

# More Negative Yields: A Possibility Not to Dismiss

**THE CONCEPT OF NEGATIVE YIELDS SEEMS ABSURD:** Why would an investor pay to lend money to a country or company that's offering a negative yield on its bonds? Negative yields are not a natural phenomenon, as a bond's yield should compensate the lender for assuming the risk of the borrower. But negative yields on bonds already exist in some parts of the world, and even the taboo of central banks setting interest rates below zero seems to have weakened. Just recently, Italy issued two-year government bonds at a yield of -0.023% for the first time, and the European Central Bank (ECB) opened the door to lowering deposit rates below its already-negative level of -0.2%. Several other central banks have engaged with negative policy rates as well. While my base case is for developed market yields to remain low but positive for a long time, there are certain scenarios in which I can imagine negative yields becoming more widespread, including in the U.S.

In this month's commentary, I will address:

- Countries where negative bond yields already exist
- Reasons why yields turn negative
- Drivers that could expand the occurrence of negative yields
- Risks of negative bond yields

## Countries Where Negative Bond Yields Already Exist

FIGURE 1 shows the extent to which the negative rates implemented by central banks around the world have affected bond yields. There are now 12 countries where two-year bond yields trade below 0%, up from just five countries a year ago. All are European countries that have been influenced by the ECB's large-scale quantitative easing program and the potential for negative deposit rates. Even countries outside of the eurozone, such as Sweden and Switzerland, are under pressure to keep rates low in order to contain any economic headwinds that could result from their currencies strengthening against the euro.



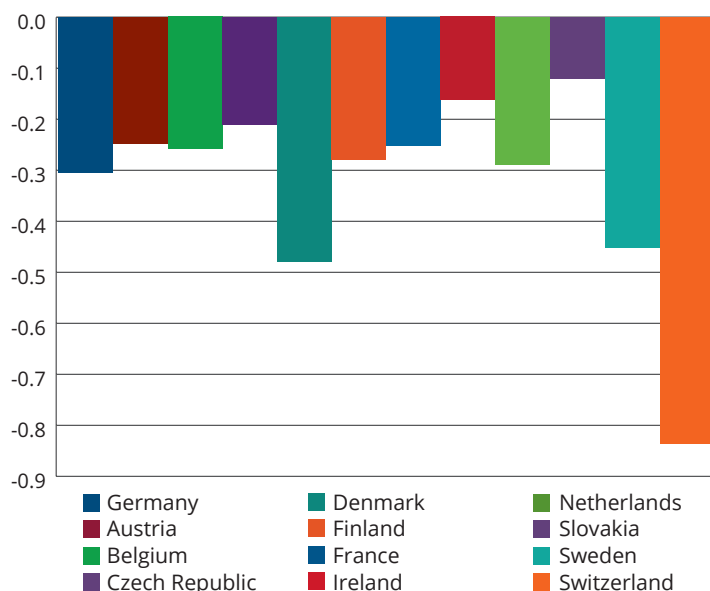
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—Nanette Abuhoff Jacobson

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**FIGURE 1**  
**Negative Yields Already Exist in Many European Countries**  
Two-Year Government Bond Yields (%)



Source: Bloomberg

## Reasons Why Yields Turn Negative

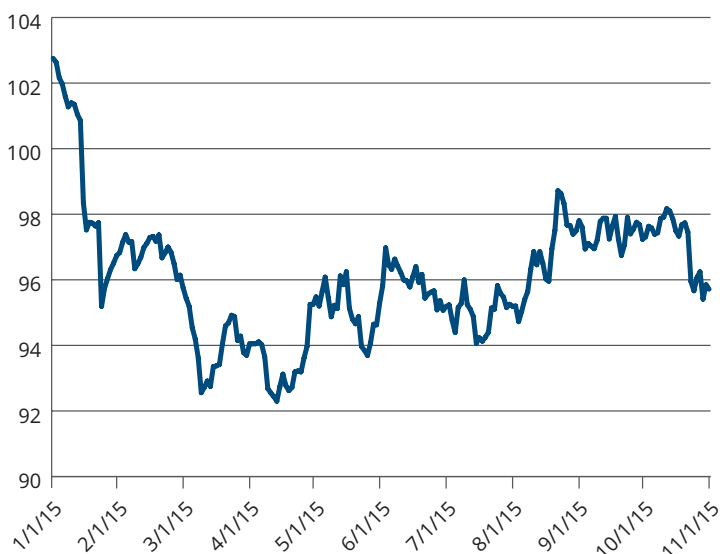
Bond yields can turn negative for several reasons. If investors expect an economic recession or a deflationary environment, situations that could prompt rates to fall further, it may make sense to buy negative-yielding bonds that could potentially be sold for a capital gain should yields become even more negative.

Quantitative easing (QE)<sup>1</sup> by central banks may make investors more confident that they will earn capital gains on bonds with very low or negative yields: Even if an investor buys a bond with a negative yield, the central bank could subsequently buy that bond at an even lower yield. Today, I believe that easy monetary policy from developed markets will continue to provide a persistent bid for government bonds. QE in the eurozone is currently creating €60 billion in monthly demand for government bonds, and ECB President Mario Draghi hinted last month that the asset-purchase program is likely to be extended beyond September 2016. Similarly, the Bank of Japan could very well expand its QE program. Finally, investors may simply prefer negative-yielding “safe-haven” assets over the risk of a large drawdown from less-secure investments.

Another factor helping to keep bond yields in low or negative territory is the increasingly common central bank tactic of lowering interest rates in order to lower the value of their currency. For example, the ECB has been highly focused on a weaker euro as a means to boost exports, which account for approximately 25% of the eurozone’s gross domestic

product.<sup>2</sup> FIGURE 2 shows that while Europe’s nominal effective exchange rate (a trade-weighted average of a currency’s value) has climbed in recent months, the ECB has made concerted efforts to tamp down the increase. Mr. Draghi also cited the possibility of cutting the ECB deposit rate from its current -20 bps. Together, these signals appear to be more explicit indications that the ECB is comfortable cutting interest rates further into negative territory in order to weaken the euro.

**FIGURE 2**  
**Keeping the Euro Low is Another ECB Objective**  
Europe’s Nominal Effective Exchange Rate



Sources: Bloomberg, ECB

Interestingly, natural buyers of bonds exist even when yields are negative. Less-price-sensitive buyers include central banks and insurance companies or pension funds, whose mandates, liabilities, or regulations force them to purchase high-quality fixed income assets regardless of price. U.S. money market funds, for example, are required to own a larger percentage of liquid government debt in order to safeguard the industry from a modern-day “run on the bank.” U.S. banks are also seeking high-quality liquid assets under new liquidity rules. Given that the issuance of Treasury bills has shrunk in recent years because of the U.S. government’s reduced financing needs, demand has exceeded supply, making these assets scarcer and pushing their yields lower. Finally, inflation expectations are low around the world, so there is less concern that high inflation will erode the value of fixed income investments, a situation that comforts bond investors.

<sup>1</sup> Quantitative easing is a type of monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective.

<sup>2</sup> Gross domestic product is the monetary value of all the finished goods and services produced within a country’s borders in a specific time period.

# Monthly Market Insight

## Drivers that Could Expand the Occurrence of Negative Yields

I believe there are three scenarios in which negative bond yields could become more pervasive: currency depreciation, risk of recession, and persistent risk aversion.

**CURRENCY DEPRECIATION** — As mentioned in the ECB example above, central banks are increasingly including currency as part of their arsenal of monetary policy. European countries that have pegged their currencies to the euro, such as Denmark, have had to cut interest rates in order to remain competitive as the euro has fallen. This is ECB currency activism in action. Given that the economic recovery in Europe is slow and fragile, using currency depreciation as an additional tool to boost growth seems to be growing in acceptance. It is also quicker and easier than implementing structural reforms.

**RISK OF RECESSION** — Countries around the world are at different stages of the economic cycle. Among developed markets, the U.S. is furthest along, as evidenced by the Federal Reserve's (Fed) current stated bias toward raising interest rates slightly in the near future. While recession risk is low in the near term, signs of credit stress are appearing. If and when the U.S. eventually experiences a downturn, I think the Fed might not have much room to lower rates without making them negative. Case in point: The market is currently pricing Fed's terminal funds rates of approximately 1.5% in mid-2018, so if a recession occurs at that time, the Fed may have a hard time lowering rates enough while keeping them positive.

**PERSISTENT RISK AVERSION** — Since the financial crisis, many investors have a lower tolerance for large drawdowns and high volatility. Evidence of this shift is twofold. First, among retail investors, cash levels are relatively high despite near-zero yields. Second, as **FIGURE 3** shows, relative to the size of their respective markets, flows into "safety" assets such as dividend-paying equities, bonds, and alternatives that offer low correlation to risk assets and lower volatility have outpaced broader equity flows since the global financial crisis. This risk-averse behavior could keep demand for

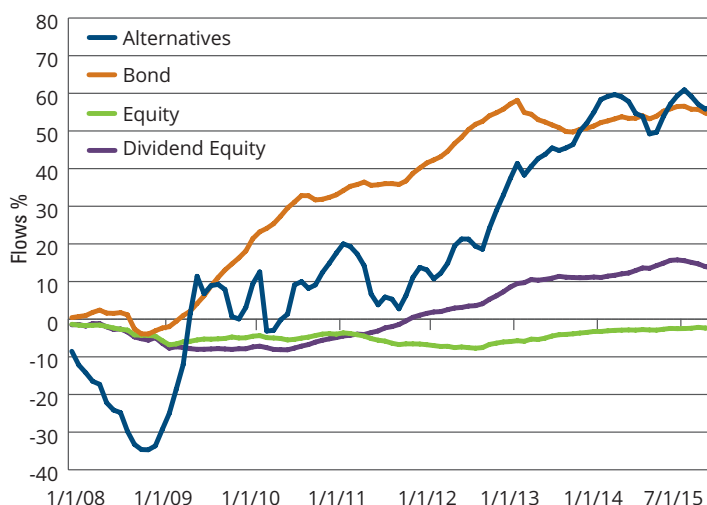
safe-haven assets such as government bonds high, despite the fact that investors must pay an "insurance premium" for them in the form of a negative yield.

## Risks of Negative Bond Yields

Negative yields expose the economy to certain risks. Extremely low borrowing costs could result in a misallocation of capital, causing some sectors of the economy to overheat. If negative rates and a weak currency trigger capital flight, some asset values could collapse. Negative yields may fail to boost economic growth if business and consumer confidence remain low despite very low borrowing costs; if that is the case, governments may need to implement incentives besides easy monetary policy in order to stimulate economic growth.

**FIGURE 3**  
**Flows Into Safety Assets Have Been Strong**

Cumulative flows as a percentage of total net assets on December 31, 2007



Source: EPFR Global

## Investment Implications

If interest rates remain low or creep lower, I believe investors should consider adding exposure to the following assets:

**Investment-grade bonds.** Credit assets generally perform well when interest rates are low or stable.

**Interest-rate sensitive equities.** Utilities, real estate-related equities, and quality dividend-paying stocks tend to outperform other equity segments in lower-rate environments.

**Mortgage-related assets.** Mortgage-backed securities (MBS) may also perform relatively well in this type of environment.

**Government bonds.** Even though asset owners think the risk of higher rates is greater than lower rates, interest-rate risk may actually be more symmetrical if one acknowledges the possibility of negative yields. From this standpoint, high-quality fixed income still adds diversification and liquidity to an investment portfolio.

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