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Negative Interest Rates: Why would investors pay to lend money?

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Investing is usually associated with making money. Whether through short selling, private equity, arbitrage or simply compounding dividends, the focus for investors is often on generating a profit that covers inflation. However, over the past year, this ideal has turned topsy-turvy, with investors stampeding into investments that, over time, are generating a loss. At the time of writing, over $15 trillion had been invested into bonds that have a negative yield. Yes, that is $15 trillion with a guaranteed loss. This piece examines why investors might prefer the sure loss over taking on any type of risk.

As a starting point, consider a ten-year German bond that has a yield to maturity of -0.55%. For each year the investment is held, the investor is giving the government $100 and getting back $99.50 at the end of the year – not the type of return an investor would expect. Negative interest rates are being seen in numerous other countries too, such as Japan, Sweden, Finland, Slovakia and Switzerland. We must understand the plausible arguments as to why investors are willing to endure negative returns.

The first point to consider is that negative interest rates are viewed as the equivalent of a safekeeping charge. If one was genuinely concerned about the world economy or the financial ability of a country to make good on its debt obligations, then paying a strong government a safekeeping charge would be a rational decision. In concept, it is no different than putting cash in a safety deposit box and paying the fees associated with storing and insuring the storage of your cash.

The second argument is that negative interest rates are the cost of purchasing an option. For example, if one was concerned that there is a possibility that Brexit will lead to a breakup in the Euro, then buying the strongest credit (Germany) or a strong credit in a different currency (Switzerland) would be an appropriate way to express that view. If the Euro were in fact ever to break up, the change in Swiss/Euro exchange rates would more than offset the negative interest rates paid on a Swiss bond.

The third argument looks at the negative interest rate the European Central Bank (ECB) pays on bank reserves. Currently, the ECB pays -0.50% and, by dropping rates below zero, the ECB is hoping to stimulate spending/risk-taking to stimulate an anaemic European economy. As a consequence, the ECB has encouraged European banks to pursue strategies that minimize the cost of holding reserves and, as a result, investing in an instrument that loses less that the overnight rate is rational. Moreover, this is a terrific strategy if you believe that, eventually, the ECB will drive rates even more negative.

The fourth argument takes into consideration the risk management policies of the issuers of annuities. An annuity provides the purchaser a guaranteed fixed sum for the remainder of his or her life. Insurance companies that issue annuities must use investments such as bonds to generate the required investment returns to pay off the annuity. As bond yields decline, insurance companies need to buy increasing amounts of bonds to limit their losses on their annuity obligations, leading to increased buying into a rising bond market with declining yields. The insurance company's risk management policies and pricing never contemplated that interest would drop to such low levels. From a career risk management perspective, it is a rational outcome – keep pace with the decline in interest rates or be fired.

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The fifth and most concerning argument is that of deflation. Throughout our lives, we have experienced a world with inflation, where prices increased either quickly or slowly. We have yet to experience an extended period of deflation. Initially, a decline in prices would be seen as positive because goods become cheaper. The problem with deflation, however, is twofold. First to consider is debt. As an example, if an investor were to purchase a piece of property and finance it with 80% debt, prices continue to decline over time, the property is worth less but the outstanding debt remains the same. Even if interest rates are zero, it would be a poor investment. For an economy, the result would be an increasing amount of debt on assets that are declining in value. As balance sheets weaken, people and businesses become more likely to declare bankruptcy. The second aspect to this is consumer behaviour. In an environment where prices are declining, people defer spending as long as possible, thereby slowing the economy even more. The end result would not only be declining prices but also a shrinking economy.

In an inflationary environment, investors are looking for the interest on a bond to be higher than the inflation rate. Thus, if inflation is 2% and a bond yields 3%, you would have with a real return of 1% and your purchasing power is increasing. Deflation is simply the opposite. If inflation is -2% and a bond yields -1%, you would have a real yield of 1%. In both situations, the portfolio's purchasing power at the end of one year would have grown by 1%. As a result, earning a negative yield in a deflationary environment is a rational investment strategy.

Finally, it is possible that a huge number of institutions and investors are entirely wrong and none of these arguments hold true. If economic activity unexpectedly picks up, coupled with an increase in inflation, the losses to bond holders will be large. Currently, there is little to indicate that a change in sentiment is imminent and economic data continues to point to slower economic growth in the coming months.

The implications of these arguments for equity investors are clear - continue to prioritize investments in companies that have strong balance sheets, the ability to maintain or increase prices in a weak economic environment, and the ability to generate strong free cash flows. Unless the economy consistently shrinks, equities should, over time, generate returns superior to the negative returns available in the fixed income market.

October 2019