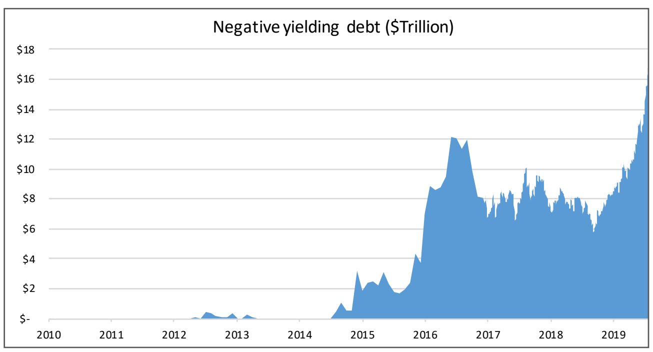
Getting Paid to Borrow: Negative yields and market implications

Amid broader market volatility, the topic of negative interest rates has become one of the most talked-about and analyzed aspects of financial markets over the past several months. Currently, more than $16 trillion in global sovereign debt is trading at negative yields, representing 29% of global government bonds as of April, according to JPMorgan.[1]

But what does it mean for debt to trade at a negative yield, and how did countries with negative rates get to this point? More important, why would an investor ever purchase a bond with a negative return, and what do negative yields really mean for investor portfolios?



Bloomberg, through 8/23/19

What is a negative-yielding bond?

A bond with a negative yield means that investors purchasing these bonds are willing to receive less money in the future for taking the risk of loaning money to certain borrowers, usually governments. Think of lending a friend $100 with the expectation for him or her to pay back $95 next year. This phenomenon has also spilled over into the mortgage market, with Jyske Bank, Denmark's third-largest bank, offering a 10-year mortgage at -0.5% interest. This means Jyske Bank is paying borrowers interest to take a 10-year home loan.

The willingness for lenders to accept negative rates runs counter to established norms in financial markets. Historically, banks receive interest from lenders for making loans. Factors including the real risk-free rate, inflation, and overall demand for riskless assets can affect the interest rate lenders can expect to receive. Currently, these factors, in aggregate, are skewed in a way that result in negative rates.

Why would someone buy a negative-yielding bond?

Many different participants with different goals contribute to financial markets, with central banks representing one of the largest participants since the Great Recession. Central banks, specifically the U.S. Federal Reserve, European Central Bank, and Bank of Japan, have kept interest rates near zero or even negative in an effort to provide access to inexpensive lender capital to borrowers while driving investors into the stock market, thus in theory spurring economic growth and preventing a recession. For this reason, other market participants consider central banks "non-economic buyers," meaning they are not motivated by profit but by achieving a goal, in this case maintaining a predetermined interest rate level to promote growth.

Central banks do this in two ways: Setting deposit rates for banks and purchasing assets to manage interest rates. In terms of deposit rates, the European Central Bank's current excess deposit rate is -0.4%, and the Bank of Japan has maintained their corresponding rate at -0.1%. This means that

As country-specific trends have all but disappeared, individual countries will only have so much power to control domestic growth and may be forced to accept accommodative monetary policy to remain competitive in global markets.

banks that have reserves in excess of the requirement are charged for not doing productive things with those reserves such as lending or purchasing other assets.[2] This penalty is meant to urge banks to lend reserves and to help support the economy.

Central Banks also make asset purchases and sales. Currently, the European Central bank (ECB) has more than €2.6 trillion on its balance sheet. Of this, the public-sector purchase program (PSPP) owns 90% of the portfolio (PSPP investments are mostly European government bonds).[3] As part of their quantitative easing program enacted in 2009, the ECB purchased bonds to keep interest rates low. Low interest rates are good for a struggling economy because it makes it cheaper to borrow money and helps support inflation. Overall, low rates have helped bolster the global economy, but rates have remained low for a very long time. This means that central banks have less ability to cut rates without driving yields into negative territory and the ECB has made at least some of the asset purchases at negative rates.

Professional and retail investors buying these bonds may feel that it makes sense to take a negative yield for a few reasons. First, investors may be willing to pay to "park" cash in certain assets in exchange for safety, meaning they would prefer to know how much will be lost in a "riskless" asset and prefer that outcome to riskier assets that may decline more. Second, and more worrisome, is that investors may think that rates will continue to fall, causing bond prices to rise and earning them gains (since bond yields and bond prices have an inverse relationship). The ECB has signaled further rate cuts in September and may relaunch their Asset Purchase Program,[4] which would reduce rates even further. Investors may be willing to accept negative yields now because they expect to realize gains in the future when the ECB cuts rates again and continues to purchase bonds.

How did we get here?

Global trends such as changing demographics and demand for risk-free debt can affect real risk-free interest rates, which represent the actual return after inflation that investors can expect in riskless assets like high-rated government bonds.

In analyzing the historical real risk-free rate across several developed countries over more than a century, global real risk-free rates remained fairly stable at just below 2%, according to the Federal Reserve Bank of Dallas. However, over the last three decades, rates have declined significantly across all countries.

This decline reflects lower economic growth and greater investor demand for these risk-free assets. Meanwhile, country-specific trends in real interest rates have almost entirely vanished since the 1970s,[5] reflecting how financial markets have become intertwined, meaning negative rates in Europe and Japan could have implications across global markets.

As real risk-free rates have declined over the last thirty years, markets are more likely to encounter negative rates, especially in low inflation situations. In addition, as country-specific trends have all but disappeared, individual countries will only have so much power to control domestic growth and may be forced to accept accommodative monetary policy to remain competitive in global markets.

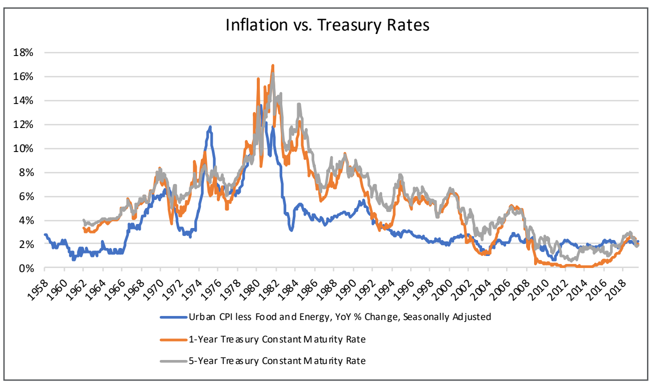
In addition to this broad trend of declining real rates, the global financial crisis forced central banks into very aggressive monetary policy decisions to stave off disaster, specifically, cutting interest rates to near-zero levels. While markets have improved, global interest rates have remained low for over a decade and have yet to return to pre-crisis levels. With economic growth cooling and rates at low levels, the only tool available to some banks is to cut rates into negative territory.

How will negative rates impact financial markets?

Unsurprisingly, investors wonder what global negative rates could mean to portfolios. And while we've never witnessed anything like this in history, it's not unreasonable to assume that this bizarre "new normal" will likely create major market distortions. Regardless of the fundamental mechanics of the economy, the uncertainty that comes with negative rates will likely make markets more sensitive to disruptions, thereby increasing overall market volatility.

Negative rates could cause speculation in certain assets, namely stocks and riskier bonds, forcing investors into riskier, more volatile assets for the sake of yield. Borrowers could also take advantage of these negative rates, leading to a debt bubble.

Negative rates also have repercussions for the banking industry since negative deposit rates would likely cause clients to withdraw cash, again forcing them into riskier investments. This is already happening in some countries as banks have begun to pass negative rates to clients. Currently, the ECB's deposit rate of -0.4% is costing German banks around €2.4 billion a year,[6] and if negative rates continue to persist without passing on costs to retail clients, banks will continue to struggle. Overall, continued negative rates could cause a significant disruption in the global banking sector that could have other unknown repercussions.



Bloomberg, through 8/23/19

A word about inflation

While the implications of pervasive negative interest rates remain uncertain, markets remain concerned about very low inflation. Inflation devalues currency over time – it is why $20 in 1960 bought much more than $20 does today. A healthy level of inflation is important because it helps drive investment and spending, since businesses and individuals should not want to hold on to a devaluing asset (cash). When money is spent or invested, the money is doing productive things for the economy, and economic growth should increase. Higher inflation usually results higher interest rates. This is because lenders want their returns to at least cover the rate of inflation.

Inflation will often decrease when the economic outlook turns negative because investors become more averse to taking risks and demand for cash increases. In this scenario, investors prefer to wait for economic conditions to improve. This causes a positive feedback loop, whereby people want to hold rather than invest or spend cash, which could lead economic conditions to deteriorate and people to horde more cash and so on. If this persists, currency will begin to appreciate as the demand for cash increases. When this happens, inflation turns negative – we call this deflation, which could be devastating for an economy because nothing would incentivize investment or spending.

Overall, negative interest rates are a new phenomenon, and markets are wisely concerned about repercussions of easy money. However, the alternative - a deflationary spiral - could be far worse and harder for central banks to manage, which is why some central banks have considered cutting even further. As we monitor negative yields, we continue to believe that a well-diversified portfolio that's appropriately allocated relative to your risk tolerance is the best defense against current uncertainties.

1 Dryden, Alex. "Why Are Bond Yields Going Negative Again?" J.P.Morgan Asset Management, April 5, 2019. https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/why-are-bond-yields-going-negative-again.

2 "Negative interest rates in Europe: A Glance at Their Causes and Implications," Global Economic Prospects, The World Bank, June 2015, https://www.worldbank.org/content/dam/Worldbank/GEP/GEP2015b/Global-Economic-Prospects-June-2015-Negative-interest-rates.pdf.

3 "Asset purchase programmes," European Central Bank, accessed August 30, 2019, https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html.

4 Tom Fairless, "ECB Signals Rate Cut, Possible Stimulus Relaunch," The Wall Street Journal, July 25, 2019, https://www.wsj.com/articles/ecb-signals-rate-cut-possible-stimulus-relaunch-11564055951.

5 Marco Del Negro, Domenico Giannone, Marc P. Giannoni and Andrea Tambalotti, "Global Trends in Interest Rates," Federal Reserve Bank of Dallas, October 16, 2018, https://www.dallasfed.org/-/media/documents/research/papers/2018/wp1812.pdf

6 Martin Arnold, "German banks wade into negative rate debate," Financial Times, August 25, 2019, https://www.ft.com/content/6a0be970-c6b5-11e9-a1f4-3669401ba76f.

09062019-606