Disruption Outlook: Negative Rates

Disruptive Forces in Investing

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Anu Rajakumar: Negative yielding bonds seem like an oxymoron. Besides, common sense suggests that buyers or investors of bonds should expect to be paid a positive investment return for holding them. But as of the end of August 2019, there were about 17 trillion dollars' worth of negative yielding bonds globally, an unprecedented level that seems to be growing. My name is Anu Rajakumar, and in today's episode of *Disruptive Forces*, you'll hear from Ashok Bhatia, Deputy Chief Investment Officer of Fixed Income; and Olumide Owolabi, Portfolio Manager on the global rates team. Together we'll discuss what negative interest rates are, why this is happening, whether we'll see negative interest rates in the U.S., and importantly, what the investment implications are of this unusual rate environment. Ashok, Olumide, thank you for joining me today.

Ashok Bhatia: Pleased to be here.

Olumide Owolabi: Thanks for having us.

Anu: Let's start with the basics. Ashok, what exactly are negative interest rates? Are bond investors really guaranteed to lose money? Because if so, that sounds like a bit of a rotten deal.

Ashok: Yeah. The name, negative interest rates, and what it implies is pretty accurate. In a typical bond or the bonds we're all used to, you invest a certain amount of capital, you get that capital or principal back when the bond matures and you get some interest coupon payments throughout the way. And negative interest rates do flip that on the head. Which is you invest a certain amount of money and between the interest payments and the principal payment you get back at the end, you end up with less than you started with. Why is this happening, and what's going on? You know, it's primarily right now a European and to a lesser extent Japanese issue. I'm sure we'll talk about this later, it's not something that's come to the United States. And it's also something that's heavily focused in the government bond market. So the markets for the safest, most risk free securities. We are starting to see this negative interest rate environment, where investors do effectively pay to invest their capital, we do start to see it creep out a little bit into the corporate bond markets in Europe, but primarily it's still at the highest quality securities. And why would anyone ever buy a bond that you're guaranteed to lose money if you hold it to maturity? I think there's two real motivations that are occurring right now. One is that there are some investors that are forced effectively to hold government bonds as part of investment mandates. Pension plans, some banks, some insurance companies, having those risk free assets is important. But part of it is if you buy a bond at a negative yield and you think it's going to have a greater negative yield a month from now, it's speculation, it's trading, but those can generate short term positive gains. So I think there's certainly some element of that going on as well. And then also negative rates, particularly in Europe, you have a negative rate for 10 year government bonds, but you have an even greater negative rate for cash securities or cash investments. So part of it is the lesser of two evils. And so that's, I think, forcing some people to do things that, in the environments that we're all used to, don't seem to make a lot of sense.

Anu: And so I guess one question is, should European and Japanese listeners be concerned about their savings accounts just yet?

Ashok: No, and this is one of the interesting things about negative rates right now, particularly in Europe again, but also in Japan, where it's started to creep in, which is that the negative rates aren't really being passed on to the household to experience the impact of it. It's the banking system that's really absorbing the cost of negative interest rates. Now, some depositors, in Europe, if you have high balances, extremely wealthy individuals, banks are starting to charge you to put your deposits in. So there you are feeling the impact of negative rates. But broadly speaking, the cost of this policy and the losses associated with investing money and negative yields, it's being borne by the banks. One of the things that's likely to happen over the next year or so is that we're going to see that continue to creep out to the household and it's going to touch more investors over time.

Anu: All right. That's a really helpful primer about negative rates. Olumide, talk me through the forces in the economy that are currently contributing to negative rates. Why is this happening?

Olumide: Negative rates are due to a handful of factors. But chief among that is the central banks themselves. So let's step back and kind of explain this a little further. Look at the central banks actually taking rates below the zero lower bound. Once that happened, that basically opened the floodgates for expectations that any time there is uncertainty, central banks will actually cut rates a little deeper into negative territory. So negative rates begets negative rates. So that is one of the biggest drivers. And the second thing is the inability of developed market economies to

generate consistent growth and both target inflation, as basically for deflationary risk over time. And with that, economic activity now moving out in places like Europe; expectations, they're beginning to increase that these deflationary pressures are actually here to stay. And when that happens, safe haven assets become asset classes that people can't just own enough of. The other reason is the supply/demand imbalance that exists within global government bonds. So with the advent of central banks buying a lot of non-risky assets and the issuance of this type of asset classes that will actually increase the pace at which they are being bought, what that creates is an imbalance. And lastly, government bonds make a part of many indices that fixed income investors use as their benchmarks. And with that you have an implicit demand for bonds, regardless of level of those rates. So you're looking at all these points coming together at the same time because of risk. That is exactly what is happening right now. Increasing geopolitical risk because of tariffs and Brexit tensions has actually made duration something everybody wants to get. So the safe haven asset has become something everybody wants to own in their portfolio. And that's why we're beginning to get more and more negative interest rate assets.

Anu: And I guess that's also been why you've seen such a big demand for gold this year in 2019.

Olumide: Yes. And I think gold, people are looking at it in terms of a long duration asset class, so to say.

Ashok: It used to be that fixed income paid a yield, and gold doesn't pay any interest. But in a world where fix income charges you a yield or has a very low yield, those assets that can fit into a portfolio and still provide diversification or hedge benefits, they're still really valuable. So negative yield bonds, as unintuitive as it seems, can still fit that role for a lot of investors.

Anu: So given the anxiousness that investors have been feeling, certainly in 2019, and really since, you know, the last quarter of 2018, have you seen any specific investment shifts in portfolios because of negative rates? Any investment implications just that you've seen in 2019?

Olumide: I think one thing that we can talk about is the investor psychology. Investor psychology has changed toward just owning a bond because of your return, into owning bonds because of protection against uncertainty. And as you get that, I think people are beginning to buy bonds more and more.

Ashok: Yeah, just to pick up on one thing, and maybe emphasize it is we do see investors that are saying look, it's a really low yield, it might even be a negative yield, might be a zero yield, but it allows me to potentially lower the volatility of my overall portfolio. So I the investor, not really buying this for the yield but for some of the hedging and the portfolio diversification benefits. I do think a second thing we are seeing is a desire to figure out where you can get any income in the fixed income markets. We're no longer in a world where you can get income from buying government bonds or risk free bonds, but for a lot of investors getting a steady set of income or a steady income stream is still really important. And those investors can't look to the government bond markets anymore and they're increasingly buying corporate bonds or mortgage securities or things that have a little bit more risk to meet income objectives.

Anu: Absolutely. Now you mentioned this was an issue really focused on the European and Japanese markets. So I guess the big question is whether or not the U.S. will see negative rates. What are your thoughts there?

Olumide: Well, I think you have to look at it from two standpoints. First of all, you look at it from the short term policy rates as well as the long term bonds. So from the short term policy rate, we really do not think the Fed are going to take rates into the negative territory because of a few issues there. One of which is the money market funds. With the money market funds, you have, an asset class, that is kind of the backbone of the financial system within the U.S. And people have this thinking that it's meant to be at par. With a negative interest rate coming into play, that will be challenged and it could actually go lower. So you could create some imbalances in the financial system which I don't think is a risk that the Fed wants to bring into play. Initially, you would ask yourself why they will do a negative interest rate; that means you are probably in a recessionary scenario. The other thing that you have to also consider with a negative interest rate, whether would the Fed act that they can actually receive or pay negative earnings—meaning the Fed community. So that is something that is at this point not very clear. I don't think, when you begin to look at the benefits, considering historical perspective, mostly from Europe, that is a risk that they want to bring into the U.S. So, I think the Fed will look at some of the policy tools that they do have, which they do have a lot. When you really consider it, they can still cut rates. They can do yield curve control. Another thing that you can see is asset purchase. The U.S. balance sheet has actually decreased, meaning the Fed balance sheet has actually decreased. So there's a lot of head room to add that. And then there's Fed guiders which is very powerful. Most especially when market participants know that you do have tools, which the U.S. does have. So looking at all of that, I don't think they would want to go into the negative interest rate policy. Now, when you talk about the long term bond, totally different ballgame. Within the long term bond, you would ask yourself, at what state do you get a negative yield in long term U.S. security. At that point you probably have some recession and the U.S. Fed has actually taken rates back to the zero lower bound. When that happens, rates will be lower across majority spectrum. Now considering the interconnectivity of global rates and the need for duration and safe haven securities and you're looking at the U.S. standing up amongst its contemporaries, I think the demand could actually pull U.S. long term securities lower into negative territory.

Ashok: The other element of it too is that the Fed views that there are costs with negative rates, and we're seeing that and we've talked a little bit about the bank depositor issue. But the negative rates do have costs to financial intermediaries and banks. I think the Fed is more sensitive to that, and particularly given, they've got a more expansive tool kit, as Olumide was hitting on. The ECB and the Bank of Japan have really played

out a lot of potential tools that they have, or they just have more limited tools. And so the Fed's really in a different spot, and as Olumide said they got a lot of wood to chop before that would I think even be on the radar screen for them.

Anu: Well, and given the lack of options for some of the non-U.S. central banks, is it possible that negative rates in Europe and Japan might be a long term feature of markets going forward?

Olumide: Well, I think in Europe and Japan, they're coming to this cycle where it's definitely difficult to come out of. Now, having said that, that means one is pricing in that you will continue to have this deflationary risk and growth will never go up. And I think for Europe it might be a very critical case, but over the years, I think they will find their bearing, meaning growth will go up. I think when you look at a lot of things that have been said in the market, I think word Japanification of Europe has come forth just because of the way Europe and European rates have been going lower and inflation in Europe, if you look at the co-inflation in Europe, is below 1 percent. And I think people are beginning to price that to be a permanent situation. That is not our co-view. We do think over the years we will get inflation in Europe, maybe not 3 percent inflation, but inflation that at least moves up between the 1 and a half to 2 percent range. And you would get growth. I think one of the things that has priced this in is because of the uncertainty that we've seen due to trade tensions as well as Brexit. So to answer your question, no, we do not think this is a permanent situation.

Anu: Yeah, that's very interesting. I guess taking all this into consideration, and this has obviously been a challenging investment environment, where are you seeing investment opportunities within the fixed income markets or other asset classes?

Ashok: So you know, I think the over-riding trend in negative rates, is certainly contributed to it, and it's going to continue, is desire for yield, for alternative sources. If you can't get income in a government bond or a risk free fixed income security and you need some income or some yield, investors are being forced to move into corporate bonds or asset backed securities or high yield or emerging markets or a little bit perhaps expand the investment horizon and take a bit more risk. I think the positive is the global growth environment remains, pretty stable, particularly in the U.S. So the growth environment, likely remains supportive of a wide range of corporate credit. But the negative yields and the relatively low yields on fixed income in general, it's also causing investors to seek out other income types of streams and those could be in private securities, it could be in dividend paying stocks. And that's going to be a trend that's with us for a while. I think one implication of that is that there's certain investors that are being forced to move into a slightly higher risk profile, if you do see a more significant global growth slowdown, that's going to bring some more volatility into the financial system, at least for a shorter period of time. I think one of the other things that that you've got to keep in mind is negative yields are not really touching the bank depositor and the individual, or household investor seeing it through low yields available in a wide range of fixed income products. And the banking system, and in particular this is in Europe, has thought that negative rates would be a temporary policy and the system would effectively absorb it. Well, as time goes on and it looks a little less temporary, we do think it's going to start impacting more individual investors, more households, and it's going to permeate throughout the investor base a little bit more significantly. That could lead to greater demand for other types of, short maturity fixed income as well. But overall, I think you've got to balance the desires for yield with the valuations and the macro backdrop for fixed income. It's still in our assessment a relatively benign environment for fixed income markets.

Anu: Got it. Well, Ashok and Olumide, I appreciate you joining me to demystify the negative rates phenomenon. I think between the inverted yield curves, historical low yield on the 30-year Treasury and a third of global tradable bonds in negative yielding territory, this has been a truly wild summer. So again, thank you very much for being on the show and sharing your insights.

Olumide: Thank you.

Ashok: Thank you.

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