

The Price of a Good Night's Sleep

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Even with the recent market rally, investors are still placing a significant premium on those assets perceived as “safe”. Case in point: the US Treasury market. By one measure – real yields measured against core inflation – long-dated Treasuries are offering the worst returns in over 30 years. The flip side of this trade is a persistent aversion to assets perceived to be the most risky, particularly Europe. Even in the more stable, northern parts of Europe many markets are trading at 8 to 9 times earnings, with dividend yields ranging from 4% to over 5%. In a low yield world, this strikes us as an interesting long-term opportunity.

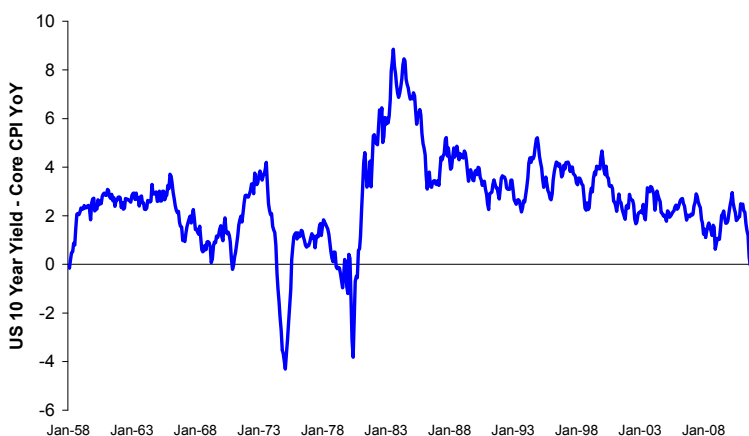
Negative Returns and More Risk: What Could Go Wrong?

In the seemingly unstoppable march towards a 0% long-bond, US Treasuries recently notched another milestone. In September, the yield on the 10-year Treasury note dipped below the rate of core inflation for the first time in 30 years. In recent months, the trend has continued. With rates still stuck at or below 2% and core inflation now at its highest level in over three years, the spread between the yield on a 10-year Treasury and core inflation is now at its most negative since 1980.

While it is not uncommon for nominal Treasury yields to dip below headline inflation, it is much rarer to see Treasury yields below core inflation. Since the late 1950s, the average spread

Chart 1

Real US Long-Term Rates
1958 to Present



Source: Bloomberg, 12/31/2012

between the 10-year Treasury note and core inflation has been roughly 2.60%, consistent with the level suggested by most economic text books.

One reason it is unusual to see yields this low relative to core inflation is that this measure of inflation – which excludes food and energy prices – tends to be more stable. For example, nominal rates dipped below headline inflation in 2008. However, this was a temporary phenomenon caused by the spike in oil prices, which briefly drove inflation north of 5%. In contrast, core inflation never climbed above 2.50% in 2008 and real rates based on core inflation remained positive.

Today's negative turn in real rates is significant. Historically, core inflation has typically been a better predictor of future inflation than the headline number. Given this, it is important to note that core inflation is still rising, albeit from low levels. In December core inflation hit 2.2%, the highest level since the fall of 2008. While none of this suggests that the United States is facing an imminent bout of inflation, it does suggest that inflation is at least stabilizing at normal levels, a conclusion reinforced by the recent anchoring of inflation expectations at around 3.2% (based on University of Michigan 1-year inflation expectations).

As we've argued in the past, for long-term investors, buying a Treasury note or bond at these yields only makes sense if you expect the United States to slip into Japanese-style deflation. To the extent that does not look likely, it is hard to justify locking in a flat to negative real yield. It is even harder to justify this when you consider that today's low coupon means that the effective duration – sensitivity to interest rates – is higher than in the past. In other words, not only are real yields negative, but Treasuries are likely to be more volatile.

Many would argue that yields are likely to stay low for some time, given the extension of the Fed's quantitative easing program coupled with their long-term commitment to low short-term rates. But to some extent this is beyond the point. While Fed intervention may keep rates low and potentially mitigate the near-term risk of capital loss, unless inflation falls substantially investors are still accepting flat to negative real return. To add insult to injury, not only are they accepting a loss of purchasing power, but are implicitly accepting more risk in the process. That is a heavy price to pay for a good night's sleep by investing in a safe haven.

Northern Europe: Cheap for a Reason or Reasonably Cheap?

The perceived safety of US Treasuries – along with a lot of buying by the Fed – helps explain why investors would be willing to accept more risk for less return. This same risk aversion also helps explain why even those parts of Europe far removed from the debt crisis – such as Norway – are still trading at a significant discount. While we think the European debt crisis will continue to linger, on a relative basis there are countries in Europe that look interesting, most of which lie in the more economically stable northern region of the continent.

Some progress has been made in Europe in recent months, although the risk of a crisis remains uncomfortably high. The most significant development has been the move by the European Central Bank (ECB) to provide unlimited funding to European banks for up to three years, an operation known as the Long-Term Refinancing Operation, or LTRO. This is important for two reasons.

First, it mitigates the liquidity problem that many European banks were having in the fall; in other words it guarantees them an emergency source of funds. Second, at least in theory, the banks can use some of this money to buy Spanish and Italian bonds, thereby easing the funding pressure in those countries. While we have yet to see much evidence of the latter, many investors are looking at the LTRO as a sort of a back-door form of quantitative easing program. Under this scenario, the ECB does not directly buy government bonds, it gets the banks to do it for them.

In addition, there is some evidence of progress in Spain, and to a lesser extent Italy, in implementing the necessary budgetary and structural reforms. That's the good news. The bad news is that it looks more likely that Greece will need to default, and potentially leave the euro zone in the next year or two. Also, while Spain and Italy have made some progress, funding costs remain high and much of the hard work lies ahead. On balance, Europe continues to muddle through, but has yet to definitely address either the fiscal or growth problems plaguing most of southern Europe.

However, given how cheap European stocks have become, muddling through may be enough. To be sure, there are still large parts of Europe – particularly Spain and Italy – we would want to avoid; these markets are cheap for a reason. That said, many of the northern countries arguably represent a good long-

term value, even if Europe goes through a recession as we would expect. For example, stocks in Germany trade at around 9 times next year's earnings, while stocks in Norway and the Netherlands trade for just 8.5 times earnings.

In addition, the Northern European countries generally are expected to grow faster, particularly the Nordic countries. Based on IMF forecasts, in 2012 Sweden, Finland and Norway are expected to grow faster than the developed country average. The northern European countries are also perceived as less risky than the problem children further to the south. A large part of the reason for this is that these countries have very modest debt burdens, ranging from 42% in Sweden to 54% in Norway (actually, Norway's net debt is actually negative as the state's assets exceed its liabilities). Finally, in a yield starved world, most of these countries currently offer a relatively rich dividend yield: nearly 4% in Germany and the Netherlands, 4.90% in Norway, and over 5% in Finland.

Given this dichotomy, we believe investors should consider the investment case for these countries. Valuation is rarely a good short-term timing discipline, but it does tend to drive returns over the long term. From our perspective, buying large-cap companies in Norway at 8.5 times earnings and getting a potential 5% yield in the process sounds more appealing than paying for the privilege of losing 1 to 2% of purchasing power every year.

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Sources: Bloomberg

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