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Market Insights & Strategy

Global Markets

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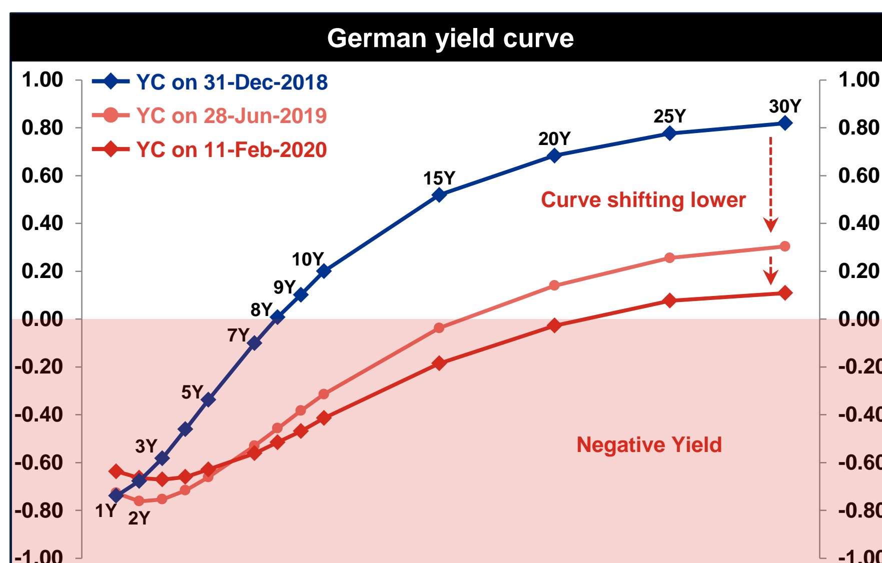
Negative bond yields
From Feast to Famine

- **Negative rates may be manna from heaven for borrowers, but they are also a ticking time-bomb for investors**
- **QE ‘crowding out’ has seen excess cash chasing limited assets**
- **Sub-zero yields will prove unsustainable if macro forecasts turn more hawkish**
- **Low-rated, negative-yielding debt most exposed to risk from inflation, growth & rates sell off**

The global macro environment of the past 5 years, in the post sovereign debt crisis era, has seen a seismic shift in financial market dynamics, especially in the Eurozone as a result of central bank intervention. Conventional wisdom suggests that risk assets – be that sovereign, quasi or corporate – should yield investors differing degrees of positive return depending on their position on the quality curve. Moreover, it is assumed that even a pure ‘risk free’ asset should offer a positive yield over time, in the context of longer-term economic growth expectations. But in recent quarters such assumptions have been thrown out the window.

Today, the German government bond yield curve is negative yielding in its entirety from 1yr out to 20yrs. Indeed, even the 30y bund was negative yielding for much of the August-October period last year.



Source: Bloomberg/FAB

The opening of monetary policy sluice gates, as highlighted by the European Central Bank’s introduction of quantitative easing in March 2015, when it began buying assets from commercial banks, has changed the rules of the game. The ECB has set the negative yield benchmark with a deposit rate of currently -0.50% and an ongoing dovish policy bias. As a result we have seen credit markets transition from feast to famine; with investors increasingly crowded out by central bank policy in recent years, there has only been one direction for bond yields to travel; lower.

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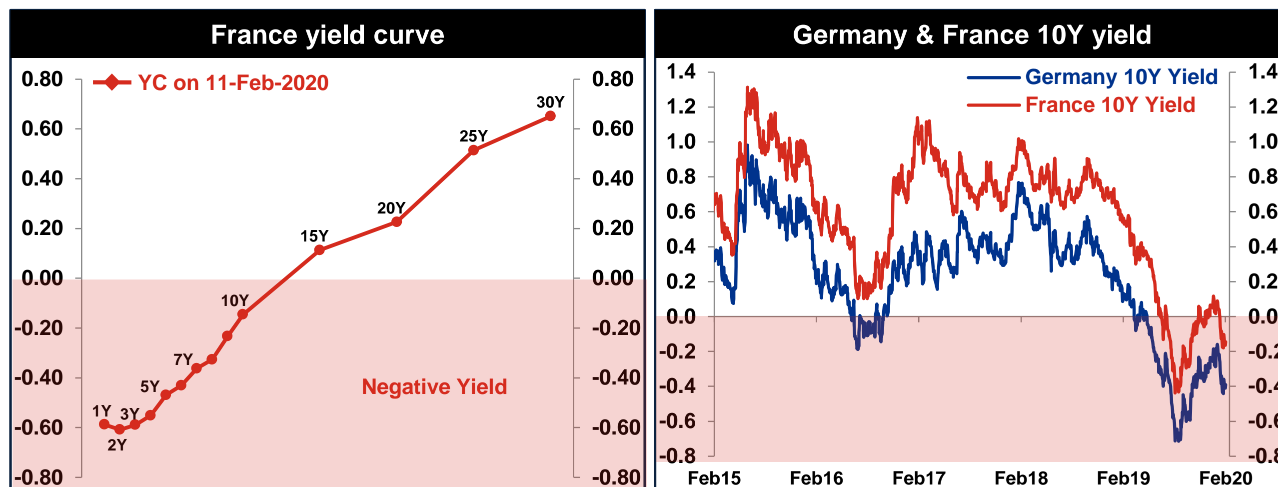
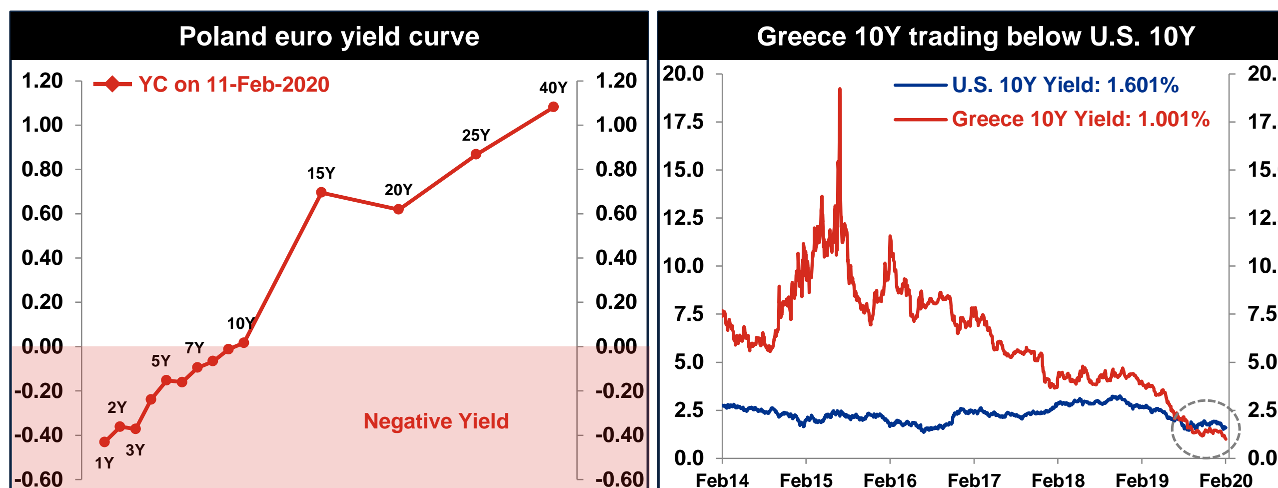
In Europe this has resulted in the steady and persistent erosion of the yield structure over the past 10 months or so, with (German) government bond yields declining into negative territory. The German 10y bund contemplated briefly negative yields in mid/late 2016, but it is since Q2 2019, as the ECB has chased dovish solutions to the deteriorating Eurozone macro story, that German yields have become structurally entrenched in sub-zero yield territory. The story is similar across much of the Euro area in fact, including France, the region's second biggest economy in terms of GDP.



Source: Bloomberg/FAB

The negative yield paradox has been highlighted in recent weeks by new 10yr issues for Austria (Aa1/AA+/AA+ with reoffer yield of -0.111%) and Poland (A2/A-/A- with reoffer yield of -0.102%), with the latter perhaps showcasing best the arguably over-exuberant current nature of risk appetite. Paying to lend money to a solid double-A rated sovereign issuer may be one thing. Paying to lend to weak single-A rated borrower is quite another.



Source: Bloomberg/FAB

Meanwhile even Greece has got in on the act of late, recently selling 13-week treasury bills at an average yield of -0.100%, with a bid-to-cover ratio of 2.0 highlighting the depth of demand even at these rarefied yield levels. The push lower in yields and transition into negative territory is all the more dramatic when one considers that 10yr Greek sovereign debt (B1/BB-/BB) is now priced some 56bps through the comparable, much better rated (AAA/AA+/Aaa) U.S. treasury.

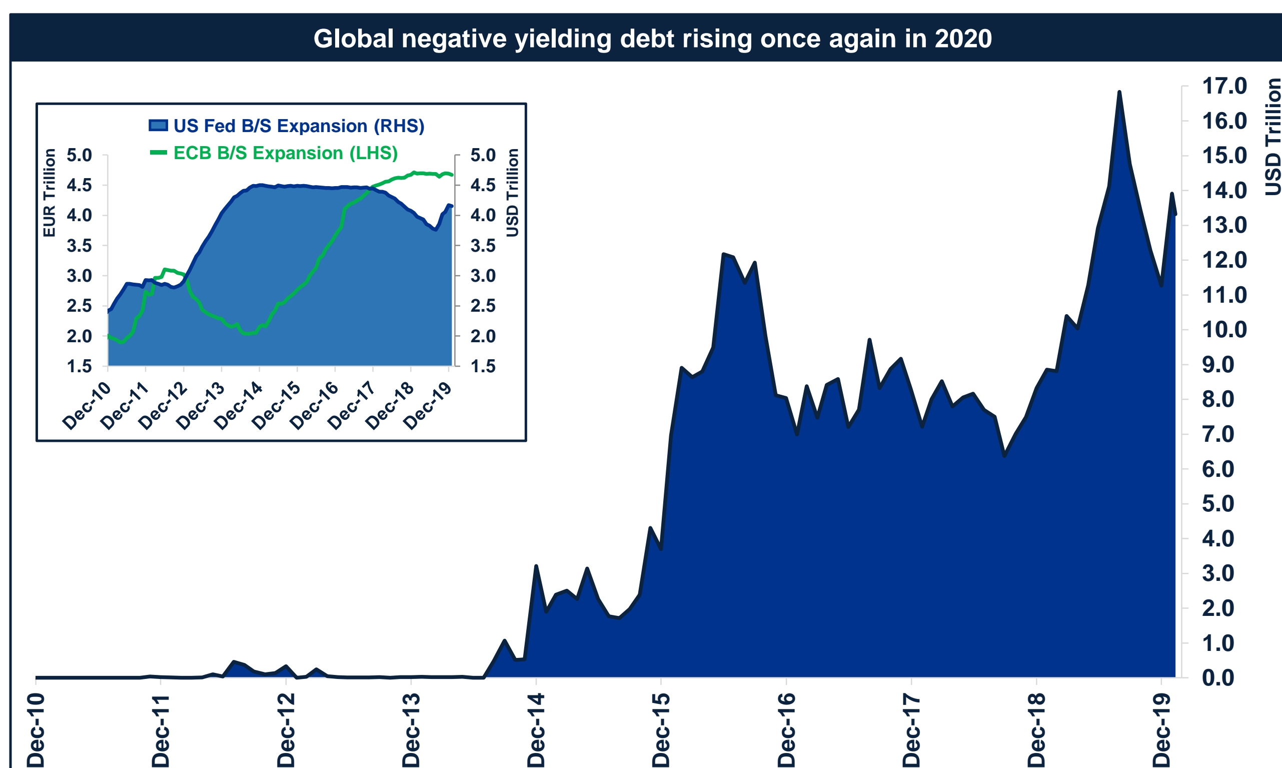
If Greece can get paid to raise funds, then it should be little surprise how oversubscribed better rated, negative-yielding borrowers have been. But from an investor’s perspective, why would you? What’s the investment rationale, unless of course you can source your incoming funds at even lower yield levels? On a longer-term relative value basis therefore, this situation must surely soon give rise to questions about sustainability.

Negative yielding bonds in perspective

Macro concerns and recent coronavirus fears have driven a flight to quality, a sharp decline in yields and a flattening of credit curves. The combination of such an investor mind-set has help to propel bond markets to rarefied yield levels. As the haven bid has strengthened, so yields have been eroded, pulling an increasing section of the market into this negative yield territory. And the deeper one gets into red, the greater must be the exposure to eventual capital loss as rates sell –off and yields edge higher again.

According to Bloomberg, the value of the negative-yielding bond asset class now sits just shy of $14 trillion, up from around $6 trillion in late 2018. There is of course a lot of 'fear factor' priced into that much sub-zero yielding paper, fueled by the haven trade founded on current uncertainties surrounding the global macro outlook, potential further slowdown in China GDP as a result of the coronavirus, as well as the overhang of Brexit negotiations and broader geopolitical risks among others.

Global negative yielding debt rising once again in 2020



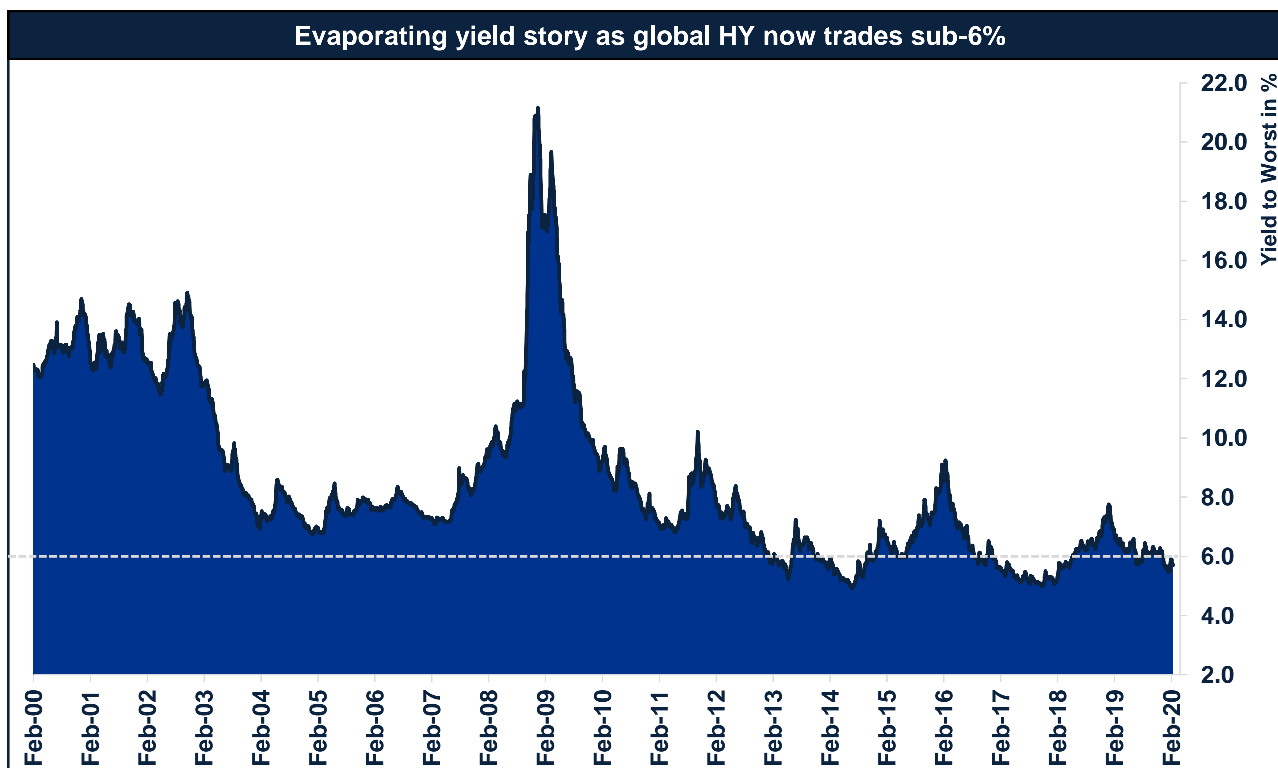
Source: Bloomberg/FAB

The known knowns

Well we know why the market has developed as it has in recent months. Central banks' dovish rhetoric and actions, combined with investor concerns about the fragile macro outlook and impact of the spread of the recent novel coronavirus, has all combined to drive an up-in-quality, haven bias in investment strategies. A small give-up in yield is seen as fair price to pay for capital preservation under such circumstance.

Government bonds have been the key beneficiaries of this defensive bid, with rates rallying accordingly. But as we have witnessed other, non-sovereign borrowers have also been pulled toward, if not into the negative yield space amid the clamber to get cash invested. This leaves all parts of the credit curve increasingly susceptible to a rates sell off in the coming months/quarters.

If one subscribes to our view that global growth could see some modest improvement over the coming 12 months – and that the U.S. economy is not on the brink of recession and that inflation will eventually be fathered by extreme monetary and fiscal stimulus – then from a fundamental perspective, we would caution that this rapid expansion of the negative-yielding bond asset class should prove transitory. More worrying though is that when rates eventually move from rally to sell-off, the market will be facing a potential time bomb. And the further down the rating spectrum one chases investment in the meantime, the greater will be the eventual risk of explosion.



Source: Bloomberg/FAB; Note: Yield as per Bloomberg Barclays Global High Yield Multi-Currency Bond Index

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