Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

AUGUST 20, 2014

BONOS, BTPS, AND BUNDS: COMPARING GLOBAL GOVERNMENT BOND YIELDS

Government bond yields from Germany to Spain continue to fall. Last week German 10-year bond yields made historic lows and dipped below 1% for the first time. In Spain and Italy, 10-year bond yield dropped 400 basis points since 2012, leaving both Spanish and Italian government securities with yields similar to US Treasury securities of the same maturity. How is it possible that the most creditworthy government in the world (the US) has bond yields on par with two of the most indebted European nations? What pushed Bund yields under 1%?

For some, this spectacular rally is yet another symptom of a global reach for yield, as investors struggle through the continued zero interest-rate policy world and possible QE from the ECB. However, as intuitively comfortable as that thesis may be ("it's all just a bubble caused by central banks!"), we suggest that economic fundamentals account for low bond yields in the euro area. Together, growth, inflation and future short-term interest rates explain much of the low bond yields in the euro area.

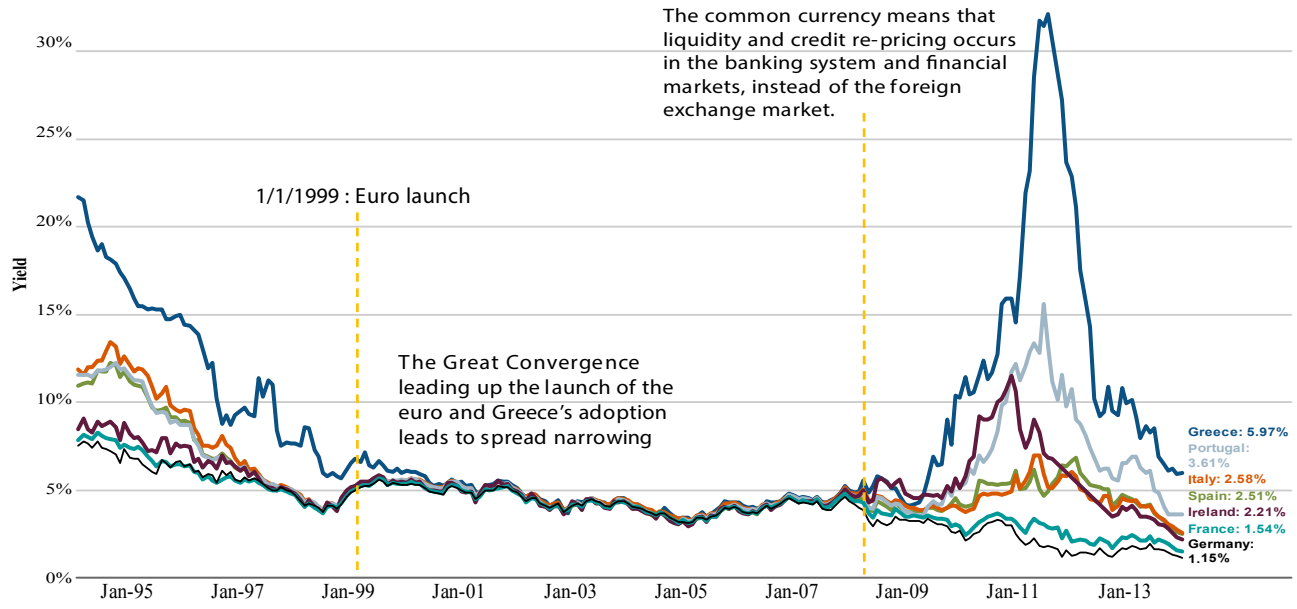
Ever since July 2012, when Mario Draghi pledged that the European Central Bank (ECB) would "do whatever it takes to preserve the euro," European bond yields have fallen and the euro has been relatively strong when compared to the dollar. Where previously investors demanded compensation for the risk of the dissolution of the monetary union, today bond buyers can scarcely remember "break-up risk" premiums. In the forgetting, yields have rallied significantly (See Chart below).

But honey-mouthed policy makers and classic market amnesia alone do not explain low yields: after all, we are talking about the lowest bond yields in history!

To begin, recent data showed that the euro area economy did not grow at all in the second quarter. Not that this quarter is unique. Over the past five years, nominal GDP growth averaged just 0.1% in Italy, -1.1% in Spain and 1.1% across the euro area as a whole. Since average nominal GDP growth is a rough valuation metric for sovereign bonds, low bond yields make sense. In the US, for example, nominal GDP growth on it own suggests yields should be around 3% (See top Chart on opposite page).

So growth explains some of the diminutive interest rates we see on sovereign debt, but inflation dynamics may be the primary drivers of differences in yields across the developed world. Even as US consumer prices increase by roughly 2% every year, CPI in the euro area has

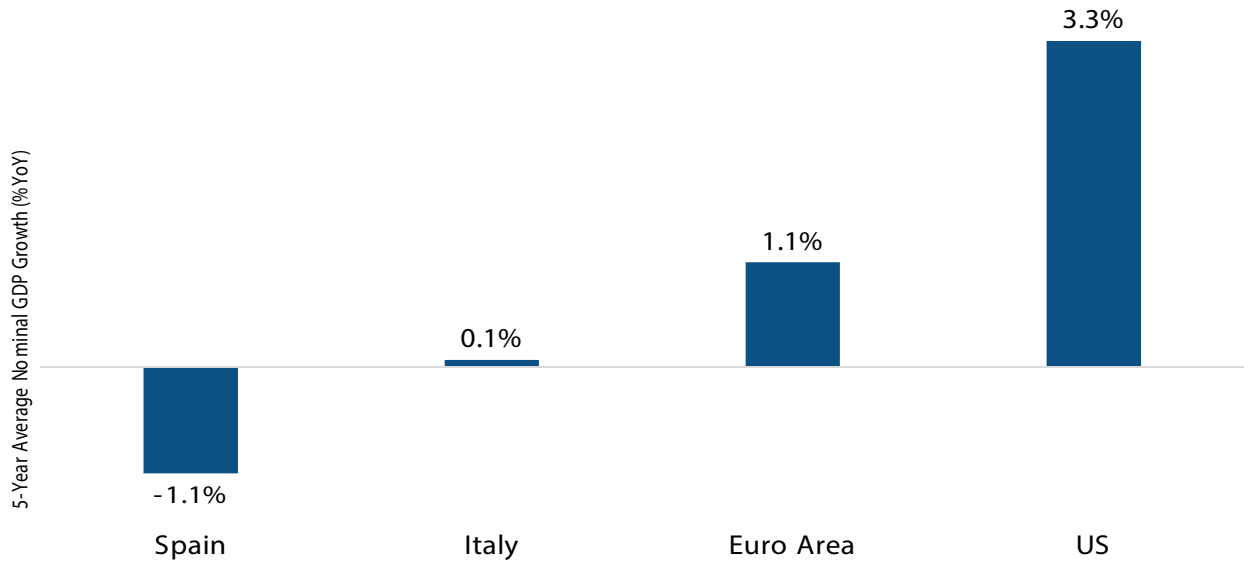
EUROPEAN BOND YIELDS HAVE CONVERGED ONCE AGAIN, AFTER MARIO DRAGHI AND THE ECB PLEDGED TO DO "WHATEVER IT TAKES TO PRESERVE THE EURO"



Source: Thompson Reuters

*Bond yield data is monthly

(%YOY) 5-YEAR AVERAGE NOMINAL GDP GROWTH ACROSS THE DEVELOPED WORLD: NO WONDER BOND YIELDS ARE LOW



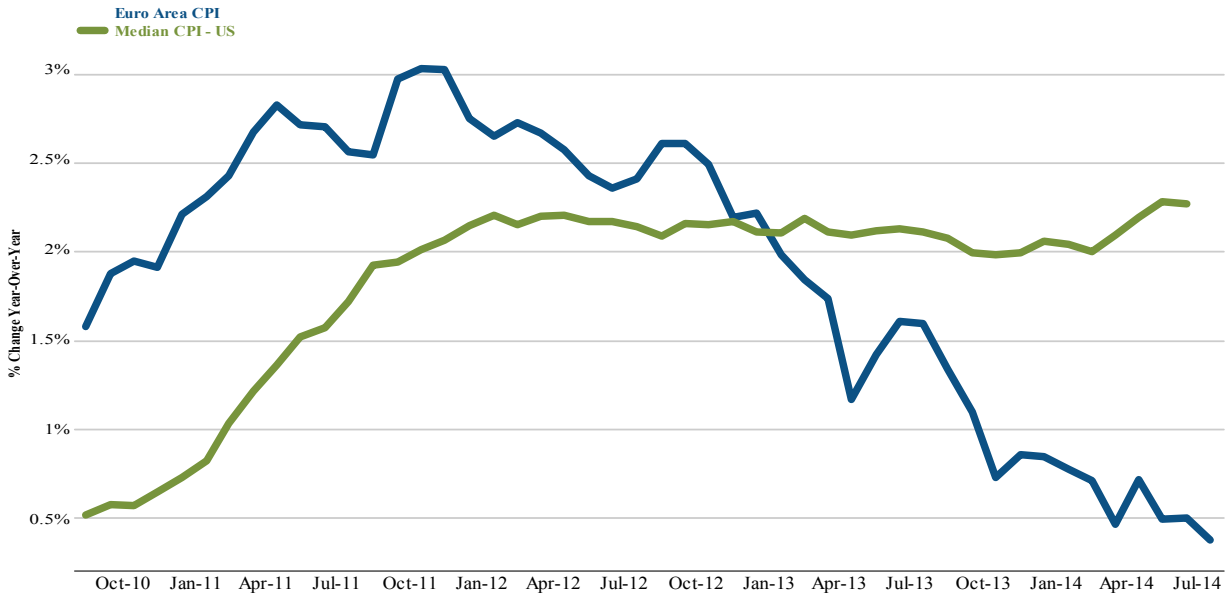
Source: Bureau of Economic Analysis, Eurostat, Italian National Statistical Institute, Spanish National Statistical Institute
Data for US are from Q2 2014, all others are from Q1 2014

only increased 0.4% since this time last year (see Chart below). More important for long-term bond investors, market measures of expected consumer price increases also look dissimilar. As noted by the Federal Reserve Bank of St. Louis, inflation swaps in the US predict 2.6% annual price gains versus 1.7% in the euro area for the next decade. Thus, "lower inflation in the euro area suggests the euro might be expected to appreciate 0.9 percent annually against the dollar, mostly offsetting the 1.3-percentage-point difference in yields between U.S. Treasuries and German [bonds]."

Finally, investors often value long-term bonds according to the expected path of short-term interest rates. If one can earn more money by borrowing for shorter time periods and reinvesting, why lend for longer? In this regard, the evolution of central bank actions contribute to the pricing of longer-term bonds. In the US, the Fed's own forecasts put the fed funds rate at 1.25% by the end of 2015. In Europe, the German sovereign forward curve does not have a rate hike priced in until 2017. If short-term rates are lower for longer in Europe, why should we expect higher longer rates?

So while government bond yields are low in the euro area, fundamental economic building blocks of long-term interest rates indicate that the extraordinarily low yields on government bonds across the euro area are not necessarily temporary, or simply driven by flows. With growth faltering, inflation expectations plummeting, and the ECB apparently on hold for most of the balance of the decade, low interest rates reflect fundamentals.

INFLATION IN THE EURO AREA HAS PLUMMETED WHILE US INFLATION HAS HELD STEADY



Source: Eurostat, Cleveland Fed