COLCHESTER®
GLOBAL INVESTORS

Global Bond Investing in an Era of Negative Interest Rates

Heathcoat House
20 Savile Row
London WIS 3PR
United Kingdom
Tel: +44 207 292 6920

885 Third Avenue
24th Floor
New York, NY 10022
United States of America
Tel: +1 646 472 1800

6 Battery Road #40-02A
Six Battery Road
Singapore 049909
Singapore
Tel: +65 3158 0222

Level 10
20 Martin Place
Sydney NSW 2000
Australia
Tel: +61 2859 92132

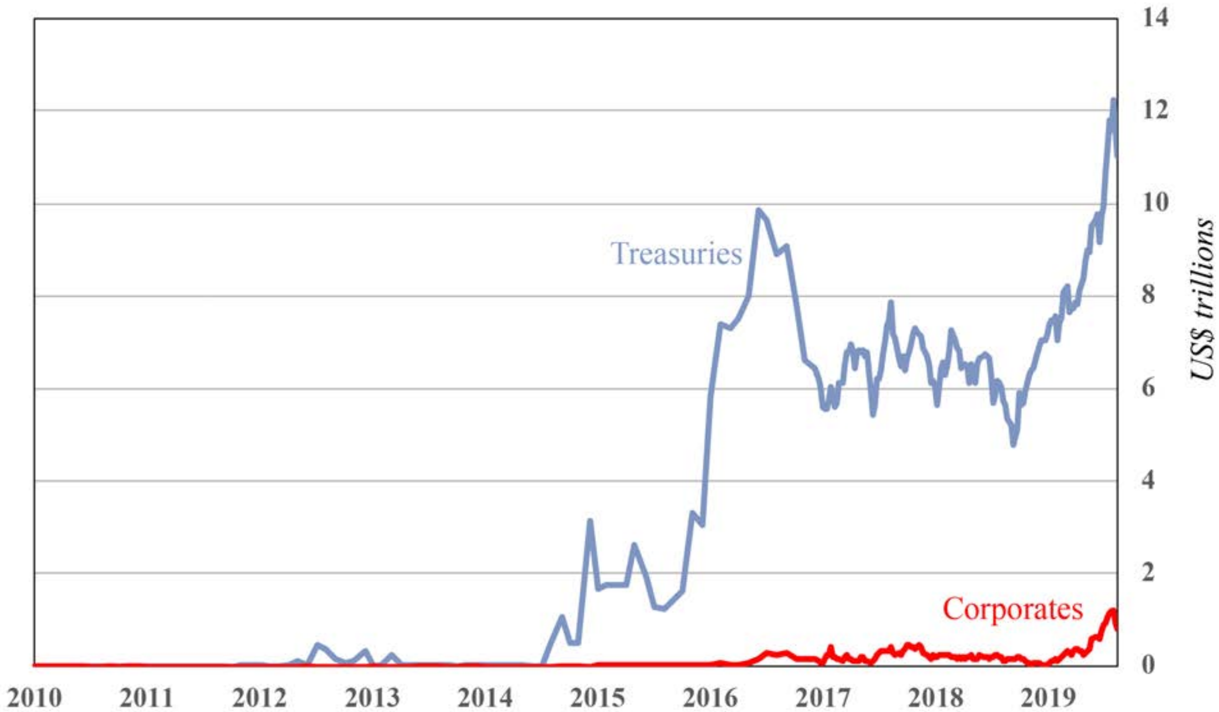
Unit 403 Index Tower
DIFC
Dubai
United Arab Emirates
Tel: +971 5 0463 5370

Global Bond Investing in an Era of Negative Interest Rates

What once would have been considered a strange anomaly may now be becoming the norm as yields on a growing proportion of the global bond markets turned negative throughout 2019. The escalating US-China trade conflict, fears of a global economic slowdown and the aggressive accommodative monetary policy response by central banks to those developments have accelerated this trend in the middle of 2019. This environment has resulted in the market yield on approximately US$11 trillion of government debt falling below zero percent as at the end of August, 2019[1]. This accounted for approximately 37% of the universe of outstanding government debt at that time[2]. Some 40% of this amount was issued by the Government of Japan, and a further 14% and 12% by the French and German Governments respectively. As a result of the extensive quantitative easing programs undertaken by central banks, collectively it is estimated that they now hold approximately 80% of all negative yielding debt. Whilst negative central bank policy rates and negative bond yields on sovereign debt had been observed for some time, this phenomenon has not been restricted to government bonds alone. In recent months yields on an increasing number of corporate bonds have also turned negative, new corporate debt has been issued at those levels and even negative rate mortgages have been offered in Denmark. While not as prevalent, such declines have resulted in the yield on approximately 7% (US$1 trillion) of the universe of global corporate investment grade debt also falling below zero percent[3].

Growing Proportion of Bond Market Offering Negative Yields

Market value of negative-yielding debt outstanding:



Source: Market Value of Bloomberg Barclays Global Aggregate Treasuries Index and Bloomberg Barclays Global Aggregate Corporate Index as at 30th Aug 2019

Why are yields negative?

Many factors influence the level of bond yields, but the monetary policy, economic and inflation environment are strong drivers. In the aftermath of the 2009 Global Financial Crisis many of the world's central banks set policy rates close to, or below, zero in response to economic contraction and declining inflation. In Denmark, the central bank's policy rate fell below zero in 2012, to be followed shortly thereafter by the European Central Bank, the Swedish Riksbank, the Swiss National Bank and the Bank of Japan. The US Fed Funds Target Rate was lowered to 0.25% in December 2008 and remained there until late 2015 when a gradual policy tightening was initiated by the Federal Reserve. This policy was reversed in July 2019 when the Fed Funds rate was lowered by 0.25% to 2.25%. In contrast to this direction of travel in the US, interest rates in many advanced economies remained extremely low and negative in some cases throughout this period. This reflected the more muted inflation backdrop in economies such as the Eurozone, Switzerland, and Japan relative to the US from 2016 to 2018.

Leaving aside the cyclical impact of trade tensions and slowing growth, there may be structural reasons why inflation and interest rates may remain very low. The impact of technological innovation and automation, as well as globalisation is often thought to have a dampening effect on inflation. Furthermore, demographics may also be exerting downward pressure on the level of real interest rates. Real interest rates can be considered as the price at which the supply of savings equals the demand for savings, i.e. investment. Given the demographic profile of many developed economies we may be observing the effects of a *savings glut* keeping interest rates lower than they have been in recent decades. None of this is to say that negative yields are here to stay, or that yields can't increase from current levels, but simply given these structural factors it is possible that on average, yields and interest rates may remain materially lower in the coming years than they have been in the past.

Should investors hold negative-yielding bonds?

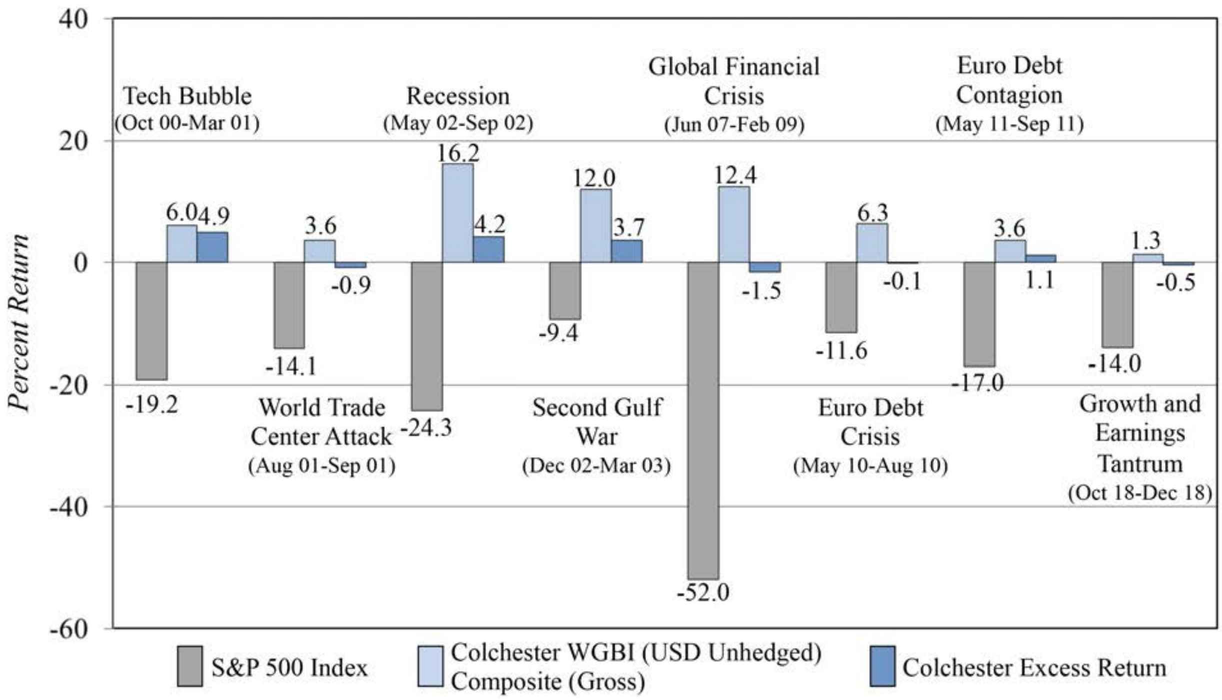
Given that negative yields imply an investor holding such a security to maturity will incur a loss (at least in nominal terms) does this imply that the 'safe-haven' characteristics of sovereign fixed income have been compromised? The evidence of the recent past would suggest not. We have observed that negative yields can become more negative in response to economic and political events and shifts in perceived risk levels. In other words, over the short term the returns to investors from 'falling' negative-yielding bonds may be positive as bond prices continue to appreciate. Indeed, many investors were surprised at the strength of the demand for safe-haven assets and the resulting size of the yield decline of already negatively yielding bonds during the most recent bout of risk aversion in the middle of 2019. For example, 10-year German Bund yields fell from -0.2% to -0.7% from mid-July to mid-August, returning +4.5% in USD hedged terms. Similarly, over the same period, 10-year Swedish bond yields fell from 0.1% to -0.4%, returning +3.0% in USD hedged terms. This is not to argue that negative yielding bonds will always deliver positive returns, but simply highlights that the diversifying return characteristics of sovereign bonds still holds true in a negative interest rate world. Returns on a negative yielding bond may be positive or negative over the short term, just as they may be on a positive nominal yielding bond.

Sovereign debt as an insurance policy

Sovereign fixed income is often traditionally viewed as a diversifier of risk within a multi-asset portfolio. Among its other roles, it is often seen as an anchor or 'insurance' against other higher beta or 'growth' assets within a diversified portfolio. As the examples above illustrate, this remains the case in the present environment as sovereign debt remains the only asset class to consistently offer a negative correlation to risk assets in a crisis. We can see in the chart below for example, that recently global sovereign bonds generated positive returns in Q4 of last year, when the S&P 500 dropped 14%. Similarly, in May of this year, the S&P 500 fell almost 7%, whilst the FTSE WGBI returned +1.7% in US dollar unhedged terms. This was at a time when yields were already negative across large parts of the Eurozone and in Japan.

Absolute and Relative Returns During Crisis - Global Bond (USD Unhedged)

Positive Return and Negative Correlation:



Source: Bloomberg; Colchester Global Investors.

The negative yields apparent in today's market are in a sense the premium for this insurance policy. It should also be considered that the low and negative levels of central banks rates and government bond yields permeates the entire spectrum of investable assets. Not only have negative yields started to emerge on meaningful amounts of corporate debt, but they are also widely considered to have supported equity prices. Thus, whilst the 'price' of the insurance offered by sovereign debt has clearly increased, this must be offset against the potentially greater, but ultimately unquantifiable risks contained in other asset classes. The risk-free interest rate, essentially the discount rate, is embedded in the valuation of all other asset classes and it follows that an adjustment in its level will most likely impact all assets classes.

Real versus nominal interest rates

Investors also need to consider potential returns in nominal and real (inflation-adjusted) terms. Whilst inflation expectations are typically positive across developed markets, investors holding negative nominal yielding bonds to maturity, could in theory earn positive returns in real terms if inflation, or more precisely deflation, were to be more negative than the nominal yield. There is a tendency for people to focus on nominal values and returns rather than real returns, a phenomenon known as '*money illusion*.' In other words, a 7% return on a bond when inflation is 7% is exactly the same as owning a 0% returning bond when inflation is 0%. In this simple scenario most would likely want to own the 7% yielding bond, even though it is equivalent to owning the 0% bond. Human nature being what it is, we have a tendency to focus on nominal rather than real returns. The value of money, or an asset, is intrinsically the real goods that can be purchased with it. Accordingly, you are better off owning the asset that gives you the higher real return as it delivers greater real purchasing power. That may be a negative nominal yielding bond with a higher expected real yield if it generates a higher ex-post real return than a positive nominal yielding bond with a lower expected real yield.

How is Colchester managing portfolios in the current environment?

As explained above, we continue to see the sovereign fixed income asset class as providing desirable diversification characteristics and specifically a negative correlation to risk assets. The events of mid 2019 suggest that despite the increasing prevalence of negative yields, this characteristic remains intact in the face of rising uncertainty and increased risk aversion. The slowdown in global money and credit growth through 2017 and 2018 is likely to contain inflation in the near term and limit any large increase in bond yields. This benign environment is likely to be broadly supportive of bond prices and minimise the 'cost' of diversification insurance that may prove useful if the global economy, trade disputes or risk assets take a turn for the worse.

Nonetheless we at Colchester are trying to limit our exposure to negative nominal yielding markets. Instead we are skewing our portfolios towards markets that are offering positive real yields, that preferably also offer a positive nominal yield. Such markets are currently limited within the G10 or 'traditional' bond markets. It is tempting in such an environment to reach for yield by moving down the credit curve into subordinated or high yield debt, increasing exposure to emerging markets, or supplementing returns with an array of structured products. However, as all have a higher correlation with equity and other growth assets, this reduces the diversification benefit of holding bonds. Accordingly, *we seek to build bond portfolios that not only offer higher relative real yields and attractive risk characteristics, but also maintain the diversifying integrity of a traditional bond market allocation*. Therefore, while we are willing to add limited exposure to some non-traditional markets such as Singapore or Mexico, to benefit from their potentially higher real yields on offer and to offset some of the 'insurance premium cost', such exposure is limited to protect the diversification characteristics that most investors are looking for from their traditional sovereign bond allocations.

Today our global bond portfolios are materially overweight versus benchmark those markets where we observe the most attractive prospective real yields. Markets such as Norway, Singapore and Mexico, where both real and nominal yields are positive, feature in our portfolios. In contrast, the strategy is very underweight the euro area where both real and nominal yields are negative and our portfolios hold no exposure to German, French or Dutch bonds where yields are lowest. The strategy does however hold some exposure to negative nominal-yielding bonds, mostly in Japan. The Japanese market offers materially more attractive relative real yields than the core of Europe once we factor in the low level of projected inflation. Furthermore, the market exhibits very low levels of volatility. As we are looking to construct portfolios that in aggregate offer a balance between value (or *expected return*), liquidity and negative correlation to risk assets, it should be no surprise that despite their negative nominal yields, Japanese bonds have a role to play.

We estimate that currently only around 18% of our standard global bond program is invested in negative nominal yielding bonds. In contrast, the standard global bond benchmark currently has approximately 35% in such securities. While passive investors are immediately *locked* into this benchmark exposure, active investors may reduce this exposure if they believe that valuations and potential returns justify it. Notwithstanding our own limited exposure to such negative yielding bonds, we would caution against the idea that such bonds should be automatically excluded from portfolios, or the opportunity set, purely on the basis that their yields are below zero. As discussed above, notwithstanding negative yields, the Eurozone and Japanese bond markets continue to offer desirable liquidity and diversification characteristics and may offer better ex-post real returns. The danger with building portfolios purely based on nominal yield targets, is that investors may unintentionally be taking on greater concentration risk and precluding themselves from opportunities that may deliver a better total return.

Ultimately, return expectations from sovereign fixed income may need to be calibrated to take account of the current level of yields. Relative to history therefore, expected nominal and real returns from sovereign bonds are undoubtedly lower than they were. This statement alone however tells us nothing about the relative attractiveness of the asset class vis-à-vis alternatives, or its sustained usefulness as a diversifier of aggregate portfolio risk. In an environment of rising risk aversion, as we have seen this year, already low bond yields can, and do, fall even further as investors move into safe-haven assets.

[1]Bloomberg Barclays Global Aggregate Negative Yield Debt: Treasuries (I32548 Index)
[2]Bloomberg Barclays Global Aggregate Treasuries Index
[3]Bloomberg Barclays Global Aggregate Neg Yielding Debt: Corporates vs. Bloomberg Barclays Aggregate Corporate

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