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ECONOTE No. 52 There is a great deal more to negative yields than meets the eye **17/7/2016**

Summary

We try, hopefully, to lay to rest the obsession with negative yields as they only signify that central banks finally got what they wanted: ACCELERATING INFLATION! Unfortunately only in the prices of some assets, namely bonds, but not in the prices of bread and of shoes. Well, you can't always get what you want ! There is nothing surreal or abnormal in investors buying bonds above their nominal prices. Whether the monetary policy behind this behavior makes any sense, is a different issue. What concern us here is not so much the negative yields but higher duration. Coupled with threatened downgrades in sovereign and corporates, this bodes ill for the rush to the door if there is a hint of rising rates, especially from the Fed.

Investment Conclusions

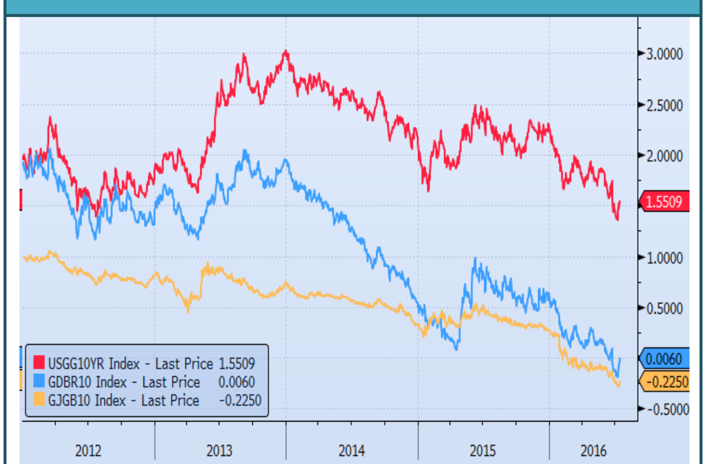
Starting with equities, there are still a few small Asians which have done well from the start of the year and not just recently, Thailand, Indonesia, Philippines and now Taiwan ranging from 5% to 15% YTD in USD (so much for the much vaunted strength of the USD !).These are useful additions to yield starved portfolios . As for FI, here is my submission for the Economics Nobel prize in Financial Advice " Stick to short maturities and short durations of good quality paper" And as for currencies, the AUD has defied the news of its permanent demise and, despite all the post-Brexit uncertainty, it has been doing well and could stabilize at above the 0.76 mark

No, they are neither crazy nor desparate

An investor paying for a bond above its nominal, at par, price, means that on maturity there will be a capital loss unless the accumulated interest rates received cover that loss. When bonds are quoted with negative yields to maturity it means just that. It does not mean, as the popular press will have it, that investors actually pay the German or the Japanese government to lend them money ! Nothing of the kind. Investors continue to receive on a quarterly basis a cheque for a sum equal to the coupon rate multiplied by the nominal price of the bond (say 1.0% pa times 1,000,000).It can mean however that for newly issued bonds, governments may receive bids over the nominal price !

So why are investors willing to make a potential loss as well as receiving very low nominal returns ? First, the loss of capital materializes only when the bond matures and it is repaid. Secondly, every quarter, the investor receives a sum of money, which may ,as a percent of the price paid for the bond, be very small but it is not "negative ". Thirdly, the G3 central banks have kept rates low and, Fed excepted, are planning to keep them so indefinitely. They may try to drive them even lower, to steeper "negative" rates, although they will not say so publicly. Remember that lower rates will mean higher bond prices and, hence, the possibility of making capital gains. Investors do not intend to hold bonds to maturity. They buy bonds in the expectation of making capital gains as prices continue to rise because of the zero rate policy of central banks. Fig 1 illustrates this with the fall in longer term yields in G3.While inflation stays benign and the central banks have no other remedy for the weak economies than to keep rates close to zero, bonds will remain attractive.However as we have shown in Econote No. 50 this is not necessarily so in Asia as movements in local rates do not follow USD rates.

Fig.1: 10Y Govies, US (red),Ger(blue)Jap(Yel) 2012-16



Source: Bloomberg

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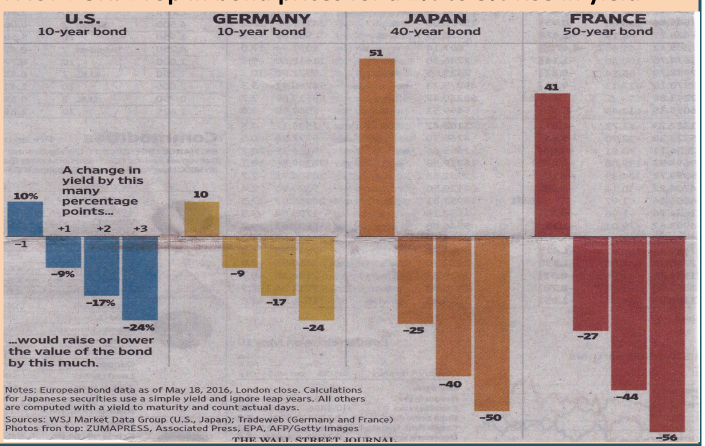
Duration: words of caution

Despite the temptation to equate duration with the tenor of a bond, duration actually shows the number of years necessary for a bond to repay its true costs.But, far more conveniently, duration can also show the responsiveness of the price of the bond to a change in interest rates.So a bond with a duration of 5 years tells us that for a one percent increase (decrease) in interest rates the price of the bond will fall (rise) by 5% .It now follows that as duration of bonds has risen (Fig.2) their overall responsiveness to an increase in rates (such as one engineered by the Fed hiking) will cause a bigger fall in their prices.Be noted also that duration can, and does, vary over time as the tenor of bonds decrease as years pass, or rates change.In general, shortening maturities lead to shorter duration, as do rising market rates and rising coupon yields. Fig.2 is hardly news as it shows a rising trend over 8 years.Combine this trend, however, with negative long term

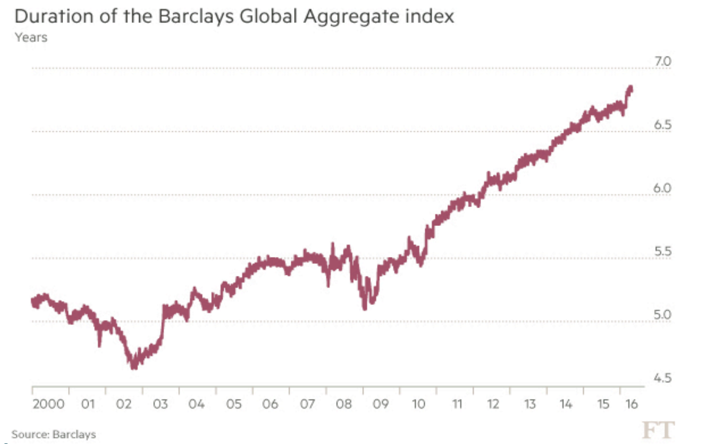
FACT BOX: Drop in bond prices for a 1% to 3% rise in yield



Source: AWSJ

yields supported by the near zero official rates, and this shows the extent to which bond prices have risen. The chart in the Fact Box illustrates the catastrophic capital losses that even small percent increases in yield will inflict on bondholders. And these price rises, and hence potential losses, are not limited to the G3.At the end of April 2016, 75% of all bonds in Switzerland were negative yielders, 75% in Japan,70% in Germany,63% in Netherlands, 55% in France, 54% in Denmark, 48% in Finland and 46% in Belgium. Estimates now are putting the total negative yielders to USD 13.0 trillion and not just govies.About EUR 250 bl of EUR denominated corporate bonds are also negative yielders.

Fig 2: Global index of duration



Panic is an acceptable option

So, here is plenty of evidence that small rises in yields will have widespread impact on bond portfolios whose own negative yields simply point to their high nominal prices.The rising duration is not necessarily the result of negative yields, as duration may rise,as we have shown, because of longer tenor bonds being issued, overall existing maturities lengthening and lower coupon rates offered.The persistence ,however, of central banks, and of the G2 in particular, with zero rates is supporting these, potentially, lethal trends.Increasing liquidity in the bond markets does not, repeat does not , lead to consumer and businesses buying more goods, both consumer and capital, and thus driving up their price. Monetarism has never worked and will not work now, except in driving the prices of assets up but not the prices of bread and of shoes.These ineffectual policies do not even weaken forex rates as the Japanese have experienced.People are neither crazy nor irrational.They carry on buying bonds as their prices go up but have no plans to hold them to maturity thus materialising negative yields.Now the question is who is going to be first out of the fire exit when the US Fed hikes (a suicidal option right now, but quite possible in 2017).The subsequent “correction” (talk of the use of meiosis in financial prose..) in bond markets will be something to behold.Keep duration as low as possible and likewise tenors, and keep an eye on the threat of lower credit quality in terms of rising downgrades.A.Freris (writing completed on 17/7/2016)