FINANCIAL TIMES
July 23, 2012 7:05 pm

We have entered the world of disaster economics

By Gillian Tett

Are the bond markets going mad? It is a question that many investors might ask. For as anxiety has erupted in the eurozone, something striking has occurred with respect to US Treasuries and German Bunds.

If you look at the credit derivatives market – the place where investors judge the risk of bond default – government bonds are getting riskier, not just in places such as Greece but in supposed havens such as Germany, too. Two years ago, for example, the credit default spread on a German Bund stood at 40 basis points – meaning that it cost €40,000 to insure €10m of bonds each year against default. Recently, though, the spread has been well above 100bp, and could rise again if Angela Merkel, the German chancellor, opts for more bailouts. US bonds have also become riskier, judging by credit default swap prices, as Congress remains gridlocked on fiscal policy.

Normally this would imply that bond yields should also rise. After all, classic investment theory suggests that bond prices fall (and yields rise) with higher credit risk. That is exactly what has happened with corporate bonds in recent years, not to mention with sovereigns such as Greece. But in Germany and the US government bond yields have recently hit multi-decade lows. Short-term to medium-term bonds are paying negative real returns.
Why? One explanation is that the CDS market overstates default risk. Another – increasingly popular – idea is that bond investors are complacent about Germany and the US. A thoughtful new paper from Joshua Rosner, the investment analyst, predicts that German bond yields could soon rise as investors wake up to the costs of a eurozone bailout. The gap could also be blamed on deflation fears, a liquidity trap or government meddling (ie quantitative easing.)

But another intriguing idea that is creating a market buzz has been advanced by economists at Fulcrum Asset Management (including Gavyn Davies in an FT blog post.) This blames a psychological-cum-generational shift among investors around the concept of “disaster”.

During most of the past few decades, Fulcrum argues, investors and economists did not discuss “disaster” much. Little wonder: if you use the definition of “disaster” advanced by the economist Robert Barro – namely at least a 10 per cent decline in national gross domestic product per capita – there were 58 disasters in the 20th century. But crucially, only two of these occurred between 1950 and 2000; most modern investors built their careers in a world without disaster risk.

But now the world has changed. And so investor behaviour has shifted too, Fulcrum says. For the key point to understand about investing is that assets have two functions: they can produce returns, but they also offer protection. When disaster risk is low, investors stress the former; when the risk rises, they focus on the latter.

However, the nature of this approach can vary across markets. In countries where government default risk is deemed low, bonds are better than equities for

“protection”; but in markets where default risk is higher, equities and bonds are correlated. Fulcrum thinks there is a clear statistical way to tell which country is in which camp: when the sovereign CDS spread jumps above 200bp, bond and equities move together. But when CDS spreads are below 200bp, government bonds retain their “safe” status, and yields and CDS prices are uncorrelated. Spain and Greece are in the first camp, and France is almost in that group too. But the US and Germany are in the second group. Hence bond yields can fall – even as default concerns rise in a moderate way.

This argument has shortcomings. It does not take account of how expected inflation or deflation affects bond prices. Nor does it recognise other asset classes. Frightened investors might choose to buy commodities or corporate bonds, instead of government bonds. And while a 200bp “tipping point” seems to work well in the eurozone, it is unclear how it applies to the US.

If this disaster theory has a grain of truth – as I suspect it does – there are at least three implications. First, it suggests that governments may have overstated the degree to which quantitative easing, not fear, has reduced bond yields. Second, it implies that the investor grab for safe assets may not be a short-term phenomenon; “disaster risk” could influence asset prices for a long time. Third, there is a bigger point: the financial world may need to overhaul its investment frameworks.

When portfolio theory developed in the second half of the 20th century, financiers assumed that the world would always be fairly stable; but as Mr Barro’s work shows, this low-disaster period may have been an exception to the norm. The idea that investors always want to maximise returns in a rational way, not “insure” against Armageddon, may have been a function of an unusual time, not a timeless truth. Perhaps the world will return to that era; but do not bet on it soon. In a world of “disaster” economics, in other words, bond markets could remain “baffling” for a long time; unless, of course, an inflation or political shock creates an explosion of default fears in Germany (or the US) – and those bonds and credit derivatives markets finally come into line.

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