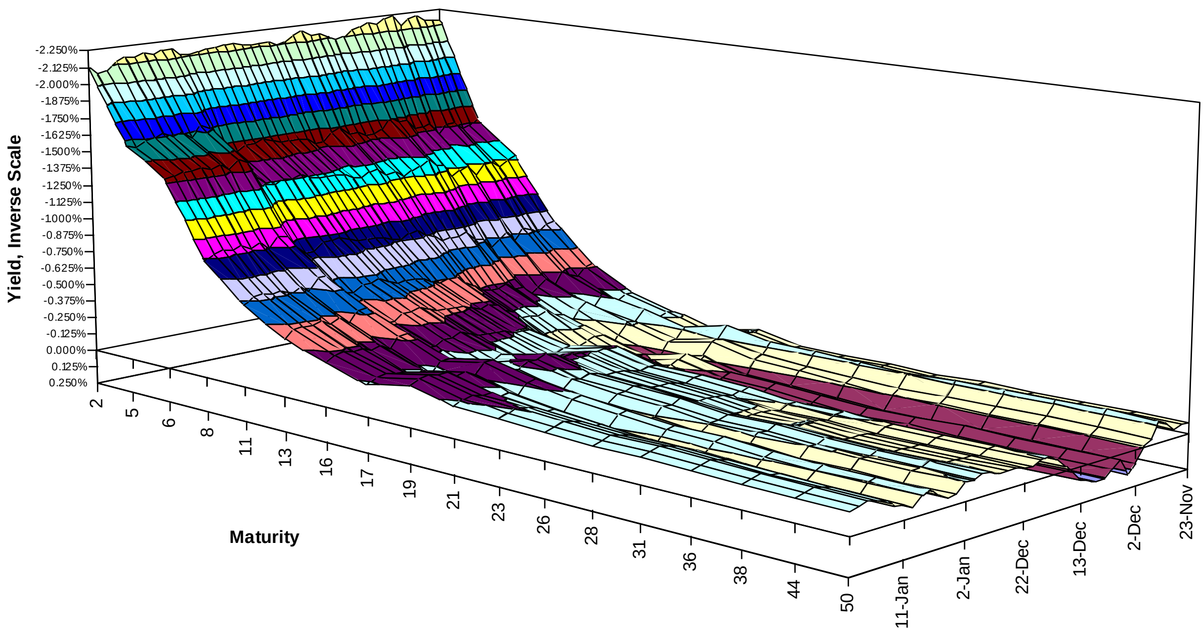
U.K. Real Interest Rates Very Negative

Investors At London Bridge Have Affinity For Brooklyn Bridge

Japan went to its zero interest rate policy thirteen years ago and began its quantitative easing campaign almost eleven years ago; news of their successes should be arriving any day now. When I told students the next step would be for interest rates to go negative, they reacted in disbelief, as if I were describing some sort of physical impossibility. Well, that was then and this is now: As I noted in Switzerland's Negative Interest Rate Dilemma and in Is TED Spread Being Distorted By LIBOR? in December and August 2011, respectively, negative nominal interest rates are part of our market landscape now.

The situation with British inflation-linked Gilts is somewhat different; here the investor is accepting a negative implied real rate. We are not just talking about negative real rates for the short-dated issues produced by the risk of inflation accrual indices disappearing; no, issues out to fifty years have negative real rates.

Money For (Less Than) Nothing



Why would anyone with basic survival instincts be willing to do this? Whenever you see someone accepting a known loss the answer that should run through your head right after "What an idiot!" is "Insurance." A buyer of Gilts is taking a known loss now in exchange for avoiding a potentially greater loss elsewhere. That buyer stands to profit if realized inflation comes in ahead of the breakeven rate built into the issue's price as well.

A third reason is linked, as are so many others these days, to the effects of regulation. British Gilts are high-quality sovereign bonds; an increasing rarity in this downgraded world of ours. If banks, insurance firms, pension plans or other regulated entities need to show a certain exposure to AAA-rated securities to meet their capital standards requirements, paying a premium for an inflation-linked Gilt, accepting the interest rate penalty and rolling the dice on higher inflation than embedded in the current price will do the trick. Never mind they are doubling down on both the credit risk and the British government's honesty in reporting inflation; that will be someone else's problem down the road.

Whether this is the same road down which numerous cans have been kicked is unknowable at present. I will get back to you as soon as I can.