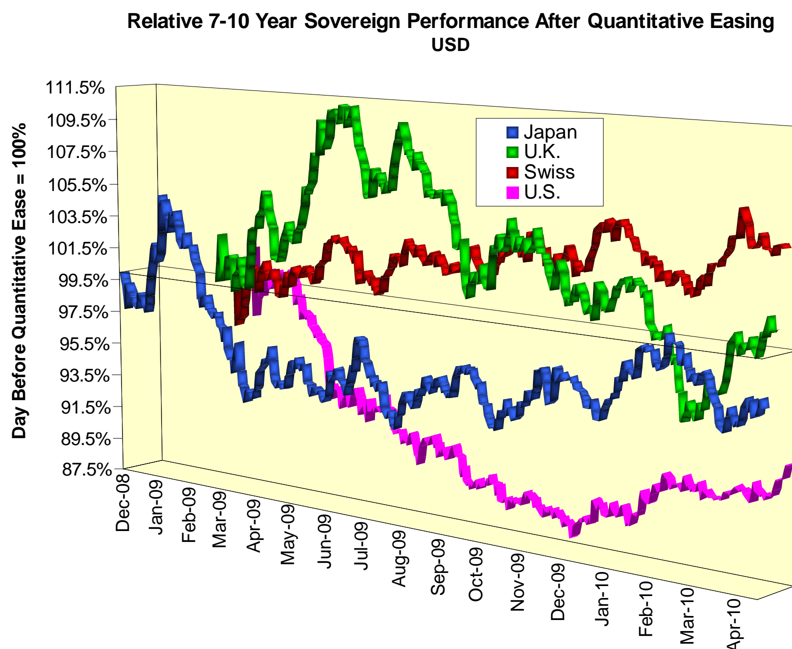
Bond Performance And Quantitative Easing

One of the more astonishing aspects of investing is just how important the reinvestment of dividend and interest payments is. For example, in the five-year period ending March 2010, the price appreciation on the S&P 500 was -0.9453%. The total return with gross dividends reinvested into the index was 9.9646%. A similar calculation for U.S. Treasury bonds, 7-10 years maturity, has a price return of 4.146% and a total return of 32.16%.

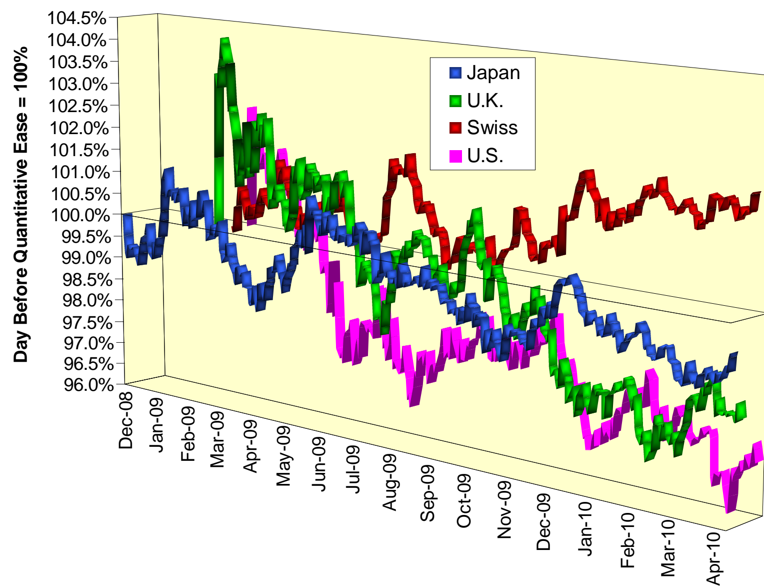
This reinvestment mechanism has a way of fixing its dentures upon your derriere when quantitative easing, which we looked at yesterday in the context of global equities, is involved. The bond coupons you receive are exposed to either very low short-term interest rates or to repurchase of additional bonds at a higher price and presumably at a greater risk. While the original bond may rise in price, anything outside of a zero-coupon issue is going to suffer as the result of lower short-term interest rates.

Revisiting The Fab Four

No, this has nothing to do with the Fabulous Fab or those of his ilk, but rather to the four major economies who have engaged in quantitative easing since December 2008. These are Japan in December 2008, and the U.K., Switzerland and the U.S. in March 2009. If we re-index each of these national 7-10 year sovereign debt markets relative to the Bank of America-Merrill Lynch Global Sovereign Broad Market Plus index to the day before the announcement of quantitative easing, we find two of the four have underperformed. Both the U.S. and Japanese bond markets – and the U.S. dollar and Japanese yen are by far the two major currencies used in funding global carry trades – have underperformed the global benchmark. If you want to blame low short-term interest rates and their effect on reinvestment, please go ahead and do so, for it is the right answer.



If we switch the measurement back to local currency terms, the results look even worse for the easy-way-out crowd. Here only the Swiss bonds have outperformed the global benchmark, and the U.S. has come in last.



The irony here is the impetus for engaging in quantitative easing in the first place was an economy operating well below capacity levels. Those economies are supposed to have low inflation and low interest rates, just the sort of environment in which bonds should do well. Yet the evidence seems to suggest the very act of driving short-term rates lower with the stated goal of economic stimulus – what, do you think they would ever state something as crass yet truthful as, "We are printing money to lower government financing costs and to rescue the banks who would not know a bad credit risk from an spaghetti sauce stain?" – has the perverse effect of making that country's bond market underperform.

We are supposed to learn the lesson at some point in our life you cannot get something for nothing; there is always a cost. The costs of quantitative easing include financing others' asset bubbles, forcing your domestic markets into underperformance, punishing the risk-averse, misallocating resources by encouraging bubbles and making me mad. The benefits are a much shorter list: None I can think of beyond the bogus, "He kept us out of deflation and would have kept us out of war had we only asked." If quantitative easing is a policy success, I would sure hate to see what constitutes a failure.