DiNuzzo Index Advisors, Inc.

FEE-ONLY WEALTH MANAGERS

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Bond Anomalies

Here's a trivia question to startle your friends with. According to International Monetary Fund statistics, what country has the highest government debt levels, compared with its economic output, in the world?

You might be inclined to guess troubled or developing nations like the African nation of Eritrea (134% of its 2011 GDP), Lebanon (136%), or Jamaica (139%)--or, if you were aware that it existed, the sovereign nation of Saint Kitts and Nevis (153%), a former British colony is located in the beautiful Caribbean Leeward Islands north of Venezuela.

After reading so many headlines, you might guess that Greece (161%) is in the deepest debt hole, or perhaps the United States (103%).

As it happens, none of these countries is even close to the runaway leader in government debt as a percentage of its economic output: Japan, which is paying interest on bonds whose face value equals more than 229% of Japan's GDP.

Perhaps the most interesting thing about this bit of trivia is that bond traders don't seem to be worried about Japan's ability or willingness to pay back its creditors. As you've probably seen from the headlines, when investors are worried about a country's soaring debt levels, they will often demand higher rates--so the rate that a country pays is a pretty good proxy for how concerned (or not) investors are about the country's solvency. With that in mind, look at the little table below, which shows the debt to GDP levels of various countries next to their 10-year bond rates. Think of it as a comparison between how much global bond investors SHOULD be alarmed vs. how alarmed they actually are.

Country	10-Yr Bond Rates	2011 Debt/GDP
Greece	28.66%	160.61
Pakistan	13.37%	60.12
Brazil	12.55%	66.18
Portugal	11.36%	106.79
India	8.35%	68.05
Hungary	8.28%	80.45
Ireland	8.21%	104.95
South Africa	8.20%	37.88
Colombia	7.60%	34.67
Peru	6.76%	21.64
Indonesia	6.47%	25.03
Spain	6.09%	68.47
Russia	6.00%	9.60
Mexico	5.92%	43.81
Italy	5.70%	120.11
Poland	5.35%	55.39
Israel	4.41%	74.34

South Korea	3.65%	34.14
Thailand	3.64%	41.69
Malaysia	3.51%	52.56
China	3.38%	25.84
New Zealand	3.30%	37.04
Czech Republic	3.25%	41.46
Australia	3.09%	22.86
Belgium	3.00%	98.51
France	2.57%	86.26
Norway	2.38%	49.61
Austria	2.24%	72.20
Netherlands	1.84%	66.23
Canada	1.83%	84.95
United Kingdom	1.72%	82.50
Finland	1.69%	48.56
United States	1.65%	102.94
Sweden	1.48%	37.44
Singapore	1.44%	100.79
Germany	1.38%	81.51
Hong Kong	0.96%	33.86
Japan	0.88%	229.77
Switzerland	0.65%	48.65

Comparing the right-hand column with the one in the middle, you see some head-scratching anomalies. Greece, which has the second-highest debt-to-GDP level in the world, pays by far the world's highest interest rates on its debt, which seems appropriate. But Italy, which is not far behind on the debt list, is paying interest rates somewhere near the middle of the pack, and the U.S. and Singapore, which have significant debt levels compared with the rest of the world, are paying almost nothing for the privilege of borrowing from global investors. Meanwhile, relatively thrifty countries like Colombia, Peru and Indonesia are paying much higher yields than debt-burdened Belgium, France and Singapore.

By far the biggest outlier on the table, however, is Japan, with debt-to-GDP levels more than twice as high as the U.S., paying rates lower than anybody on the table but Switzerland. How can that be? Because more than 90% (some estimates say more than 95%) of Japan's government bonds are owned by Japanese citizens, compared with an estimated 57% in Italy, and 54% in the U.S. In other words, the global bond markets cannot demand higher interest rates on yen-denominated government bonds because they don't own Japanese debt; global investors are looking for more return on their money than Japan is currently offering.

Sincerely,

PJ

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