



# Wake Up Europe!

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In June of 1984 I was a young portfolio manager finding myself at odds with the wisdom of the day. Yields on 30-year Treasuries had rebounded from 10% to 14% as inflation had bounced from 2.5% and was running at just over 4%. The leading sages of the day were very bearish on bonds, as they had been rewarded for that view for the prior 20 years. At the time, I loaded up on 30-year bonds and 30-year zero-coupon bonds—those were positions we can only dream about today. However, the point of this blog is not that there was great value 35 years ago. Instead, my point is that the U.S. was issuing bonds that were a ridiculous burden on Americans. Real 30-year bond yields 10% higher while the rate of inflation began a secular decline is something we have seldom seen again—and a waste of taxpayer money in my opinion. The great inflation had been broken and did not need to be crushed again.

Now, we have Europe. Something is not working in Europe, but the authorities don't seem to be able to figure it out. European Central Bank (ECB) rates hit zero in 2012 as President Mario Draghi said he would do whatever it took to counteract his predecessor Trichet's disaster of a rate rise in 2011. Rates continued to drop reaching minus 40 basis points (bps) in early 2016. This was all in the effort to get inflation to rise. As of today, money supply is growing, but inflation is not. We believe that the ECB has done all it can and that what Europe needs is demand. Central bankers seem to harken back to the world where they could turn on the credit spigot and borrowers would line up. The last decade's challenges have reminded borrowers that they must pay back the principal, and the ECB's fears about deflation make them fearful as well.

So, what is Europe to do? Europeans should be happy to borrow at negative yields and use the proceeds to invest in much-needed infrastructure that might increase the region's growth rate. One might go so far as to imagine Germany spending money on Italian infrastructure that could have positive feedback into German gross domestic product (GDP) by a few basis points. While in 1984 I was incredulous to pay 10% real for my government's debt, it now seems equally foolish to not borrow money at negative cost to invest in projects that may have a positive return. I don't think finding such projects is a high hurdle.

Let's play a hypothetical mind game for a minute. Germany issues ten times its GDP in 10-year Bunds at the current yield of -0.4%. Germany issues the bonds to the ECB for newly minted €1 billion notes, at the current price of 104% of par. The 33,000 notes—100% of par value—are then put in the vault, so they don't get "loose" and cause the much-feared German hyperinflation. With the 4% bonus—in other words, 40% of GDP—the government either spends like mad on infrastructure or pays down two-thirds of outstanding German debt.

While this hypothetical scenario is highly unlikely, policymakers are already down Alice's rabbit hole of free debt, so why not try to fully enjoy the opportunity? More realistically, eurozone countries could issue negative-yielding debt to spend on infrastructure, or anything that contributes to growth, at least until rates move above zero. Bond yields were crazy high in the early 1980s and now they're crazy low—therefore, Europe should wake up and take advantage of this negative yield anomaly.

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