

Think positive

It's time to start figuring out how the negative-rate environment will unwind and find the best opportunities to profit



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A GUARANTEED loss over five years. Why would anyone decide to make such an investment? Historically economists have debated negative interest rates, but only in theory. But short-term cash interest rates could logically become negative, especially due to extraordinary market conditions. This occurred briefly during the 2008-2009 financial crisis, when the banking system was at risk of failing. During such times, investors could logically decide to pay a small "fee" by accepting negative interest rates for cash, in exchange for the security of receiving their money back.

Other than such exceptional times, economists would struggle to find a logical reason why investors would decide to accept such negative interest rates over the long term, such as in a five-year bond, especially when the world is not in the middle of a full-blown crisis.

The unthinkable has now become reality in Europe. Five-year bond yields in Germany, Austria, the Netherlands, Sweden and Denmark have become negative. In Switzerland, negative yields go all the way to 10-year maturities. Over one trillion euros (\$1.5 trillion) worth of debt is trading at negative yields in Europe. In Denmark, the situation has become even more bizarre. Some consumers with borrowings from banks are actually being paid to leverage. Interest rates have been cut so far

below zero that some interest rates on local property have become negative. Some mortgage borrowers face the situation of actually receiving a small amount of money credited to them on each mortgage payment date, instead of paying interest. For now, this is a great situation for investors who have large loans, at the expense of savers who hold cash.

The reason for this seemingly unthinkable situation is clearly the central banks' massive actions to boost their local economies. What is less clear is why this would extend all the way to five-year maturity bonds. The European Central Bank's (ECB) official cash interest rate is negative, and while most banks are not yet charging cash in bank accounts, they may need to start doing so if negative rates persist for a longer period.

Institutional investors are being charged to hold some currencies in cash, and even here in Singapore, banks are charging negative interest rates for Swiss franc cash holdings. Many European banks are subsidising the difference between the negative official rates and what they pay customers, as they can offset this cost against the (unrealised) capital gains from their large holdings of European Union (EU) government bonds, where prices have appreciated significantly due to these same negative rates.

Other EU regulation also causes such an unnatural situation to persist longer. EU solvency laws force some institutions, particularly insurance companies, to hold larger amounts of EU sovereign bonds, much of which trades at negative yields up to five years, or very low positive yields going out to 10 years. Both of these are

unappetising choices for institutions, but there is little in the way of similar alternatives that can be considered.

While we would expect such a situation to occur only during periods of significant market stress, many investors are instead left scratching their heads at the strong performance of EU asset prices, compared to such a dismal underlying economic situation which would warrant such a monetary policy.

One rational assumption is that such an environment will not last, and that the ECB's actions will work in stimulating the underlying economies, whereby interest rates will normalise and once again turn positive.

Another interpretation is that we are entering a period of worsening global deflation. Interest rates will not rise in any meaningful manner in any major economy. This would include the US, where expectations of higher interest rates have been repeatedly pushed back. Since these global monetary experiments have never been attempted before, how the situation will play out is not clear. However, there are a few longer-term conclusions investors can draw with a reasonable level of confidence, and this would be the time to start thinking about them and positioning one's investment portfolio accordingly.

While interest rates may stay low for longer than most people expect, negative medium-term bond yields are very likely the culmination of the bond bull market that started in the early 80s, when long-dated government yields approached 20 per cent per annum. Bond yields globally have never been at current levels, so the risk/reward for long-dated bonds is clearly

extremely negative at current yields.

Reducing bond duration would be the passive way to protect an investment portfolio. There are, however, more active actions investors can take to actually profit from a fall in bond prices, while keeping in mind that such a fall is not imminent, but likely to play out over a number of years.

Certain financial-sector companies, particularly insurance, need to generate a minimum required return on their financial investments. Particularly in Europe, with so much of the bond market trading at near zero yields, this minimum required return is becoming more and more difficult to achieve.

In the short term insurance companies have benefited from large capital gains from their sovereign bond investments, but if negative yields persist for a longer period of time, these gains would have come at the expense of lower long-term returns. As bonds mature and the capital needs to be re-invested, portfolio yields will drop significantly.

The global bond yield environment has caused many investors to lament the low returns in both cash and bonds. In the short term many have decided to move down the risk curve by increasing bond duration or reduce credit quality in order to keep receiving ever diminishing yields. Investors would be better served by looking past the current situation and figuring out how this will all unwind in the medium term, and thinking now about the best opportunities to profit from such an unwinding, which will catch most people by surprise. **W**

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