurring, central banks preserve a buffer zone for the inflation rate. Up until now, central bankers have generally been targeting inflation at around 2%. However, one can wonder if this reality is sufficient.

When the economy dips into recession, inflation typically starts decelerating sharply soon thereafter. During the last global recession in 2001, the U.S. core inflation rate dropped from more than 2.5% to close to 1% in less than two years.

This drop happened in the context of rising home prices. In the context of falling home prices, there is a high probability that inflation would decelerate much more, flirting with deflation.



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Given the amount of mortgage debt held by households, and the overvaluation of home prices in many regions of the world, central bankers could be very tempted to preserve a bigger buffer zone by letting inflation rates accelerate. In other words, from this point on, central bankers could be spending more time worrying about deflation than inflation.

This implies that the monetary policy stance could, on average, be kept more often accommodative than restrictive, turning the structural backdrop increasingly bearish for bonds. As inflation starts grinding higher, long-term inflation expectations would start drifting higher, putting upward pressure on long term bond yields.

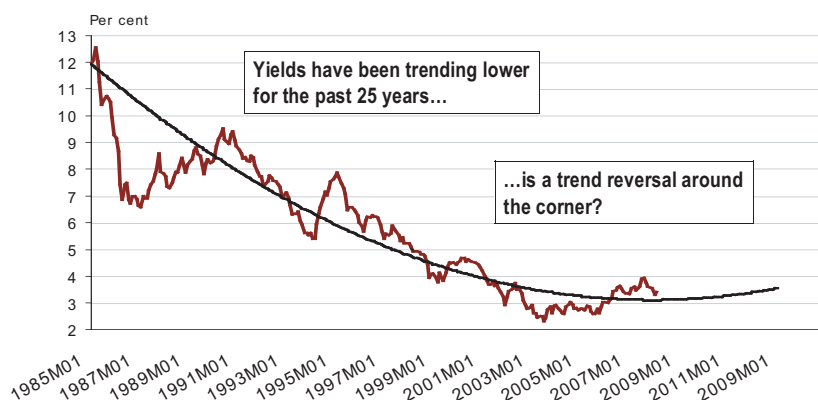
DARKENING LONG-TERM OUTLOOK FOR BONDS

Holding a very bearish long-term view on bonds requires a strong conviction that the world is heading for a permanent regime shift from a low- to a high-inflation environment.

Ultimately, this could only happen in the context of a shift in central

HOW LOW CAN BOND YIELDS GO?

Global 10-year bond yields and secular downtrend



SOURCE: Datastream & CIBC Global Asset Management Inc.

banks' priorities from fighting inflation to avoiding deflation.

In the current context of low inflation, frothy real estate prices and historically elevated consumer debt burdens, deflation looks more and more like the worst of the two evils. We suspect that in situations of heightened uncertainty, world central banks will increasingly err on the side of inflation rather than deflation. In short, the long-term outlook for bond markets appears to be darkening.

At this juncture, all eyes are now on the Federal Reserve. With the U.S. economy flirting with recession, and home prices falling, the risks of a deflationary bust have significantly risen. Judging by its quick reaction, the Fed is fully aware of the risk represented by a multi-year decline in home prices. The result: higher inflation over the next several decades. – I²

Vincent Lépine is VP of research at CIBC Global Asset Management Inc. (www.cibcam.com). The views expressed in this article are the personal views of the author and should not be taken as the views of CIBC Global Asset Management Inc. or Canadian Imperial Bank of Commerce. All opinions and estimates expressed in this article are as of Jan. 31, 2008, unless otherwise indicated, and are subject to change.