

Mental men prefer bonds

“In a time of universal deceit, telling the truth is a revolutionary act.”

- George Orwell.

Japan got there first. 15 years ago, we met a Japanese equity manager who made an astonishing prediction:

“Japan was the dress rehearsal. The rest of the world will be the main event.”

That seemed an extraordinary suggestion 15 years ago. Today, not so much.

In the aftermath of the late 1980s real estate and stock market bubble, and its subsequent banking crisis, Japan became a giant laboratory experiment for novel monetary policies. In 2001 the Bank of Japan tried QE. It was a policy that Richard Koo of the Nomura Research Institute described as the “greatest monetary non-event”. It turned out, not for the first time, that academic economists had it all wrong. Borrowers, not lenders, were the fundamental bottleneck in Japan’s recession:

“The central bank’s implementation of QE at a time of zero interest rates was similar to a shopkeeper who, unable to sell more than 100 apples a day at \$1 each, tries stocking the shelves with 1,000 apples, and when that has no effect, adds another 1,000. As long as the price remains the same, there is no reason consumer behaviour should change – sales will remain stuck at about 100 even if the shopkeeper puts 3,000 apples on display. This is essentially the story of QE, which not only failed to bring about economic recovery, but also failed to stop asset prices from falling well into 2003.”

The central banks of the rest of the developed world have had more success in boosting asset prices through their own deployment of QE, but they have had just as little impact on their real economies. What QE has done is made the asset-rich richer, and the poor relatively poorer. Inasmuch as social equality is a stated aim of most governments, QE has been a disaster.

But it has done wonders for bond prices.

John Seagram of CLSA points out that despite having yielded very little for a very long time, Japanese Government Bonds (JGBs) have been surprise performers in 2016. The 40 year JGB has risen by 50 percent in price since the start of the year, and now offers an annual yield of roughly 7 basis points.

Assuming investors hold the JGB to maturity in 2056, they will achieve a **total** return of just 2.96 percent over the life of the bond.

Those investors might be interested to see what they could earn from a different asset class. If they bought and held a Topix ETF instead, they would earn a current dividend yield of

2.37 percent. Assuming, very conservatively, that the market's dividend yield remained unchanged for the next 40 years, over the same term as the bond's life they would get a return of 94.8 percent from the stock market – or **32 times** the return of the JGB.

But that's just income. What might we expect the underlying value of the Topix to be over the next 40 years ?

“Over the last 20 years the Topix has doubled its book value, and its price / book ratio currently stands at 1.05x. The current Topix earnings yield is 7.27 percent, 2.37 percent of which is paid out in dividends; that leaves a retained net earnings yield of 4.9 percent, which over 20 years adds up to 98 percent, i.e. a doubling of book value over 20 years. On the basis that the Topix manages to double its book value again over the next 20 years, then doubles it again over the following 20 years, and that the market stands at a price / book ratio of 1x in 40 years' time, then the total return to the investor, including dividends of 94.8 percent, would equate to +394.8 percent, or **133 times** the 2.96 percent guaranteed return from the JGB. These return projections assume zero growth and that net earnings and dividend income remain unchanged for 40 years.. some might describe that as conservative.”

Many government bonds are more expensive than the 40 year JGB, in that they offer no yield whatsoever, or only a negative one. 10 year German bonds currently yield *minus* 0.07 percent. 10 year Swiss paper currently yields *minus* 0.64 percent. At some point, the financial media really must stop using the designation “safe haven” to describe this poisonous trash.

Ben Hunt of Salient Partners writes convincingly about [the power of narratives](#) and their effect on a credulous investing community. The problem now is that narratives that protect the status quo are starting to falter very badly. Brexit is just one brick that has fallen off the edifice of Business As Usual. As Hunt puts it, the Fix is still in, but it's getting harder and harder to maintain:

“..status quo political and economic institutions – particularly Central Banks – have failed to protect incomes and have pushed income and wealth inequality past a political breaking point. They made a big bet: we're going to bail-out / paper-over the banks to prevent massive losses in the financial sector, we're going to inflate the stock market so that the household sector feels wealthier, and we're going to make vast sums of money available for the corporate and government sectors to borrow really cheaply.”

Narratives die hard, but when the 'omnipotent central bank' narrative finally and conclusively fails, bond investors will suffer a religious experience as the market rushes to reprice poisonous – but currently still very popular – trash.

More central bankers should start listening to Richard Koo:

“Even though QE failed to produce the expected results, the belief that monetary policy is always effective persists among economists in Japan and elsewhere. To these economists, QE did not fail: it simply was not tried hard enough. According to this view, if boosting excess reserves of commercial banks to \$25 trillion has no effect, then we should try injecting \$50 trillion, or \$100 trillion.”

We could call such a policy “Krugman’s stimulus”.

Ben Hunt again:

“Our portfolios should minimize the maximum risk the world actually presents, not maximize the reward our crystal ball models predict. **Timing, timing, timing.** We need to pay attention to what matters, and right now that’s all policy and all Narrative all the time. In a negative rate world, you’ve got to think in terms of catalysts, not “stocks for the long haul”. And one more thing. **To paraphrase Groucho Marx in *Duck Soup*, if a four-year-old can’t understand what you’re doing in your portfolio, don’t do it.** For me, that means real assets and real yield, fractional ownership in real companies with real cash flows from real economic activity with real people. You know, what a stock market used to mean before it became a Central Bank casino.”

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