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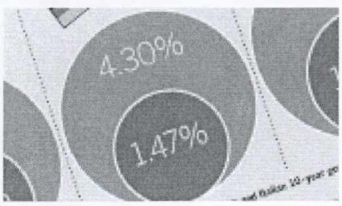
Greek exit fears put havens at premium

By Robin Wigglesworth and Michael Mackenzie

Fears over a potential Greek exit from the eurozone have sent investors fleeing for havens once more, pushing German, UK and US bond yields to or near fresh record lows.

Large institutional investors like pension funds and insurers have sometimes dubbed buying these bonds as the "pain trade", given the extremely subdued, below-inflation yields now on offer.



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Although the returns have been very attractive in recent years – as the price of these supposedly safer government bonds have rallied strongly – the low current yields put pressure on insurers and pension funds to meet their future liabilities.

"No one has been damaged by the safe haven trade so far," points out Alan Wilde, head of fixed income and currencies at Barings. "But it's difficult for a fund manager to invest in anything yielding around 1 per cent when you know your investors need higher returns than that to fill their deficits."

The pain has deepened this week. Ten-year composite UK gilt and German Bund yields both hit record lows on Monday, of 1.88 per cent and 1.45 per cent respectively. The 10-year yield of US Treasuries fell to 1.76 per cent, the lowest since last autumn.

Bunds have been the main beneficiary of Europe's turmoil, thanks to their status as the eurozone's favourite haven. German borrowing costs are particularly subdued in shorter duration bonds. Bonds with a maturity of up to two years yield below 0.1 per cent, below comparable Japanese securities.

"If it's a risk-off day, people will pile into Bunds," says Andrew Morton, head of G10 government bond trading at Citigroup. "People aren't buying Bunds for the 10-year return, but in anticipation that they'll perform on a one-week horizon."

Many investors and analysts have argued that these safer government bonds are overbought, and are vulnerable to corrections.

For example, Anton Heese of Morgan Stanley recently estimated that 10-year Bunds are overvalued by about 100 basis points. Steven Major, global head of fixed income research at

HSBC, says that on a fundamental basis, Germany's 10-year borrowing costs should be closer to 4 per cent.

Most notably, John Paulson, the hedge fund manager who made billions by foreseeing the collapse of the US housing market, last month revealed that he is shorting German government bonds.

The rationale for Bund bears is that Germany – as the eurozone's largest economy and its most creditworthy member – will inevitably have to act as the main fiscal backstop for the union's stricken members.

"Whatever the solution, Germany will have to pay the most," predicts Mr Major. "If there is some sort of crisis resolution then Bund yields can snap back up quickly again."

In the US, weekly positioning data have indicated reluctance among Treasury investors to own government bonds aggressively. Many portfolio managers are overweight higher yielding corporate bonds and mortgages versus Treasuries.

The looming end of the Federal Reserve's "Operation Twist" – in which the central bank started to buy heavily into longer-dated Treasuries to subdue longer-term yields – will also remove a hefty buyer of US government debt.

UK gilts have also benefited from safe haven flows, but are susceptible to headwinds from the UK's indebtedness, weak growth and the threat of ratings downgrades.

"There's not much to recommend gilts at the moment apart from the fact that the UK isn't in the euro," Mr Wilde argues.

Yet for now, there are many factors that are likely to keep these safe haven government bond yields subdued – or even send them lower.

When the US Fed ended two previous rounds of quantitative easing, riskier assets performed far worse than US Treasuries, traders point out. The persistence of haven flows into Treasuries was illustrated on Tuesday with the release of official data for March showing solid demand from foreign central banks, led by China and Brazil.

"We expect the souring in global risk sentiment in recent months, as concerns about the deteriorating European debt crisis and slowing global growth momentum intensifies, to continue to bolster foreign investors' appetite for US Treasury securities," says Millan Mulraine, strategist at TD Securities.

German Bunds are also likely to continue to benefit from their position as an effective "disaster insurance" against the possibility of a chaotic eurozone break-up.

"In the worst case scenario where assets get redenominated in the various national currencies, you would much rather hold Deutschmark bonds than drachma bonds," Mr Major says. "The yields may be low but you'd get an instant currency appreciation."

Given the likelihood of continued turmoil in Europe, Mr Major says "it isn't impossible" for Bund yields to go to 1 per cent.

Strategists and fund managers argue that large institutional investors cannot continue to pile into government bonds with yields below inflation indefinitely. Yet few are betting that the painful – but relatively safe – trade will be derailed soon.

"It's difficult to see how yields can stay this low indefinitely, but it's also difficult to see what could reverse it in the short term," Mr Wilde says. "There's still a lot of uncertainty, and safer assets will benefit from that."