January Article

Do investors choose to lose money? Welcome to the world of negative bond yields.

What kind of market sets up a price in which there are no positive returns for buyer?

Is there any market in the world in which the buyer is effectively loosing money and still decides to proceed with the trade? The answer is yes: bond markets.

Bond markets, like any other market, are driven by supply and demand, which set up an equilibrium price satisfying both the buyer and the seller. However, we live now in a strange world in which bond investors (money lenders) are willing to lend money and instead of demanding an interest on the amount they have lent, they pay the borrower what we know as the interest. According to JPMorgan, more than € 1.5 tn worth of Eurozone bonds are now trading in the markets with negative yields. Germany, Sweden, Netherlands, Japan and Switzerland are just some examples of countries that have recently seen their government bonds reaching negative yields. Even more surprising, is the fact that some corporate bonds such as Shell and Nestlé, which are riskier and thus harder to cross the 0% yield bound, have also crossed this boundary. The question is obvious: why would anyone pay to lend money to somebody else?

Turning negative in Europe

Value eurozone bonds with negative yield (€tn)

Source: JPMorgan via Financial Times

Well, what basic economics tells us is that in a free world, no trade would happen if there was not a win-win situation. In fact, as I will try to demonstrate, there are hidden benefits and reasonable reasons for which investors might want to own fixed-income assets with negative yields: safety purposes, positive returns in real terms, positive returns due to currency fluctuations and as part of a simple trading strategy.

Safety

The first observation one must acknowledge is that given the amounts of money involved, parking it physically is not possible so investors must park it somewhere. The flight to safety when there is turbulence in capital markets is quite common. Typically when uncertainty gains momentum, many investors choose to allocate their funds in risk-free assets, pushing up bond prices and pushing down yields consequently. Investors usually prefer to loose a small percentage of their portfolio for sure than taking the risk of having a large loss in risky assets. When there is a lot of fear in the markets, yields might reach negative territory but that does not seem to be the case nowadays justifying why bonds yields are negative because not only short-term but also long-term bonds are being priced with negative yields.

Real terms

One more plausible reason has to do with inflation, more specifically inflation expectations. Inflation expectation is the main driver of long-term bond yields. When investors perceive a period with high-inflation, they will demand higher yields so that in real terms they do not lose money. In this deflationary environment fuelled by the lack of economic growth and accelerated by the sharp fall of oil prices, very low bond yields do not come as a surprise because as long as the bond yield is higher than inflation, investors are making a profit.

Central banks decisions

Central banks have the power to influence the short-term interest rate, by setting the rate at which banks can park their cash. To boost economic growth or inflation, the monetary authority usually uses this mechanism and cut interest rates so that banks have an economic incentive to lend to the real economy. Today, many central banks of developed economies have decided to impose negative deposit interest rate and that, alongside with very low inflation expectations, explain why short-term bond yields are negative.

Currency fluctuations

Even though currency is not usually subject of very intense discussion it can play a major role when computing returns in your home currency. It may well happen that investors lose money in foreign currency while making a profit if that foreign currency appreciates against his home currency. This appreciation might also be linked to different inflation expectations between different economies.

Trading Strategy

Despite the fact that all previous points illustrate hypothetical reasons to why we observe negative bond yields in capital markets nowadays, in my opinion most of investors who own those bonds do not intend to hold them until maturity. If one expects the demand for any asset to increase in the future, he can also expect that asset's price to go up. This is true for bonds and more specifically in Eurozone countries government bonds due to the announced *quantitative easing* by the ECB, which will start in March. The point is simple, if investors expect bond price to go up further, why worry about negative yields?

All these are valid reasons for which bond yields might be negative. Currently, not only short-term government bond yields entered this territory. Netherlands, Finland and Sweden government bonds are trading with negative yields for periods longer than 5 years and in Switzerland, even a 13 years government bond has a negative yield.

Governments and individuals are pleased that their borrowing costs are so low but these abnormal rates are a clear sign that the economy is to remain stalled for quite some time.

Author

João M. Cunha

joao.cunha@nova investmentclub.com