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"THE RETURN OF 30 YEAR AUSTRALIAN GOVERNMENT BONDS: FEAST OR FAMINE FOR INVESTORS?"

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- managed accounts
- implementation support and consulting

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Introduction

This article looks at some of the issues for investors that arise from the return of 30y governments to Australia, a prospect that has been raised recently by government and policy advisers.

Australia is no stranger to issuing long term government debt – for example the Commonwealth government issued several series of bonds with terms of up to 46 years in the 1930s.

However, following the herculean efforts to repay debts during the 2000s, Australia's government debt is now not only very small compared to most other developed economies (even after the GFC borrowing spree), but it is also relatively short term in nature. Approximately one third of the $150 billion in outstanding government debt matures in 2 years or less, another third matures in 3 to 6 years and the final third is for longer terms of up to 16 years.

From a borrower's perspective (the government), lengthening the term of debts has several benefits – it makes for easier cash flow planning, it reduces the need to go back to the market continually to roll over shorter term debts and, most importantly, it reduces the likely real (ie after inflation) cost of repaying the principal, and pushes out the date for repayment far into the distant future.

However from the point of view of tax-payers and investors there are a number of problems with the idea of reviving the issuance of longer term government debt.

Tax-payers beware

Tax-payers should be very wary of governments seeking to issue long term debt – quite apart from the higher interest cost to tax-payers that longer term debt requires. It is better if governments didn't have easy ways to get themselves into long term debt. Long term government borrowing is fine when it is used to finance essential long term investments that are productive – like re-building national infrastructure after a major war – but not simply to fund current welfare payments, which just finances current consumption.

Using long term debt to finance long term productive projects like the Snowy Mountain scheme, railway networks or new alternative energy sources (like wind or solar power infrastructure) would make sense as the resultant assets are likely to remain productive for at least the term of the debt. On the other hand it is hard to see how a high-tech venture like the "National Broadband Network" would not be obsolete within a few short years.

Government debt, like all debt, needs to generate revenues or tangible cash savings in excess of the interest cost for a period at least as long as the term of the debt, and it also needs to generate cash flows to repay the principal. Debts raised to finance welfare, consumption or short term projects do neither.

Australian tax-payers and investors would reap many more benefits from the development of a deeper and more liquid market for long term high grade corporate bonds rather than long term government bonds. The benefits include:

- A deeper long term corporate bond market would reduce the current heavy reliance on banks for funding – bank lending policies are fickle, banks are extremely highly geared and prone to get themselves into trouble regularly, as we have been reminded again in the GFC
- It would allow better cash flow planning for the companies, and make them less vulnerable to short term swings in interest rates
- It would better enable companies to invest in long term projects – to employ people, compete with foreign companies, generate wealth and pay taxes
- Long term prime corporate debt provides investors with higher yields (higher than on government debt) and puts the capital allocation decisions in the hands of accountable company directors instead of politicians and government bureaucrats

Government bonds and investment portfolios

From an investor's perspective, bonds have a vital role to play in portfolio construction. High grade bonds (like government and prime corporate bonds) are extremely useful when combined with equities in portfolios during recessionary cycles. The capital values of bonds rise as interest rates fall, offsetting falls in share prices during recessions.

Likewise, the fixed bond interest payments are very useful in offsetting falls in company dividends in recessions. The GCF saw these effects work well in portfolios containing equities and bonds together. In addition, bonds also offer relative certainty of payment of the nominal face value at maturity, whereas equities are perpetual in nature.

On the downside, bonds offer no prospect of capital growth (unless bought at a discount) and their values are volatile and sensitive to changes in interest rates and inflationary expectations. But the main problem with bonds is the crippling effect of inflation on their regular coupon payments, on their capital values over time, and on their face values at maturity. Inflation-linked bonds overcome the effects of inflation on the face value at maturity, but are they just as volatile as nominal bonds and they offer much lower yields to investors.

What will a re-emergence of 30 year government bonds add to the equation for investors?

From a portfolio construction point of view, having 30 year high grade bonds available once again will add considerable value because they are about twice as sensitive to changes in interest rates as 10 year bonds, and more than three times as sensitive to interest rates as 5 year bonds. This increased volatility is useful to offset the volatility of shares, especially in recessions when interest rates, company share prices dividends, and property values and rents are falling.

Volatility

On the other hand, despite the slightly higher interest rates paid on 30 year bonds compared to shorter term bonds, retail investors will probably not take well to 30 years bonds because of their higher volatility. Many retail investors find the volatility of even 10 year bonds too high and consequently most retail bond funds use bonds with terms of 5 years or less.

The price they pay for this lower volatility in capital values is lower interest rates. 30 year 6% bonds have a duration of around 14 (meaning a 1% rise or fall in yields results in a 14% fall or rise in value), compared to a duration of around 4.5 for 5 year bonds, making the capital value of 30 year bonds more than three times as sensitive to changes in interest rates than 5 year bonds. This price volatility puts most retail investors off long term bonds.

Demographics

The main problem with the use of bonds in retirement portfolios is one of demographics. Traditional portfolio management theory is based on the idea that retirees only have a few years of expenses to fund so they needed to hold mainly bonds and cash in their portfolios. However this theory has not kept pace with the dramatic changes in demographics in recent decades.

The two biggest financial risks facing retirees are the risk of income and capital failing to keep pace with inflation and the risk of out-living their investments. These days most retirees should be planning to fund expenses for at least 20 or 30 years – and even longer if they have trusts or bequests for children or grandchildren. Most retirees should still have large portions of the funds invested in growth assets in order to protect against the ravages of inflation, to keep their portfolios growing in case they live longer than they expect, and also to allow for the fact that the costs of health and aged care rise at more than the general consumer price inflation rate.

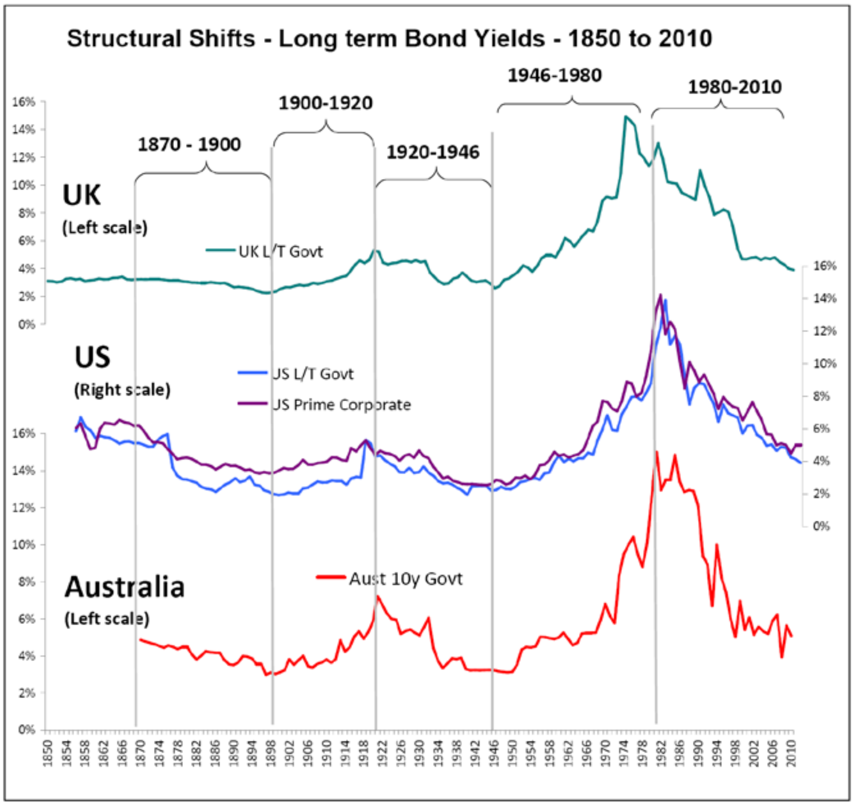
Structural shifts

A third potential problem with long term bonds for long term investors relates to structural shifts in financial markets. Bonds do well when inflation and interest rates are falling, but do poorly when they are rising.

Inflation and interest rates throughout the western world including Australia last peaked in around 1980, after a long run-up in inflation and interest rates between the end of the Second World War and the late 1970s. This period was characterized by the expansion of governments, the rise of the welfare state, rising tax rates, the explosion of consumer credit and upwardly spiraling wages and prices.

In the period since 1980 Australia followed the global structural shift toward smaller governments, privatizations of government enterprises, de-regulation of financial markets, freeing up of labour markets, central bank independence, lowering of trade protection barriers and tighter monetary policies. These measures, together with the huge savings surpluses from China, Japan and Germany, resulted in a structural decline in global (and Australian) inflation and interest rates between 1980 and 2010.

Bonds did particularly well in this environment, and the period of greatest impact in Australia was the 1990s decade. Over the course of the 1990s, inflation in Australia fell from 7% to 3% pa and Australian long term bonds generated returns of 13% pa in real terms, compared to 8.7% pa real total returns (ie including dividends) from Australian shares.



<u>1870 to 1900:</u> falling inflation & bond yields
- rise of economic nationalism & protectionism
- rise of social & military spending
- spread of gold standard, scramble for colonies
- 1870s depression, 1890s depression & deflation

<u>1900 to 1920</u>: rising inflation & bond yields
- price surges before, during & after WW1
- failure of price control mechanisms

<u>1920 to 1946</u>: falling inflation & bond yields
- commodities gluts
- tight monetary policy, no welfare safety nets
- 1930s depression & deflation

<u>1946 to 1980</u>: rising inflation & bond yields
- expansion of governments & social spending
- expansion of consumer goods & credit
- abandonment of gold standard
- wages & prices breakouts, labour unrest

<u>1980 to 2010+:</u> falling inflation & bond yields
- smaller government, privatisations, central bank indep.
- manufacturing in cheap developing countries
- glut of oil & agricultural commodities
- savings surplus from develping world
- failure of communism, failure of free market finance

After the current phase of de-leveraging:

<u>The next big phase:</u> rising inflation & bond yields
- rise of government, re-regulation
- central banks lose independence, loose monetary policy
- competitive devaluations, protectionism
- return of capital controls, deliberate inflation targeting

Where does that leave us in 2010?

Inflation and interest rates are the lowest we have seen in a generation, and are still heading lower. Although the developed world faces a period of deflation and even lower long term interest rates as it de-leverages over the next few years, what we are seeing now is the un-winding of many of the key factors that drove the structural shift to lower inflation and interest rates over the past 30 years.

In the post GFC era the US, UK and Europe (and Australia to a lesser extent) are going through a structural shift back toward big government, greater government involvement in industry, re-regulation of financial markets, rising economic nationalism, clawing back of central bank independence, loose fiscal and monetary policies. We are also likely to see a decline in surpluses from China (as its focus shifts from exports to domestic consumption), from Japan (as its rising welfare bill eats into savings) and from Germany (as its savings are used to subsidise welfare in a decaying Europe).

These trends all point to a structural shift back toward higher inflation and interest rates in the decades ahead, following the completion of the current de-leveraging, disinflation stage. If this happens real returns from bonds will suffer, and from longer term bonds in particular. This major structural shift goes beyond the regular ups and downs of short term business cycles and will take decades to evolve, but investors with multi-decade time horizons must take it into account when planning their long term portfolios.

Faced with this outlook for the decades ahead, longer term government bonds will certainly be useful in boosting returns in diversified portfolios during the cyclical ups and downs of the business cycle but they will not provide an instant panacea for Australia's long term retirement income dilemma.

As "buy & hold" investments bought at the current very low interest rates, long term government bonds by themselves or as the core of long term portfolios or annuities are more likely to put long term investors on the road to ruin than on the path to prosperity.

Government debt and bond yields

Bond yields reflect investor's perceptions of the two main sources of potential loss to bond-holders:

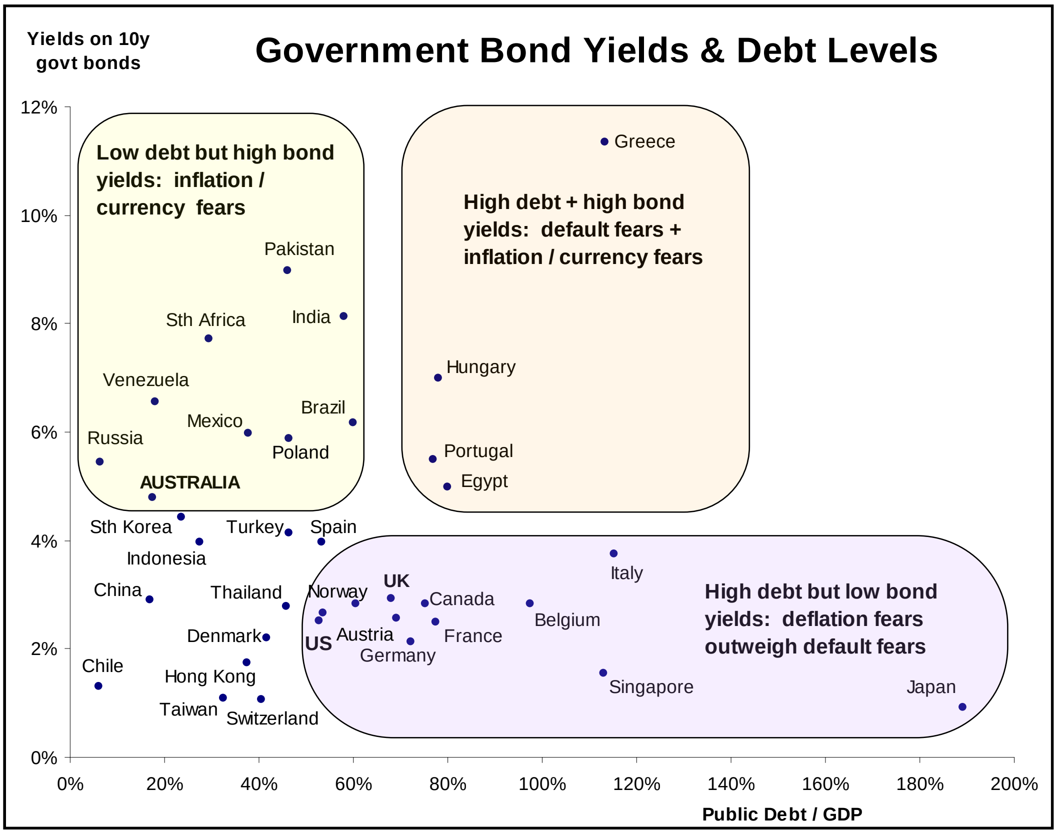
- credit risk - the risk of loss through default by the borrower or debt restructure; and
- interest rate risk - the risk of loss of future purchasing power due to inflation and/or currency losses due primarily to inflation in the case of foreign bond holders

If bond yields are high it means investors are factoring in the possibility of losses – either through default or restructure – and/or loss of purchasing power of their money due to inflation and/or currency losses. But high debt levels do not necessarily mean high bond yields.

Japan has the highest level of government debt in the world (apart from Zimbabwe), but it also has the lowest long term bond yields in the world, with 10 year government bond yields trading at less than 1% pa. At these levels the market has priced in almost no risk of Japan defaulting on its debt. More than 95% of Japanese government debt is owned by local Japanese investors and so the government would simply print more money to pay it off, rather than default outright. At yields of less than 1% pa, the market is also expecting the past two decades of flat growth and negative inflation to continue for the next 10 years as well.

Turning to the US, yields on 10 year US Treasuries are down to 2.5% pa and yields on 30 year bonds are down to 3.5% pa. Although around 60% of US government debt is owed to foreigners, the US is still by far the largest economy in the world and the USD is still the world's main reserve currency so, like Japan, it can (and is) simply print more money to repay its debts and, in the process, re-inflate its economy. At these very low yields the market is more worried about deflation than any risk of default or inflation over the next decade.

Most of the rest of the developed countries are also in the same situation, with high government debt levels but low bond yields. These countries are in the lower right segment of Chart 2, and the prospect of flat growth and nil or negative inflation is outweighing any risk of default or future inflation. Chart 2 plots the level of government debt to GDP of several countries against yields on their 10 year government bonds.



In the upper left segment of the chart are countries with low debt but relatively high bond yields. This segment includes Australia and many emerging markets. In this segment the high bond yields reflect fears of losses of real value due to inflation (for local bond-holders) and/or currency losses due to inflation (for foreign bond-holders).

In the lower left segment are countries with low debt and low bond yields – reflecting low risk of inflation and currency losses, and also low risk of default. China and most of the “Asian Tigers” countries are in this position, along with Switzerland and Denmark.

However in the upper right segment are the countries with both high debt levels and high bond yields – indicating high risk of default and/or currency losses.

How low can they go?

At the current level of bond yields in the major big debtor economies of the US, UK, western Europe and Japan, investors are pricing in no risk of default or restructure and also no risk of future inflation for the next decade.

Yields on long term government bonds in the major developed markets may be low now but they have a way to go before being as low as in the bottom of previous cycles. Yields on 10 year US government bonds are now around 2.5% (and reached as low as 2.2% at the bottom of the GFC at the end of 2008), but they not as low as they were in previous cycles – yields were below 2% at the bottom of the cycles in 1902 and again below 2% in 1941.

In the case of the UK, yields are now around 2.8% (which is back down to where they were at the bottom of the GFC) but this is still well above the levels at the bottom of previous cycles – yields got to as low as 2.2% in 1897 and 2.6% in 1946.

Yields will probably continue to fall further in the near future as more investors pile headlong into the “safety” of government bonds and away from “risky” shares. In addition, central banks continue to buy their own government’s bonds to keep interest rates low and pump liquidity in to the system to re-inflate their economies.

This is likely to push yields lower in the short-medium term – generating positive returns for bond investors - but this will quickly turn sour when the first signs of economic recovery appear.

Just when the pessimism is at its worst, and bond yields are at their lowest, the markets will wake up one day and suddenly realise that the world is not going to come to an end and the threat of inflation is very real indeed. Bond yields will snap back and we will be into the next big cycle of rising interest rates, and bond yields and inflation. Long term bonds are not the place to be when this happens.

Lessons from 1994

The last time it happened was in 1994. The world (and Australia) had just been through severe recession in the early 1990s. Bond yields had sunk to very low levels (relative to where they were before the recession), pricing in a pessimist outlook for low growth and low inflation. Then, the world woke up in the first week of February 1994 and realized that it was not the end of the world after all, and that inflation was going to be a serious issue after all. Starting in the first week of February 1994 bond yields shot back up all over the world over 1994 - up from 5.6% to 8% in the US, up from 5.6% to 7.5% in the UK, and up from 6.3% to 10.7% in Australia.

The sudden rises in bond returns caused losses around the world not just in bond markets, but also in “risk” asset classes that are priced off bond yields – including share markets and property markets. All the major asset classes were hammered in 1994, even including gold, and the best performing major asset class was cash.

Asset class	1994 Total Return (in AUD)
Australian 5y government bonds	-4.7%
Australian 10y government bonds	-8.7%
Global Bonds (in AUD)	-2.7%
Australian shares	-8.7%
Global shares (in AUD)	-7.6%
Emerging Markets shares (in AUD)	-18.9%
Australian listed property	-7.1%
Global property	-10.8%
Gold (in AUD)	-15.4%
Australian cash	+5.4%
Australian bank bills	+5.7%
Australian Dollar (in USD)	+15.8%

We are not facing a February 1994 situation just yet. Households, banks and governments across much of the developed economies are still over-burdened with debt, and policy makers don’t even know the size of the problem, let alone the solution.

When the developed economies finally show the first signs of sustained growth, and investors realise that it’s not the end of the world after all, bond yields will spike up again and we will be into the next big phase of growth – with rising interest rates, inflation and bond yields. When that happens long term bonds will not provide the “safe haven” from losses investors were looking for.

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