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GLOBAL MARKET COMMENT

GLOBAL GOVERNMENT BONDS: BLOWING BUBBLES

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Robert Lang
Marcelo Morales

Global Government Bonds
Blowing Bubbles

Is it only possible to identify an asset bubble after it has burst (as Federal Reserve Chairman Alan Greenspan has controversially contended)? Judging by the frequency with which the global government bond markets have been characterized as a bubble this year, the pundits certainly deem otherwise. Before the market reversed course sharply in recent weeks,[1] ten-year bond yields had fallen to multi-year lows, pressured by central bank efforts to reflate their economies. From their recent peaks to their June 2003 troughs, yields on U.S. Treasuries dropped from 6.68% (January 2000) to 3.13%, U.K. gilts, 5.41% (September 1999) to 3.89%, German bunds from 5.58% (January 2000) to 3.44%, and JGBs from 2.01% (February 1999) to 0.43%.

The Message of Real Yields[2]

However, while nominal yields are relatively low by historical standards, real yields remain relatively high—only in Japan are they well below average (see Table A). Current real U.S. Treasury yields are 2.26%, only 0.2 standard deviations below their 41-year average of 2.75%. In the United Kingdom, real gilt yields are 1.45%, only 0.3 standard deviations below their post-1958 average of 2.52%. The real yield of German bunds is 3.07%, 0.8 standard deviations below their 26-year average of 3.99%. Only in Japan, where the real yield of JGBs is 1.36% does this exceed one standard deviation from the historical average (JGBs' 1.36% real yield is 1.24 standard deviations below their post-1982 average of 3.17%).

Nominal Bonds

	Yields (%)	Standard Deviations Below Historical Average
U.S.	4.42	1.2
U.K.	4.39	1.5
Germany	4.07	1.7
Japan	0.95	1.5

Real Bonds

	Yields (%)	Standard Deviations Below Historical Average
U.S.	2.26	0.2
U.K.	1.45	0.3
Germany	3.07	0.8
Japan	1.36	1.2

[1] In only six weeks, U.S. Treasury yields have jumped 129 basis points (bps) to 4.42%; U.K. gilts, 50 bps to 4.39%; German bunds, 63 bps to 4.07%; and Japanese Government Bonds (JGBs), 52 bps to 0.95%!

[2] There are a variety of ways to measure real yields, each with its shortcomings. For the purpose of this exercise, we use ten-year government bonds, less 12-month trailing core consumer price inflation. Because trailing inflation does not measure inflation *expectations,* it misses important inflection points in price changes. While inflation-linked bonds incorporate inflation expectations, their short history and less liquid markets relative to conventional bonds makes them a less than ideal measure of real yields.

Other Real Yield Measures: Rich But Not Bubbles

If inflation-linked bonds are used as the basis for measuring real yields, one arrives at a similar conclusion. Yes, the 1.71% yield of ten-year U.S. TIPS on June 30 is 2.7 standard deviations below their six-year average of 3.44% (see Table B), and U.K. Linkers, at 1.69% are similarly 2.2 standard deviations below their long-term average of 3.25% (see Table C), directly reflecting reduced inflation expectations in both economies; however, this still constitutes a relatively attractive real rate of return by historical standards.

Real rates on short-term notes, which central banks can affect more directly through their use of policy interest rates, convey a similar story as do ten-year notes: low, but within historical ranges (see Table D). In the United States, real two-year notes yielded -0.53% as of July 22, which was 0.4 standard deviations below the 62-year mean of 0.95%; in the United Kingdom, *three*-year notes yielded 0.77% as of July 23, which was 0.4 standard deviations below the 40-year average of 2.18%. In Germany, where inflation has generally been more stable since the late 1960s than in other developed economies, two-year schatz real yields, at 1.36%, are 1.4 standard deviations below the 36-year average of 3.14%. In Japan, two-year notes offered a real yield of 0.50%, which is 1.0 standard deviations below the 22-year average of 2.27%.

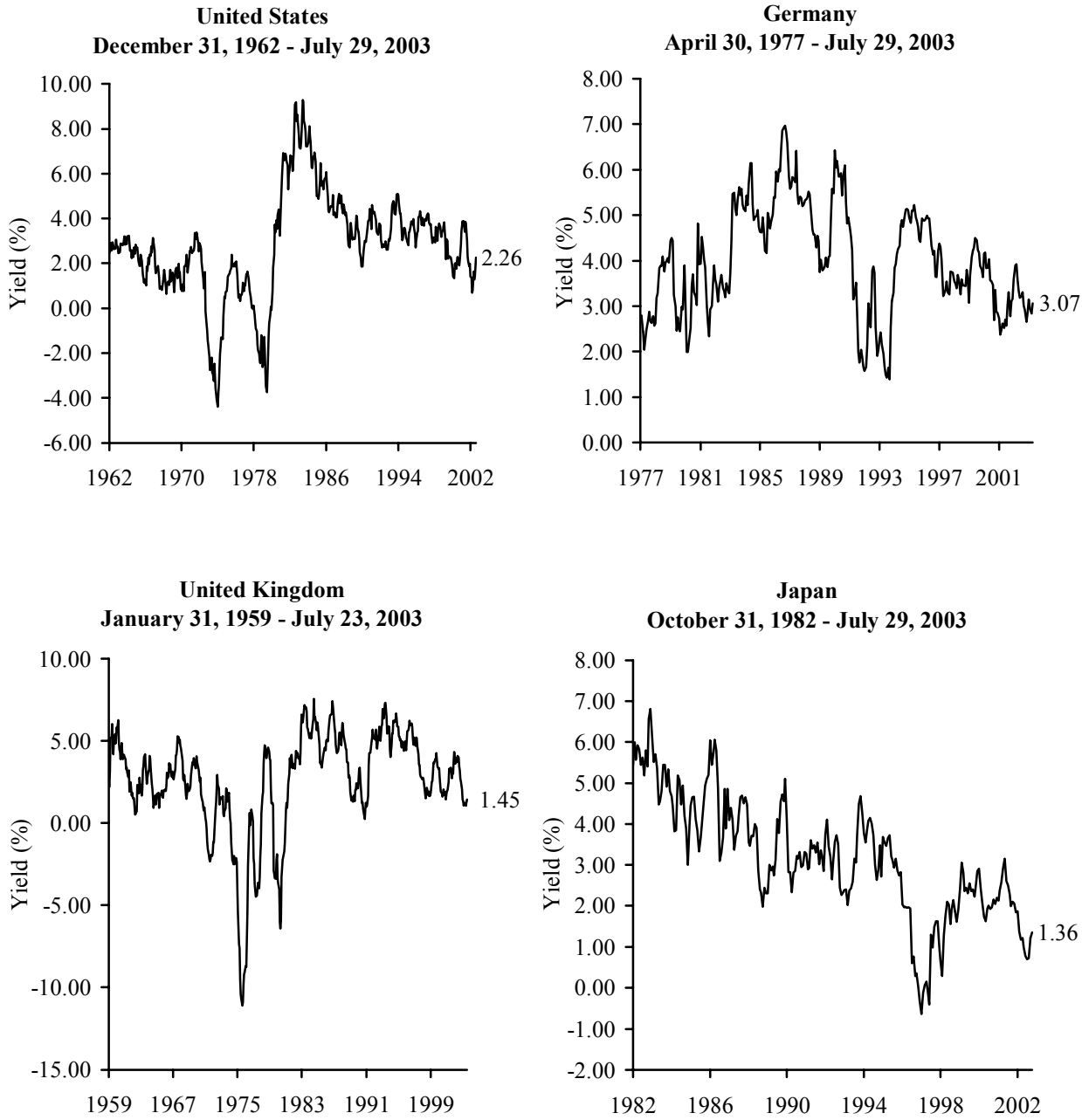
So What?

The bottom line is that one cannot make a case that global real interest rates are abnormally low across the yield curve—what *is* relatively low by post-WWII standard is the rate of inflation and inflation expectations, and therefore (by extension) the *nominal* yield on government bonds. The real yield curve, however, is unusually steep, which means that despite central banks' strenuous efforts to reflate their economies through lower policy rates, this has not translated into a bonanza of *de minimus* cost of capital for corporate borrowers. To the extent that firms base their capital expenditures on the real cost of borrowing, its "stickiness" may be dampening their enthusiasm for further investment.

In addition, the fact that real bond yields are only slightly rich suggests that investors should be wary of pundits who recklessly toss around the term, "bubble." Happy to concede a few years ago that no one can predict either inflation or interest rates with any consistent success, these prognosticators now eagerly insist they can do both because they "know" rates can only rise from here. We have no idea what interest rates or inflation might do over the next six or 12 months, and the fact that real bond yields are not far from their historical averages simply confirms our aversion to allocating assets on the basis of any such presumption.

Table A

REAL YIELDS FOR TEN-YEAR GOVERNMENT BONDS IN LOCAL CURRENCY



Sources: Bureau of Labor Statistics, Global Financial Data, and Thomson Datastream.

Notes: Real yields represent the difference between nominal bond yields and inflation, plotted monthly, using trailing 12-month inflation to deflate yields. Consumer Price Index was used for Germany and Japan. The CPI-U was used for the United States and the UK Retail Price Index was used for the United Kingdom.

Table B

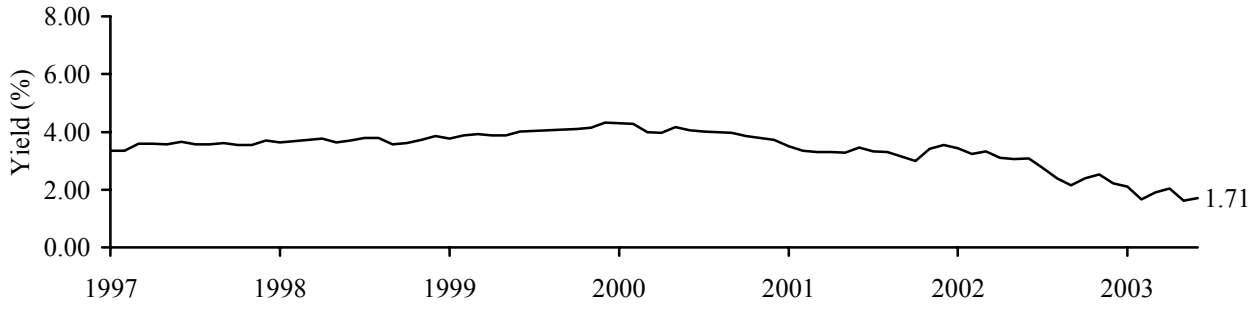
INFLATION EXPECTATIONS AND TEN-YEAR TREASURY YIELDS

January 31, 1997 - June 30, 2003

Inflation Expectations

Ten-Year Treasuries

Ten-Year Treasury Inflation-Protection Securities (TIPS)



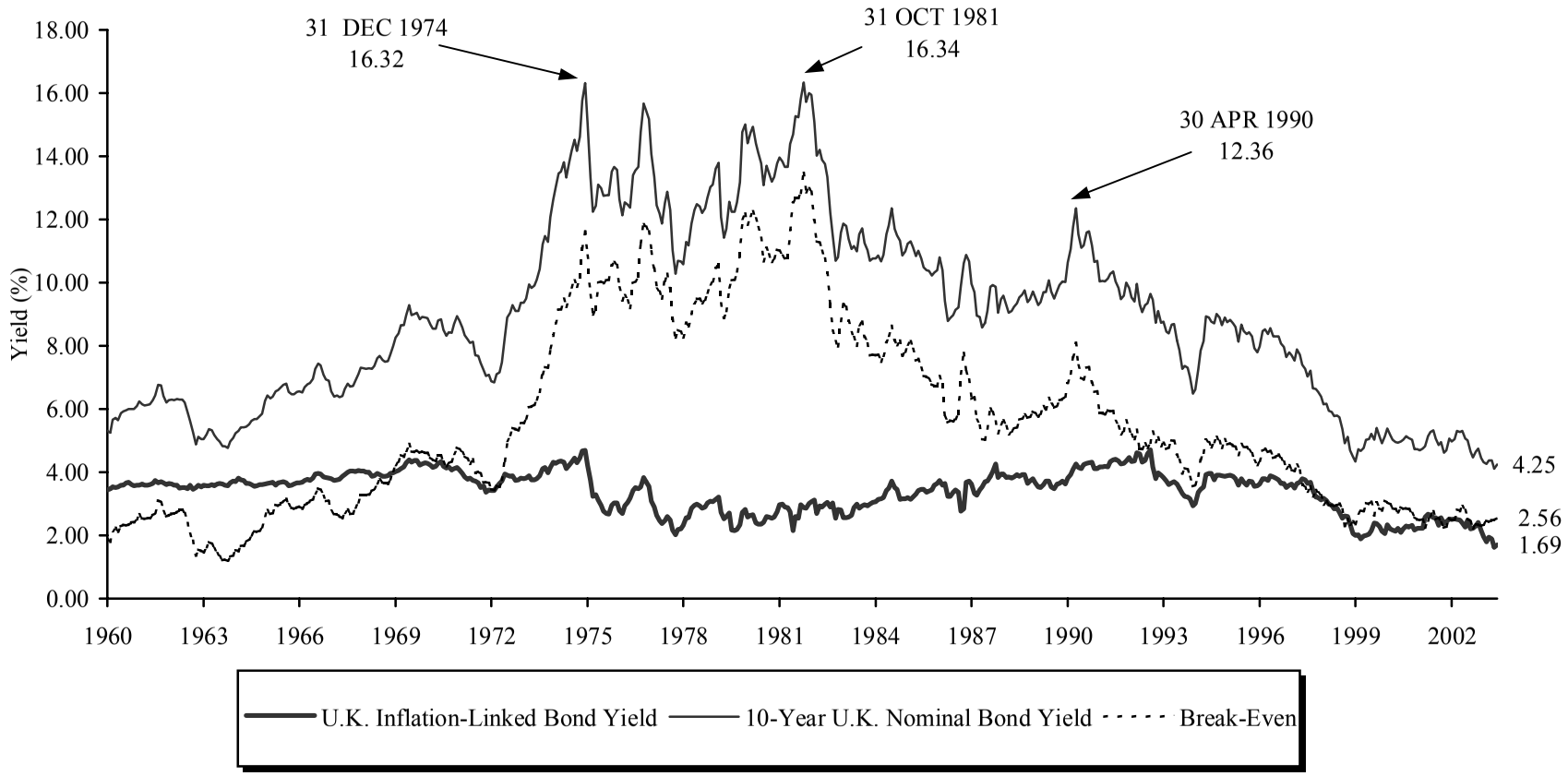
Sources: The Bloomberg and Thomson Datastream.

Note: Inflation expectations are based on the yield spreads between ten-year Treasuries and TIPS.

Table C

U.K. TREASURY YIELDS

January 1, 1960 - June 30, 2003

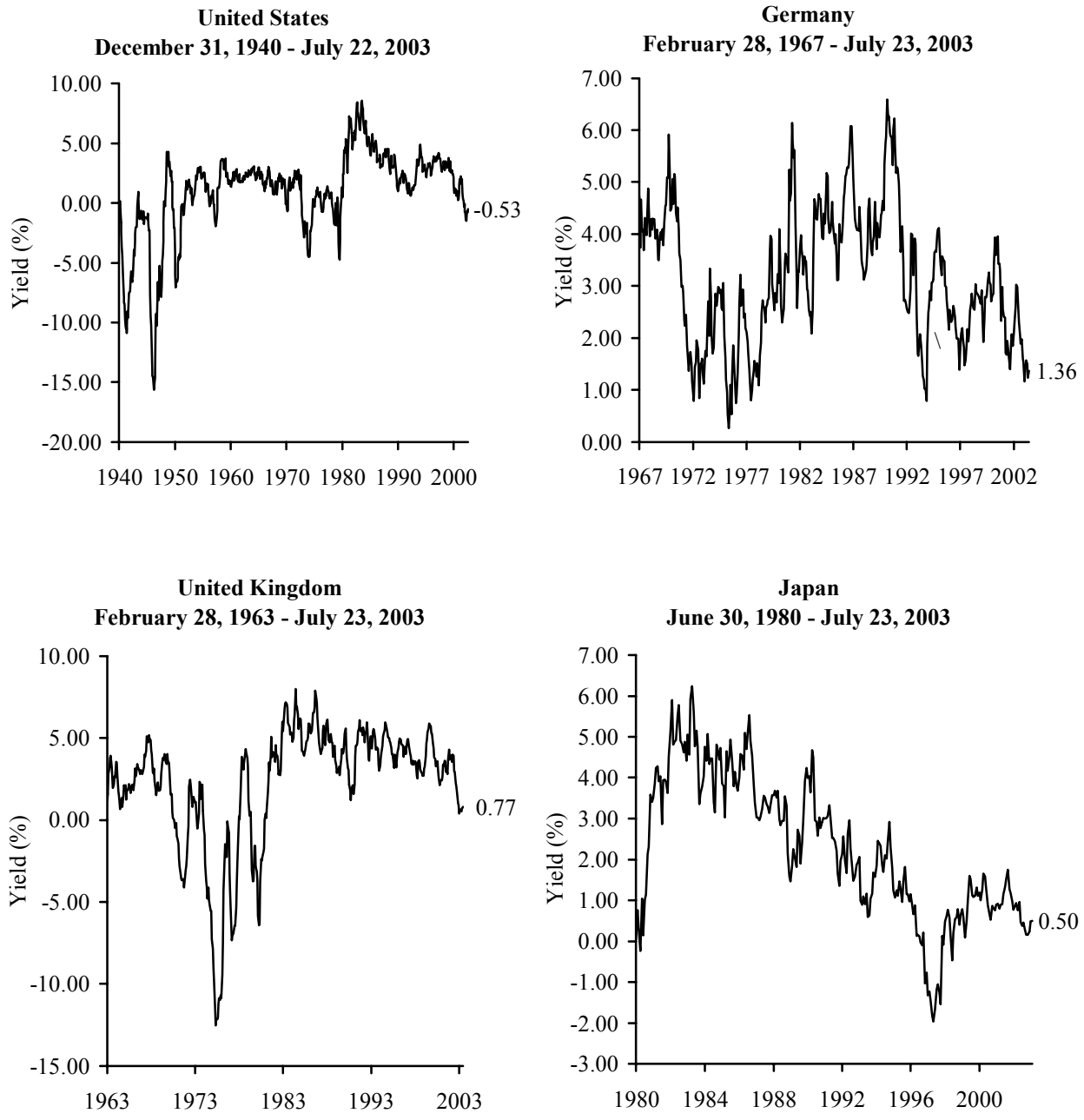


Sources: Bridgewater Associates and Global Financial Data.

Note: The Bridgewater 10-Year U.K. Inflation-Linked Bond Yield is simulated from 1960-80 and is live from 1981-2003.

Table D

REAL YIELDS FOR SHORT-TERM GOVERNMENT BONDS IN LOCAL CURRENCY



Sources: Bureau of Labor Statistics, Global Financial Data, and Thomson Datastream.

Notes: Real yields represent the difference between nominal bond yields and inflation, plotted monthly, using trailing 12-month inflation to deflate yields. Consumer Price Index was used for Germany and Japan. The CPI-U was used for the United States and the UK Retail Price Index was used for the United Kingdom. The U.S., German, and Japanese yields are two-year government notes, while the U.K. yields are three-year government notes.