Negative Yields

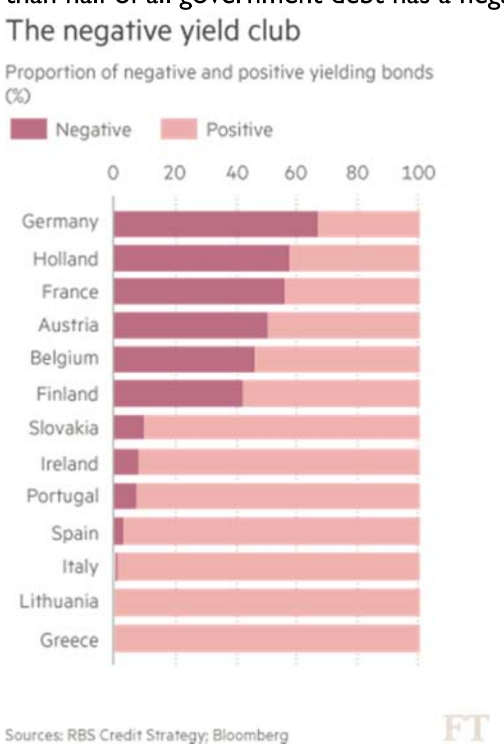
By Michael Rosen on March 19, 2015 at 3:00 pm

One of the (many) perplexing phenomena facing investors is the persistent (and falling) low yields on government bonds.

Most of the time, we look to *real* yields to determine the impact of interest rates on an economy: negative real yields is generally highly stimulative (as it encourages excess borrowing) whereas positive real yields may discourage borrowing. In the aftermath of the financial collapse in 2008, monetary policies became quite aggressive in trying to engineer low (negative) real yields. The US and the UK, in particular, were successful in maintaining negative real rates, thus enabling their economies to grow ahead of the cost of servicing debt. As a result, debt has been reduced and economic output has surpassed previous highs.

Europe has not been as nimble, keeping positive real rates as their economies shrank and deflation set in. Consequently, unemployment rates are twice the levels seen in the US and UK (11% vs. 5.5%), debt burdens are rising and economic output is still below the previous peak.

Over the past few months, central banks in Europe have gone into battle mode. It may be too little, too late, but it does appear that they have had their epiphanies. Nominal overnight deposit rates have become negative (and even more negative in some countries), and around 2 trillion euros of government debt, about 25% of the total bond market, carry negative yields. In some countries, more than half of all government debt has a negative yield (see graph below).



As bond yields fall, bond duration rises, meaning the risk/return profile becomes ever more unattractive. Yet there are more long duration bonds than ever before: in Germany, the aggregate duration of bonds with maturities greater than 10 years is 30% higher today than in 2010, and is 70% more than the average over the years 1995-2010.

Why would investors agree to pay for the privilege of lending their money to governments (and even some corporations)? There are a few possible explanations. Some investors (pension funds, insurance companies) may be indifferent to yield simply because they are buying bonds in order to hedge specific liabilities. Putting the cash under a mattress would be better, but it would have to be a pretty big mattress and someone would have to stand watch over it. Some investors may believe that there will be further deflation, and are looking to profit by buying negative yields in hopes of selling at even more negative yields.

From the perspective of a bank, negative nominal yields reflect a desire to shrink their balance sheets: they simply don't want more deposits, and negative yields is a way to discourage this. From the lender (investor) perspective, negative yields reflect a high degree of risk aversion and lack of confidence in government policies. In this regard, Quantitative Easing ("QE"), which is the central bank buying government bonds, may be a curious "solution:" withdrawing the supply of secure debt when the demand to hold such debt is especially high. Rather than boosting confidence and risk-taking, negative yields may have the perverse effect of heightening fear and boosting the demand to hold secure debt at ever lower (negative) yields.

The recent evidence that European central bankers are on the right track is somewhat encouraging, with equities and confidence up this year and the depreciating currency boosting competitiveness. But it is far too early to pop the Veuve Clicquot, even if it is 15% cheaper than last year.