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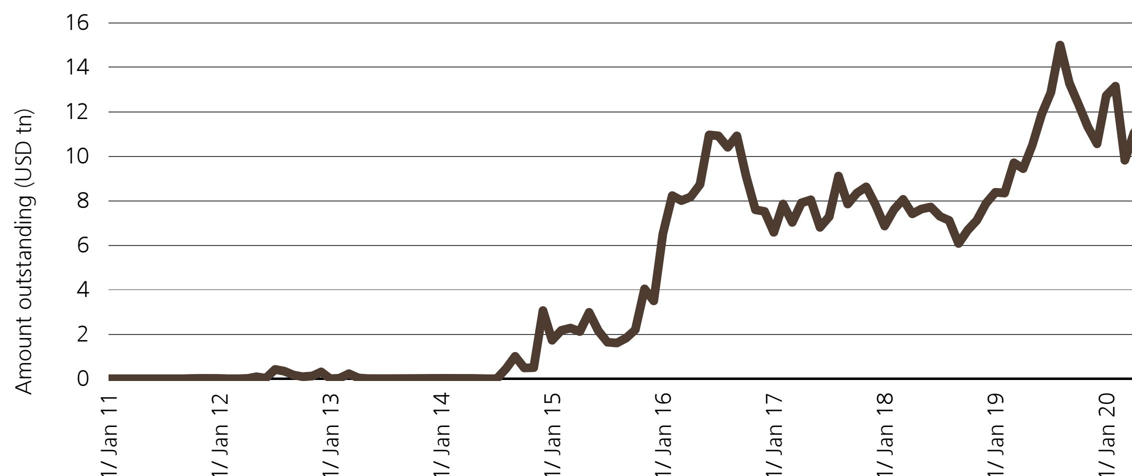
Webinar: Negative interest rates—a game changer?

Until earlier this year, negative yields on government debt existed mainly in the Eurozone and Japan, and investors expected a gradual convergence towards higher US levels. Then, the emergence of COVID-19 changed the narrative. Our investment experts discuss what may come next.

Key webinar takeaways

– In mid-2016, around the 60% of Eurozone government bonds had a negative yield, and investors searching for yield counted on global interest rates eventually converging towards the higher level of the US.
– The 2020 COVID-19 crisis has shaken that view, and now many see an opposite trend developing: of US rates converging toward the zero range prevailing in Europe and Japan.
– Market analysts put the probability of negative rates at just over 40% for the US, and nearly 50% in the United Kingdom over the next year.
– Investors are looking for ways to meet this challenge

A short history of negative-yielding debt
Bloomberg Barclays Global Aggregate Negative Yielding Debt Index – amounts outstanding USD tn



Source: Bloomberg Barclays Global Aggregate Negative Yielding Debt Index, as of June 2020.

Massimiliano Castelli

Until 2015, negative yielding bonds were relatively rare. Then, starting in Europe, global negative-yielding debt shot up from less than USD 3 trillion in 2015 to over USD 12 trillion in 2016. In mid-2016, around 60% of Eurozone government bonds already had a negative yield! Over the next year or two, yields slowly recovered and the total amount of negative-yielding debt globally sunk to slightly over USD 6 trillion by mid-2018. But the rise in yields was relatively short-lived. By mid-2019 – one year later – central banks around the world once gain engaged in unprecedented monetary easing and negative yielding debt ballooned to USD 15 trillion. This is equivalent to about one quarter of the total government bond market with around 70% of Eurozone government debt affected.

The US was still somehow an exception, and markets generally expected that over time, global interest rates would ultimately converge again towards the higher levels of the US. In early 2020, COVID-19 hit the global economy and instead it was US rates that converged towards the zero bound range already prevailing in Europe and Japan.

The pandemic has affected fixed income markets in a number of ways:

– At the beginning of the pandemic, negative yielding debt nearly disappeared. For example, while Europe still had negative-yielding corporate bonds worth over one trillion in February 2020, by March, the pool of negative-yielding investment-grade corporate debt in the Eurozone practically disappeared due to rising spreads.

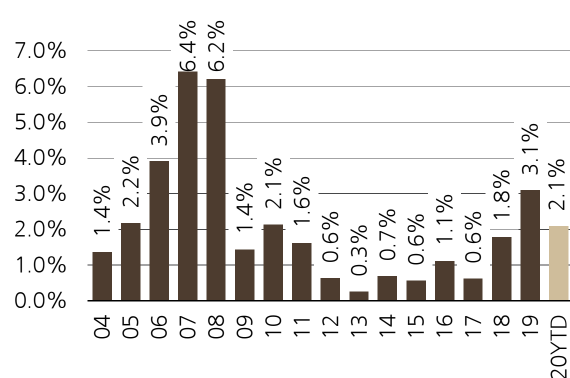
– Negative yielding government debt in the Eurozone also decreased in the light of extensive fiscal stimulus packages. Globally, the pool of negative yielding debt declined to around USD 12 trillion in May 2020 from over USD 14 trillion in February.

– With major central banks now backstopping virtually all types of investment-grade debt, negative-yielding debt is expected to increase again, even though sovereigns are issuing record amounts of paper, and corporates are using central bank support to refinance large amounts of debt.

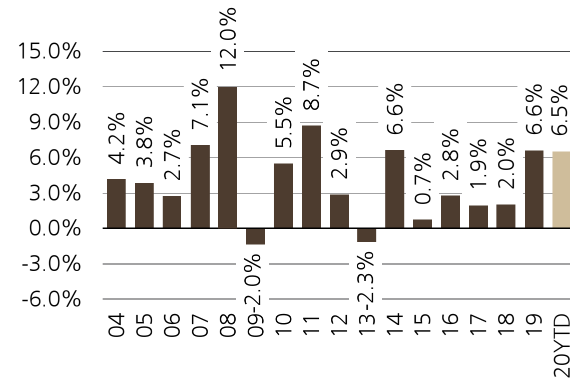
Government Bond Portfolio returns

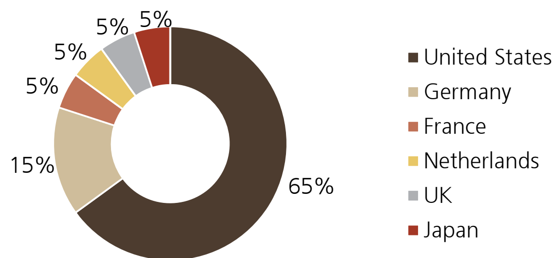
Advanced economies' government bonds are and will remain a key asset class in sovereign institutions portfolios

Global Government Bond Short Duration (GGB 1–3), Hypothetical Returns, %



Global Government Bond Long Duration (GGB), Hypothetical Returns, %





United States
Germany
France
Netherlands
UK
Japan

Key features

- Broadly resembling the currency composition of global FX reserves
- Non-USD indexes all hedged in USD

Source: UBS-AM, Bloomberg. Data as of end of May 2020. For illustrative purposes only.

Fixed income investors face a changing landscape

In the GSM Strategy and Advisory team we track various sovereign institutional portfolios, including central bank sample portfolios which have the bulk of their assets invested into government bonds. For instance, a typical central bank portfolio consisting of 50% cash/short duration government bonds and 50% of long-duration investment grade government and non-government bonds generated a return of 2.6% year-to-date as of 31 May, outperforming the more risky portfolios which include more spread products or even equities. On a rolling 12m-basis, the portfolio shows impressive returns of 5.1%.

However, these returns are not the result of higher yields but increases in bond prices. We saw a similar effect during the 2 years of the GFC when the portfolio in question (CB2) was able to achieve annualized returns of more than 5.0%. However, in the 10 following years (2009-19), the average annual yield fell dramatically to an average annualized rate of 2.6%, compared with 4.0% for the time before the GFC (2002-06).

With interest rates also in the US having approached the lower bound, we will not reach the relatively modest returns of the 2009-19 period in the years ahead.

As a consequence, the costs and challenges associated with low or negative rates are more and more taking the center stage of the discussion. And it is not only a return issue; negative-yielding debt has ramifications that affect substantial parts of the economy and society as a whole:

– Saving for retirement is move difficult. Although having achieved relatively good returns during the bull market of the past 10 years, the average US pension plan is still only 85% funded. On top, other "Safe" assets that are often used to save for retirement including property, life insurance and annuities are ultimately all priced off of bond yields and are become more expensive with low rates.

– The problem of creating "zombie" companies which are able to roll over debt despite questionable economic perspectives. For an economy, it might be in the long run more beneficial to let these companies go and to build up more viable businesses.
– Increased inequality with holders of financial assets getting a wealth boost at the expense of smaller savers. Large corporations can refinance at virtually zero while credit card debt comes at close to 20%.

Huw van Steenis

The specter of negative rates is looming for the Anglo Saxon economies. Roughly half of G10 economies have cut policy rates below zero. The UK has sold three-year debt at a negative yield for the first time. But given the span of the pandemic's shock, more countries will follow suit.

The probability of negative rates for the following year is considered to be just over 40% for the US, and nearly 50% for the United Kingdom. The Bank of England has said policy rates below zero are under active review, as is also the case in New Zealand and Australia. In the US, the market is starting to price in this possibility from next year. Whilst in our base case we do not expect more central banks to go negative, we thought worth exploring the investment implications. A move below zero would be an unwelcome and unnecessary experiment for markets, for three reasons.

First, the evidence that negative policy rates have successfully generated growth or inflation is at best weak. Financial conditions appear to improve, at first. And financial conditions ease. But several recent papers highlight that low rates correlate with low inflation, perhaps because they probably cause longer-term expectations of price rises to weaken, rather than strengthen. It is also debatable whether negative rates have an impact on inflation through the channel of exchange rates, as currencies depreciate.

Like steroids, unconventional policy can be highly effective in short dosages, but just as long-term usage of steroids weakens bones, so too, below-zero rates can weaken the financial system.

Second, the financial frictions of negative rates may be more severe in UK and the US. As professor Charles Goodhart and I have argued before, macroeconomic models typically take banks and other intermediaries for granted. But negative rates erode the profitability of banks, possibly reducing the availability of credit in the economy at a time when banks' resilience is much needed.

Japanese banks, and more recently their European counterparts, have illustrated some of the problems caused by cutting rates. Japan's regional banks have among the lowest returns on assets of any around the world. Larger banks have fared somewhat better, in part by lending more overseas. Japanese banks bought about a third of the higher-rated tranches of US collateralised loan obligations — investment vehicles that buy leveraged loans — in the past few years.

Quantitative easing programmes have helped the global economy and enabled banks to repair their balance sheets. Low rates have improved the affordability of their loans, reduced bad debts and lifted the value of assets. Japanese banks have relied upon capital gains from owning government bonds to offset pressures on profitability.

One counterargument is that the impact of negative rates appears to have been fairly benign in Sweden, Denmark and Switzerland, through the tiering of rates, where only part of banks' reserves at the central bank are penalised. While these measures help, they are no panacea. Banks have sought to offset negative rates by charging higher fees, repricing mortgage spreads and, in some cases, lending more aggressively. The longer the experiment lasts, the more Danish and Swiss banks are having to pass on negative rates to clients. They could also weaken crucial short-term debt markets. The USD5tn in US money-market fund sector, which was a trip wire of the financial crisis in 2008, would surely be at risk. To overcome some of these challenges, significant regulatory changes would be needed to reduce the risks to banks and money-market funds.

But the politics of insulating institutions from negative rates cannot be taken as a given. It took the European Central Bank five years to introduce a tiered interest rate regime, for example, under which some of banks' deposits are exempted from the negative rate.

Third, even the proponents of negative rates admit there is a point where the policy does more harm than good.

According to economists Markus Brunnermeier and Yann Koby, this "reversal rate" varies according to the characteristics of a particular banking system, but also changes over time, so central bankers would need to tread gingerly. A measure requiring such extreme caution is not one well suited to confront emergency conditions.

Thus far, the Federal Reserve, like the BoE, has judged that negative interest rates are not an "attractive" policy tool. But the view has become more nuanced on both sides of the Atlantic, with the Fed saying it is not considering negative rates "for now".

But if the economy were in a prolonged recession from the pandemic aftershock, all measures to boost aggregate demand would be on the table — especially if fiscal policy were constrained by politics, or the rising size of sovereign debt burdens.

Another important but overlooked factor is the reduction in the use of cash. Academic supporters of negative rates have long argued that this would need to happen for negative rates to be pushed much below minus 1 per cent. COVID-19 is now prompting a shift to contactless payment and online trading, which could give policymakers grounds to argue that negative rates could be implemented with less risk.

Our base case is we that we won't get there. Risks to the base case is a prolonged recession, or if there a second wave of COVID-19 infections, and all of the issues that we all each of us have been debating about tribal scale.

Who is the most likely to go negative? Markets imply UK is first, followed by New Zealand and the US. For many investors, this is another reason to stay clear of some of the banks and insurers, however many banks already are trading at rock bottom prices because of the significance of certainty in the range of outcomes on credit losses, earning power and capital returns. And we can see a very strong correlation reasserting itself between European bank equities relative to stock markets, versus 10 year bond yields.

For investors, all this is another reason to steer clear of the banking sector. Many lenders are already trading at rock-bottom prices for fear of huge credit losses, weaker earnings and low or no dividends. Smaller banks would suffer most. Correlation of European banks relative to markets vs 10 year bund is strong

Pension funds' asset allocations are increasingly being distorted by negative rates, too. One of the most striking consequences has been to encourage investors out of Japanese and more recently European markets and into US credit and equities instead. The thirst for yield has led to a self-reinforcing bid for longer-dated bonds. As most savers target a particular level of retirement income, the lower rates go the more they will need to save to hit their targets, reducing their ability to spend today.

Moreover, a 2018 report by the Bank for International Settlements argued that the solvency of insurers and pension funds would be a larger concern than that of banks, in a scenario of very low rates for very long periods. Many insurers have so far followed a "barbell" investment strategy with government bonds at one end and large exposures to riskier corporate debt at the other — both of which could be under pressure in a negative rate situation.

The debate over negative rates will be kept alive by concerns that countries' economic-policy arsenals are insufficient to deal with the effects of the COVID-19 crisis. But many investors will be hoping central banks stick to more conventional measures such as bond-buying, forward guidance and yield curve control, alongside fiscal policy. If policymakers overlook the risks of negative rates to the financial sector, central bankers could be hurting more than they are helping

To read The New Digital-Payments Race, click here.

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Huw van Steenis On What Central Banks Will Do Next – Bloomberg OddLots podcast

To succeed, Facebook's Libra must prove itself in the Indian market - FT OpEd

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The Future of Finance Report for Bank of England

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