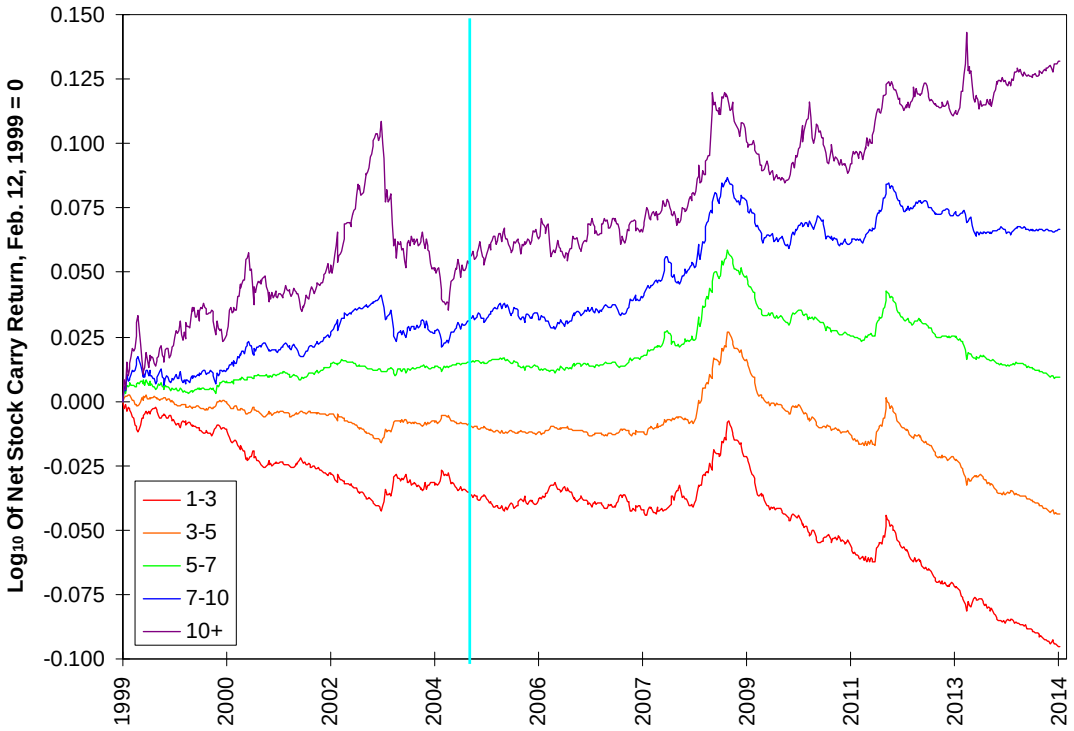
Japanese Bonds And The Ghost Of QE Future

I concluded last week that once you start QE you have to keep it going, probably until the sun blows up and maybe even longer. But just because the negatives from stopping, such as the catastrophic deleveraging of financial markets and the impoverishment of asset holders who along with the government have been QE's real beneficiaries, are scary does not mean everything else is a winner. Take Japanese government bonds (JGBs), please.

You might think the total returns for bonds in a market where the central bank went to a zero interest rate policy (ZIRP) in February 1999 and started QE two years later, in March 2001, would be pretty good, and I really kind of hope this is what you think as I need a straight-man for the rest of this joke. What is missing from this equation is the net carry cost of holding one of these positions; to buy the bond, a commercial investor has to pay the opportunity cost of short-term funds. Let's use three-month Euroyen, the interbank rate, as this short-term funding cost. Commercial investors have to borrow here as only the Japanese government can borrow at their Treasury rate.

If we account for this borrowing cost and present the net carry returns by maturity segment on a logarithmic scale going back to February 1999, we see something astonishing (work with me and act surprised): The net carry returns for both the 1-3 and 3-5 year segments of JGBs are negative and those for the 5-7 year segment are headed in that direction. I inserted a turquoise vertical line at the 307-week mark as this is where the U.S. is in its ZIRP era.

Net Carry Return For JGBs After Zero Interest Rate Policy Began

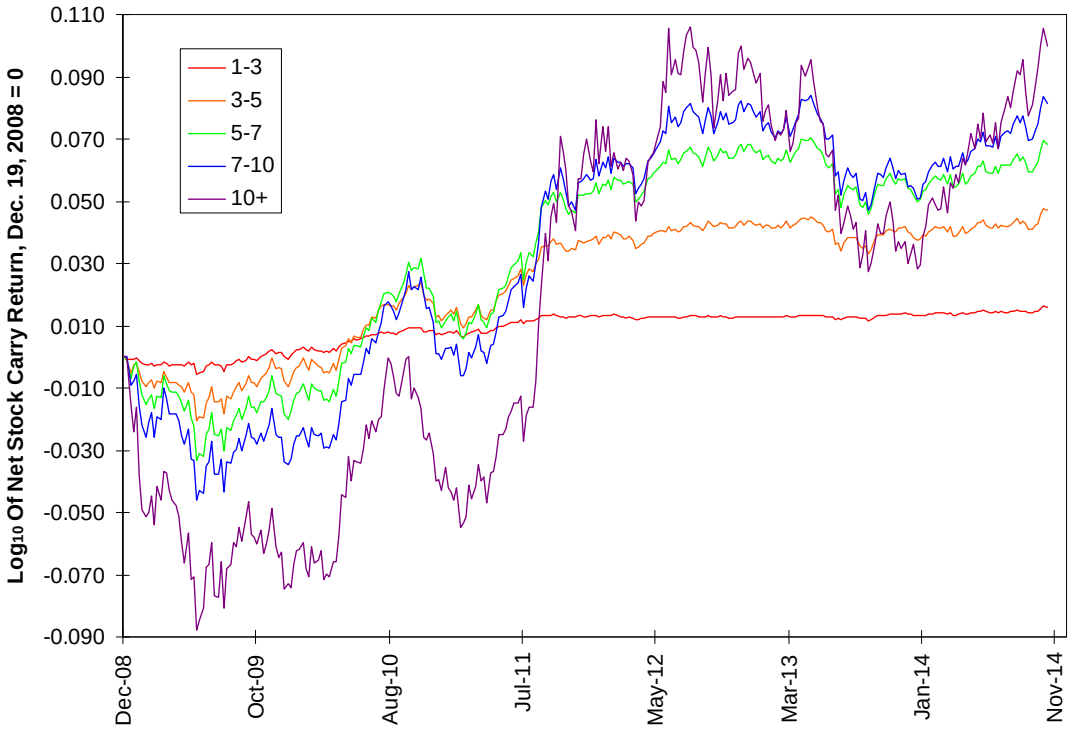


How can this be, you ask? The answer is deceptively simple. As the coupon yield on JGBs collapsed below the three-month interbank rate, commercial borrowers found themselves paying more to hold lower-yielding instruments with virtually no capital appreciation potential. This problem became particularly acute after the U.S., U.K. and Switzerland started QE in March 2009. Unless your funding cost was essentially zero, something that applies to many of Japan's individual savers in Postal Savings accounts, you had to go long or go home.

The U.S. Situation

The U.S. is not at this point yet, but if we map returns using three-month LIBOR as a funding cost, we find returns on the 1-3 year Treasury segment have flat-lined during our post-December 2008 ZIRP era, and those for the 3-5 year segment have not done much better. The winners in our go-long-or-go-home derby were dictated by the adoption of Operation Twist in August 2011.

Net Carry Return On UST After Zero Interest Rate Policy Began



Will the U.S. and others with near-zero or even negative short-term sovereign yields follow the Japanese experience? It will depend on how low yields go, both absolutely and relative to funding costs. But if we keep on believing QE has an outcome other than preventing the disasters that will arrive with its cessation, the answer will be yes. In the meantime, fixed-income investors either will have to assume more credit and duration risk or go to every mattress sale from here to President's Day to find someplace to put their cash.