Real yields on a high

Recent market instability has restricted corporate access to a number of bond markets. There is a myriad of arguments in favour of short-term market consolidation. For example, this bear market now exceeds the typical duration of bear markets; the US front-end discounts four rate hikes in the next year which many consider to be excessive; and treasuries had negative returns last year – and have never performed poorly two years in a row.

The more fundamental argument in favour of going long, while headline inflation remains low, is the high level of real yields. Real yields on inflation-linked bonds are at their highest levels since issuance in Europe and the US.

The difficulty with this argument is that these securities have not been traded long enough to give an accurate assessment of real yields over several cycles. For example, real yields were much higher in the 1980s when measured by nominal treasury yields less CPI. Of course, this was because inflation was a real risk then, which consensus opinion seems to believe is no longer likely.

For this analysis, assume the 'creative destruction' of recent technology innovations continues to ensure that there is no pick-up in US inflation and it remains at 2.5%. The difference between nominal yields and inflation is the real yield plus a risk premium (ignoring tax effects). In the absence of a risk premium, the fair value for long treasuries should be in the region of 6.75/7% given current levels of real yields, but could be as high as 7.5% if real yields were to reach 5%. Increasingly, in the absence of inflation, fair value in the world's bond markets could be driven by perceptions of the fair value of real yields.

Real yields must rise

The 1990s suggest that real yields have peaked. In our view, this was an unusual period in which the US economy was strong but, for large periods, the rest of the world was relatively weak, and it may not be representative of a world where growth is strong everywhere.

The economic argument in favour of higher real yields, is based on the rate of return achievable from capital investments versus the cost of capital. In equilibrium, the rate of return should equal the cost of capital – in both cases the risk premium plus a risk-free rate. However, if the array of profitable investment opportunities is so great, it is feasible that little capital is attracted to risk-free assets. Real yields might have to rise just to continue to attract capital if the risk premium is low and the rate of return on risky investments is high – this might occur even if the absolute supply of risk-free debt is declining.

The bullish view of bonds could be correct if the wealth effect that has had such an impact on the US economy was reduced. For this to happen, equities need to become sensitive to real yields. While parts of the 'old' US economy can be expected to be sensitive to higher real rates, the 'new' economy show little sign of reacting. Until the new US economy focuses on real rates they will surely have to rise. The extent of such a rise will, with many other things, be decided by the performance of the world's stockmarkets. ■

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INTERNATIONAL BONDS

These are a selection of bonds announced recently. The details, updated to the middle of last month, were supplied by *IFR Securities Data, London* and other

Issuer	Launch rating M	Launch rating S&P	Amount (m)	Coupon (%)	Price	Maturity	Launch Spread (bp)	Fees (%)	Bookrunner
COLT Telecom*(a)*			EUR368	2	100.00	16 Dec/06			Morgan Stanley Dean Witter
HJ Heinz	A1	A+	EUR300	5	101.665 100.09R	5 Jan/05	47	1.875	Warburg Dillon Read
Kings College Hospital	Aaa	AAA	GBP91.5	3.442	100.006	31 Mar/36	145	0.75	Greenwich NatWest
Pearson	Baa1	BBB+	EUR650	6.125	99.695	1 Feb/07	82	0.375	Dresdner Kleinwort Benson JP Morgan
Procter & Gamble	AA2	AA	GBP300	6.25	99.935	Jan/30	150	0.625	JP Morgan
Sainsbury	A1	A	CHF30	2.97	100	14 Jan/02		0.05	Deutsche Bank
Volvo Treasury AV	A3	NR	EUR400	4.625	99.715	10 Jan/03	52	0.2	Lehamn Brothers

*(a) Equity-linked. Launch ratings are from Moody's (M) or Standard & Poor's (S&P). NR = Not Rated. R = fixed re-offer price. * = Floating Rate Note. Launch spread is over comparable government bond.*