BANQUE
ERIC STURDZA

INVESTMENT FOCUS
NEGATIVE INTEREST RATES

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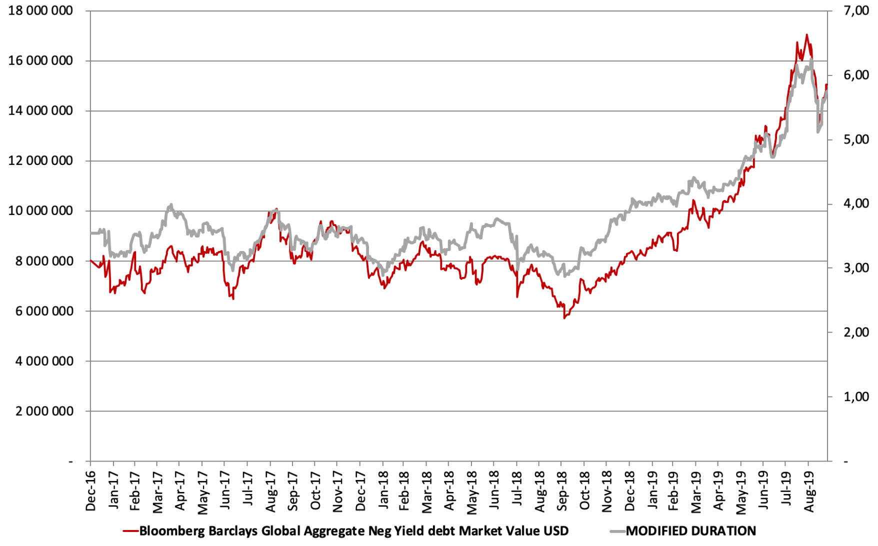
NEGATIVE INTEREST RATES

Which Fixed Income segments are affected?

By deciding to decrease its negative marginal deposit rate (-0.5%) even further in September, the European Central Bank has increased pressure on investors facing negative interest rates.

As shown in the graph 1, this feature is far from being marginal with close to USD 15'000 billion worth of bonds today yielding negative rates. This is close to 26% of the total amount of debt issued worldwide. This is even more problematic as interest rate sensitivity of these negative yielding fixed income securities has drastically increased over the past two years. As a consequence, any potential future interest rate rise will have a more significant negative impact on those bond prices, while at the same time, investors are no longer paid to bear those risks, quite the contrary.

Graph 1: Market value of negative yielding debt & average duration



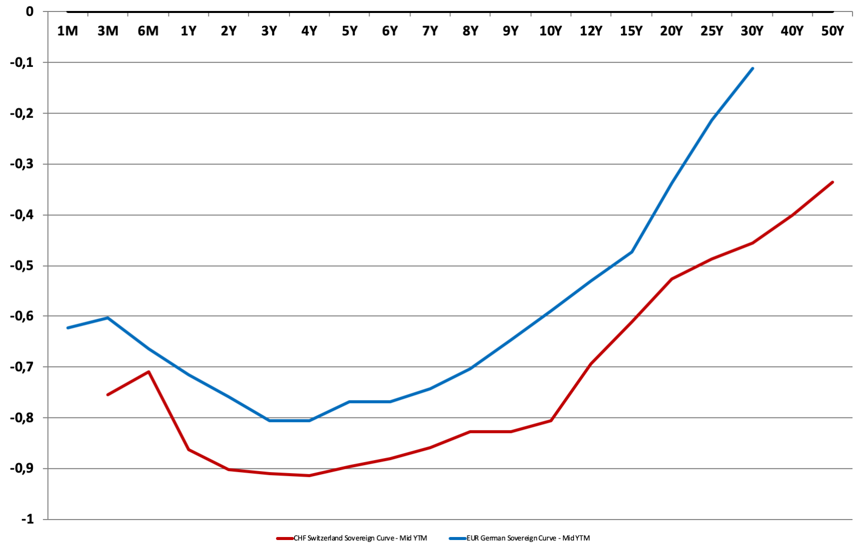
Source: Bloomberg, Banque Eric Sturdza

NEGATIVE INTEREST RATES

Looking at government bonds, the whole Gernan and Swiss yield curves are in negative territory. France and Japan are also experiencing the same issue with negative rates on government bonds up to a 15 year maturity. The EU periphery countries have also been impacted : Spain and Portugal are negative up to 8 year maturities, Italy up to 3 years..

Credit is not immune with Investment Grade companies like Nestle having its 10 year bonds yielding negative. Generally speaking, solid investment grade names tend to trade in negative territory for maturities under 5 years.

Graph 1: Yield Curve
Germany Federal State (blue) – Swiss Confederation (red)



Source: Banque Eric Sturdza, Bloomberg, September 25, 2019

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Why a negative interest rate?

Following the Great Financial Crisis of 2008, in a concerted effort the major central banks (ECB, FED, PBoC, BoJ) have adressed threats and issues on financial stability and economic growth by lowering key interest rates and providing massive liquidity injections into the financial system. The European Central Bank was late to implement its first Quantitative Easing program to address the sovereign debt crisis in 2011-2012. This initial sluggishness and the restrictive fiscal policy pursued at the same time fueled fears of secular stagnation and a deflationary spiral, pushing the ECB to lower its deposit rate into negative territory by 2014.

It is also worth noting the situation of some smaller economies, open to the outside and with less financial imbalances such as Switzerland or Denmark, which have followed suit or preceded the Euro zone in setting up negative rates. In these cases, negative interest rate policies have often been put in place to curb capital inflows and thus currency appreciation. As such in Switzerland, the Swiss National Bank already applied negative interest rates on sight deposits of up to 12% in 1974, to limit the appreciation of the Swiss Franc, a measure that was not necessarily successful.

What are the implications

From a macro economic standpoint, it is tough to say what would have been the economic situation in the Euro zone if the ECB had not lowered its rates and had not brought them into negative territory. Whether we would have avoided a deflationary spiral and a Japanese-style scenario remains open to question.

As for the consequences and future implications, they are also inherently difficult to comprehend: Inflation in financial assets, fixed income and real estate bubbles, liquidity deterioration

For the Banks, the implication of this negative interest rate policy is found in a deteriorated net interest margin and therefore a lower profitability. The disappointing banks' share prices over the past decade act as a good reminder on how difficult the situation has been for them.

For life insurers, pension funds, retirees and individual investors, negative interest rates have another name, Financial Repression

NEGATIVE INTEREST RATES

What can we learn from previous experiences of negative interest rates?

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1. The most important lesson is that there is no «Free Lunch», as in to the saloon. This means that it is possible to envisage solutions addressing this policy of negative interest rates, but that any solution involves either a risk or the acceptance of these negative rates.
2. The next striking point is that Japanese insurers while remaining in their «natural habitat», the fixed income markets, have accepted that to achieve positive returns they must take more risk: interest rate risk, credit risk or liquidity risk in some measure.
3. They have also invested in asset classes adjacent to the fixed income class such as alternative strategies and even to a small extent equities.
4. Lastly another avenue explored by institutional investors has been the acceptance of some form of currency risk, whether through carry trade strategies or Dual Currency Deposit products to name but a few examples.