Japanese Bonds Under Zero Interest Rate Policy

How ironic for Charles Dickens, author of so many doorstop-sized novels about the dreariness of Victorian England to be best loved on this side of the Atlantic for *A Christmas Carol.* This relatively bite-sized tale features the Ghost of Christmas Future, a wonderful literary device whose role, carried out successfully, was to show Scrooge what would happen if he failed to get with the program.

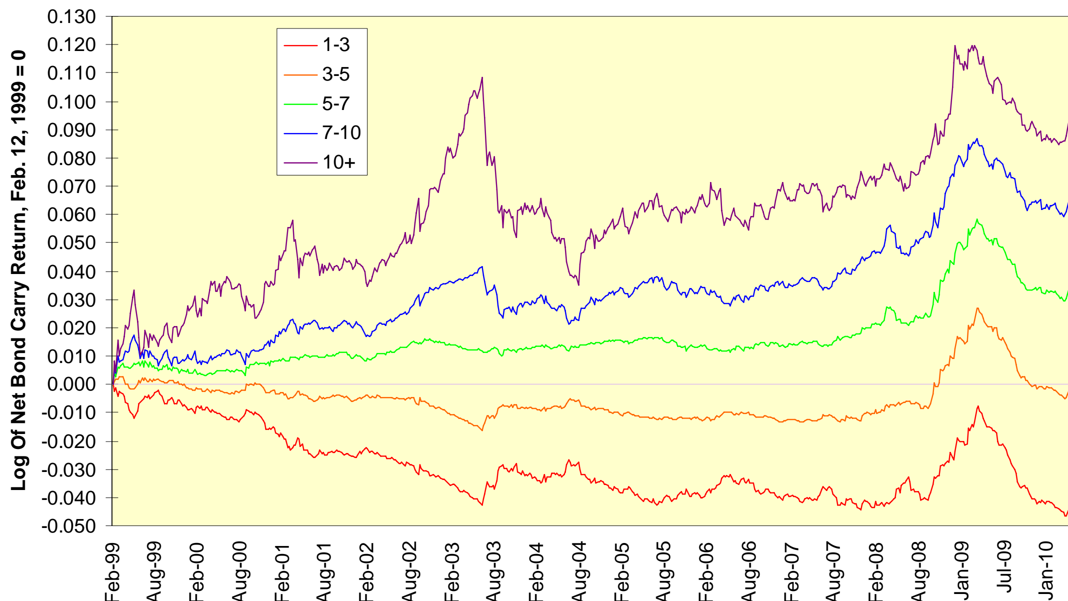
Japan has unwittingly and probably unhappily but most important unsuccessfully to-date served as our moocher for the future (it cannot be a blast from the past, can it?). As noted last week, Japan went to a zero interest-rate policy (ZIRP) in February 1999 and first engaged in quantitative easing in March 2001. Critically for us ghost-busters, it tried to back away from both policies in the April-May 2006 period only to back down when the unwinding of yen carry trades caused some distress amongst the world's yield-hog community.

The Bank of Japan pondered a second attempt at renormalizing short-term rates just as the world's credit crunch was getting underway in August 2007, only to back away from some spectacularly bad market timing, and was last seen resuming quantitative easing in December 2008. Lest we criticize, let's remember the Federal Reserve has declared war on deflation twice, once in May 2003 and once again during 2008; apparently quantitative easing, like the postman, always rings twice.

Net Carry

How have Japanese government bonds (JGBs) fared during the post-ZIRP era? Let's recall the principle all trades are spreads; anyone buying a Japanese bond has to forfeit the opportunity cost, such as it is, of short-term interest rates in Japan. If we split JGBs into the maturity classes defined by Merrill Lynch and present the net carry return, the total return on the bond index less the foregone short-term return, on a logarithmic scale, we can see how the net carry return for 1-3 and 3-5 year JGBs has been negative for more than eleven years. Risk-averse savers in the U.S. should ponder this notion: If you think stingy returns are a temporary phenomenon, think again.

Japanese Capital Markets After Zero Interest Rate Policy Began



If you wanted to make any sort of return on JGBs, you had to go long. But do not spent it all in one spot; the average annual net carry returns for 7-10 year and 10+ year JGBs have been 0.584% and 0.824%, respectively. Considering these bonds have looked like return-free risk for more than a decade, these are not very attractive rewards for risk-averse Japanese savers.

Of course, all of these numbers beat the net carry return on Japanese stocks rather handily; there you lost 1.013% per annum for your troubles.

Now for the scary part as this is a ghost story: The returns on JBGs of five-year maturity and longer were greater at a comparable point into ZIRP, about 18 months, than they have been to-date in the U.S. Our far more aggressive policy of monetary incontinence has punished holders of longer-term Treasuries. Ironically, the net carry returns for U.S. 1-3 and 3-5 year Treasuries have been positive and comparatively greater than similar JGBs since December 2008. We have a dreadful 2009 to thank for this little twist.

Does quantitative ease and ZIRP reward government bond holders? If the Japanese past is our future, the answer is, "Bah, humbug!"