Free Money – The Negative Yielding Debt Phenomenon

With the amount of negative yielding debt skyrocketing in recent weeks to $17 trillion, we look at the causes and implications.

In June 2014, following the European debt crisis, the European Central Bank (ECB) followed Denmark, Sweden and Switzerland in cutting interest rates below zero. In January 2016, Japan followed suit, contributing towards the global market value of negative yielding debt rising from $0 to $17 trillion in just 5 years.

In an effort to encourage lending, increase consumption and counter economic stagnation, further cuts by Mario Draghi, President of the ECB, have pushed the Euro deposit rate down to -0.5%. While bank lending has increased by 10% \(^1\) since rates turned negative, the monetary stimulus has thus far failed to generate target level inflation (currently half of the 2.0% target \(^2\)) or material economic growth (currently 1.2% \(^3\)) in the Euro Area. In fact despite this extraordinary monetary stimulus, the largest economy in the Euro Area, Germany, finds itself on the brink of a recession.

With the US-China trade war dominating newswires and the most reliable recession indicators such as the inverted yield curve flashing warning signs, many investors have been moving into lower risk assets. This flight to safety has compressed government bond yields and investment grade credit spreads, turning a large portion of debt into negative yielding territory during the process.

Now, around 30% of all investment grade bonds (government and corporate inclusive) have negative yields, meaning that holding one to maturity will guarantee a loss. Despite this, as fears of a recession mount and with the ECB restarting net asset purchases at a monthly rate of €20bn, the negative yielding bonds are still attracting buyers. They are either obligated to buy bonds or are simply hoping that the bond rally continues. Indeed, many large financial institutions may struggle to find safe alternatives to invest in and passive investors simply have no other choice.

Negative rates have a number of impacts that reverberate across the economy. For European banks, the burden of negative rates has impacted profitability by compressing net interest margins. For consumers, lower rates have caused low saving rates but cheap borrowing and in Denmark it has gone

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1 ECB Euro Area statistics, Banks balance sheet - Loans
2 Euro Area harmonised index of consumer process for August – Source: Eurostat
3 Euro Area real GDP YoY – Source: Eurostat
as far as mortgages at negative rates. Businesses have also been taking advantage of lower rates by increasing balance sheet leverage without overly burdensome interest costs. We may be approaching the point at which corporations as well as governments may be able to refinance their debt at negative rates – effectively free money. Pension funds, however, may struggle to match liabilities at current rates with bonds accounting for 54% of assets held by UK pension schemes on average.  

With few signs of a resurgence in inflation and OECD global growth forecasts at a decade low, negative rates may become the new status-quo. At Waverton we believe that bond markets are unattractive at current levels and returns are likely to be modest at best. The current level of the 10-year Gilt yield (0.57%) implies a compound return to maturity in 2029 of 5.8%. For that modest return, the investor has to accept significant downside potential if yields rise; a 1% move up in yield would lose an investor 7.9% over the next year – more than the total return to maturity. Thus, Gilts are far from offering risk-free returns, more like return-free risk. But by adopting a highly selective approach to credit selection, and by utilising interest rate hedges, we think we can generate income for investors whilst preserving capital.

By James Carter

Risk Warnings

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4 Source: Mercer European Asset Allocation Survey, 2019