Bond excesses, Part II – Czech government bonds

If an investor lends money to someone, he or she should do so only when the interest rate earned is sufficiently high that it at one and the same time compensates for the risk of non-repayment of the debt and provides sufficiently high real return (i.e. after subtracting inflation) while considering the term of the loan. The yields offered today by Czech bonds are far from such situation, and investors should therefore avoid them.

The 10-year Czech government bond is currently trading with a yield to maturity of 0.7% p.a. The Czech Republic has an AA rating from S&P for its long-term liabilities in the domestic currency. Although that is a very high rating, it does not mean that the repayment risk of the bonds is zero. In S&P's tables, one can find that the 10-year cumulative risk of non-repayment for bonds with the AA rating is approximately 0.8%. Although this is a small number, it means that investors should demand a substantial positive yield to cover this risk with a sufficiently large margin of safety.

The condition of positive real return on invested funds looks much tougher to fulfil. For that to be true, inflation in the Czech Republic would need to approach zero over the next decade. This is really not very probable. Through the entire existence of an independent Czech Republic, 10-year inflation was the lowest in the decade ending in 2015, when it was 2% p.a. The most current data on inflation (2.5%) indicate that it is rising. Let us not forget that the leading central banks (as well as the Czech National Bank) mostly have set as their objective to achieve and maintain inflation of around 2% p.a. They have almost unlimited possibilities to accomplish this, but it is more probable that inflation will get out of hand than it is that they will not manage to increase it. (We won't step into the debate on whether the official inflation data correspond to the actual growth in most people's costs of living.)

Annual inflation of 2.5% means that the real value of money over 10 years will decrease by 22%. Returns from the 10-year bonds will not nearly cover this. Does it make sense to lend someone money if we get less money back in real terms? We don't think so. But that is exactly what investors can expect who are buying Czech government bonds today.

When we look at US data for the past 45 years, we can observe a certain relationship between the yields on 10-year government bonds and nominal GDP growth (real growth + inflation). The yield of the 10-year bond tends over the long term (with fluctuations above and below) to correspond approximately to the nominal rate of economic growth. In the Czech Republic, according to the CNB's outlook for 2017–2019, we will have inflation of 2.5% and real GDP growth of a little more than 3%. This would result in nominal economic growth of approximately 5.5% per year. This is the level at which under normal circumstances (i.e. without central banks artificially holding interest rates deeply below their market levels) the yields would be for Czech 10-year government bonds. A 5.5% annual return would seem adequate for covering credit risk, providing positive real returns, and compensating for the fact that one must part ways with the invested money for 10 years.

Rates of almost zero on 10-year government bonds should mean that their pricing reflects expectations for the coming 10 years that we will have zero nominal growth in the Czech economy. This would mean a combination of long-term stagnation and zero or negative inflation. Even in this case, however, the bonds would not be a good investment because under such a scenario the Czech Republic's rating would not hold at AA and the risk of non-repayment of bonds would increase substantially.

If, however, we do not have 10 years of economic winter ahead and we will have normal, albeit fluctuating, positive economic growth and slightly positive inflation, then real returns from holding the bonds to maturity will be substantially negative.

Despite that we are living in a period of economic boom, rapid GDP growth, record-low unemployment, and increasing inflation, the yields on 10-year bonds are only slightly above zero. From an investment perspective, this is a very disadvantageous risk-and-return combination. We cannot change it, and therefore the only thing that remains for us to do is to avoid going anywhere near Czech government bonds.

Invest with care!

Daniel Gladiš, 3 September 2017

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