Investment Perspective

UPSIDE DOWN: UNDERSTANDING NEGATIVE INTEREST RATES

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Investors today are hearing more and more about negative interest rates. Here in the United States negative interest rates do not exist but around the world they are a painful reality for many investors. The very term sounds counterintuitive. How can an interest rate be negative — and why would anyone invest in a vehicle featuring a negative rate? Negative interest rates are great for borrowers but investors come up short. Let's take a look at what the term means, the conditions that are leading to their global proliferation and how it relates to investment strategy.

How can a bond yield less than zero?

With negative interest rates, investors don't buy bonds and pay the government a coupon. Instead, the government (let's say Germany in our example) issues, a 10-year bond with a par value of 1,000 Euros and a 0% coupon. The buyer pays a premium (more than par) but receives no interest. At maturity, the investor receives 1,000 Euros, less than the original investment resulting in a negative yield.

If someone buys a bond issued several years ago that paid a coupon when it was issued, the investor receives the coupon but will pay well above par for the bond. If held until maturity, the decline in the bond's value will exceed the coupon payments also resulting in a negative yield.

Why are negative yields proliferating?

Today, sub-zero-yielding global debt has surpassed $16 trillion[1] and is likely to grow. And, while negative interest rates may seem like a recent phenomenon, Japan has been grappling with near zero or subzero rates for almost two decades. The Eurozone is home to much of the world's negative interest rates. In Germany all government bonds are currently sporting yields below zero[2], even 30-year Bunds that typically offer a handsome premium for the long maturity and high volatility. In Denmark a bank is preparing to offer home mortgages with interest rates at or below zero[3]. Even financially weaker countries such as Italy and Greece are experiencing very low interest rates. (See Table 1.)

10-Year Govt. Bond	Yield
Switzerland	-1.12%
Germany	-0.71%
Denmark	-0.67%
France	-0.43%
Sweden	-0.40%
Japan	-0.24%
Ireland	-0.15%
Spain	+0.05%
Portugal	+0.07%
U.K.	+0.41%
U.S.	+1.52%
Greece	+2.02%
Italy	+1.34%

Source: Rates as listed in MarketWatch and Bloomberg, 8/15/19

Clearly these are not normal times. So what is causing this "race to the bottom" in global interest rates? In short, central banks around the world (like our Federal Reserve) are combatting a global economic slowdown by manipulating interest rates ever lower in hopes of spurring growth. Unfortunately, aging populations, mature economies, trade disputes and persistently low inflation have made growth difficult to achieve. Despite negative interest rates the German economy is teetering on the brink of recession.

Global bond markets are discounting the likelihood that the European Central Bank (ECB) will reinstitute quantitative easing (QE) in September, with long-term interest rates around the world dropping precipitously since May. The ECB only completed in December 2018 a three-year quantitative easing program in which it purchased 2.6 trillion Euros of bonds in the market, thereby reducing supply and dramatically lowering bonds yields across Europe. Reflecting deteriorating economic conditions in Europe, the ECB is signaling another round of QE to further lower interest rates next month. Japan has employed this type of monetary tactic continuously since 2008 and the U.S. practiced aggressive QE from 2010-2014.

Why would investors buy negative yielding bonds?

Buyers of negative yielding bonds generally fall into three categories.

1) Safety & Liquidity: Investors worried about recession who want a secure investment vehicle that offers liquidity and are willing to accept a slight reduction in principal for the protection.

2) Mandate: Many large institutional European investors like banks, pension funds and governmental entities are required to own government guaranteed securities.

3) Speculation: Bond traders who believe interest rates will decline even further into negative territory will buy negative yielding bonds in hopes of selling them at a profit long before the bonds ever mature.

Can it happen here?

In an interview with Bloomberg News, former Fed Chairman Alan Greenspan said he doesn't believe there are barriers that might prevent U.S. yields from slipping below zero. However, we think it's unlikely the Fed will follow Europe and set its policy rate below zero. Sub-zero rates haven't solved Europe's problems, and they place enormous stress on the banking system.

Source: Federal Reserve Bank of St. Louis, https://www.fred.stlouisfed.org

Positioning yourself for security

Investors should beware. While shorter-term bond investments may currently offer rates that are more attractive than longer-term bonds, we caution against overweighting a bond portfolio too heavily into the short end of the curve. Investors risk getting trapped if short rates fall precipitously, and might miss the opportunity to lock in higher yields on longer-term bonds.

Not sure how to proceed? We can assist with various strategies that help you hedge against falling rates. Please feel free to reach out and schedule a consultation, and we can help put you on the path toward your financial goals.

About Our Author

Jeff Tanguis is an investment director at Hancock Whitney Bank, where he is responsible for developing and implementing fixed income strategy and serves as a portfolio manager for high net worth clients. Additionally, he is manages the Louisiana Tax-Free Income Fund and the Mississippi Tax-Free Income Fund for the Hancock Horizon Family of Funds. Jeff has been in the banking industry for 35 years, with 13 years as a member of the Hancock Whitney team. Prior to joining Hancock Whitney, he spent 20 years working with Hibernia Bank as the senior fixed income portfolio manager. Jeff has Bachelors of Science in Finance from Louisiana State University. He is a member of the Chartered Financial Analyst Institute and is a registered Municipal Advisor.

Sources:

[1] Bloomberg Finance, L.P.

[2] Bloomberg Finance, L.P.

[3] Bloomberg Finance, L.P.