

CurveBall: A True Underwater Story

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Strange forces are afoot when some \$15trn of debt trades at negative yields, double the level of one year ago and getting on for one third of the global investment grade bond universe¹. Negative yields are nothing new. Short dated Swiss government bonds crossed this Rubicon as early as 2011 as the European sovereign crisis peaked and the country's haven status attracted capital. German bonds followed in 2012, submerging the quality end of the European bond market into this underwater world of rates. Last week Germany and the Netherlands joined Switzerland to claim a clean sweep of negative yielding bonds across the length of their yield curves. 30-year German yields plunged as low as -0.15%; 50-year Swiss yields reached -0.3%. Few would have thought that investing in a 2.1% Austrian 'century' bond two years ago (2117 maturity) would have nearly doubled your money by now. So why does this phenomenon continue? Is the pool of 'greater fools' expanding or is there some method in this sub-zero madness?

It seems nonsensical as a creditor to get back less than you lent, unless the alternatives are even less appealing. In Europe that is the case. The deposit rate – the rate at which Eurozone banks can deposit excess cash with the ECB – has been negative since 2014 and remains at -0.4% today. Bonds at 'higher' (but still negative) yields thus look relatively attractive and for Euro based investors there is some logic in buying these bonds. There is little prospect of this key rate going higher anytime soon, as the ECB looks likely to reassert pro inflationary policy measures and may cut further. Even gold has a positive relative yield when core euro rates are negative, making the yellow metal increasingly attractive as a diversifying asset, to which recent price moves attest.

Despite the recent trend towards 'slowbalisation' in the export market for manufactured goods, financial services remain very much globally integrated, and in open economies cross border flows will be a key determinant of local asset prices. For bond investors, who frequently hedge out currency risk to isolate the diversifying qualities of global bonds, there may be a yield pick-up when hedging back into their domestic currency. Today, hedging Euros is worth an additional 2.8% to US investors, morphing a negative 0.6% 10yr bund yield in Euros into a positive yield of nearly 2.2% in USD – almost 50bps more than the yield on a 10yr US treasury.

Taking this cross-border value factor one step further, it is important to also consider the shape of the respective countries' yield curves. Steeper curves provide more 'roll-down' – the price return accrued through time as maturity shortens and yield (usually) decreases. With sovereign curves in Europe being steeper than the close-to-inverting US, the total return opportunity in Euro denominated bonds is further extended, providing more cushion to yield tourists against adverse price movements – which remain a very real threat from such a low base. Incorporating the 'roll-down' and hedged yield into a more all-encompassing 'carry' based measure sees German 10yr bonds trumping the 10yr US treasury by almost 75ps. Italian bonds offer up an enticing 480bps premium.

As global investors it's important to look at investment opportunities through a global lens. It is true, core European bonds offer limited prospective real returns to local investors (and plenty of downside risk, let's not forget). For the global investor though, there are still relative value opportunities which we can access, where this carry factor can be captured in a cheap and efficient way without compromising on quality. Our job is to locate the shallower water in this increasingly submerged world. A global mindset allows for that.

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¹Bloomberg Barclays Global Aggregate Bond Index, August 2019

Market Focus

- » UK economy contracts for the first time since 2012
- » Turbulent week for EU bond yields
- » Brent crude fell 5.4%, ending the week at \$58.5 per barrel
- » Gold price rose 3.7% ending the week at \$1500.1 an ounce

US

- » The S&P 500 was down for six consecutive sessions, its longest negative run since October of last year.
- » Earnings season continued with 62 S&P 500 companies reporting.
- » The Chinese currency weakened below 7.0 yuan per US dollar on Monday prompting allegations of currency manipulation.
- » US equities finished the week negative, falling 0.4%.
- » US Treasuries gained 0.9% during the week, bringing their performance to 7.4% for the year.

Europe

- » Eurozone retail sales rose by 1.1% on a month-on-month basis in June (compared to the 0.3% expected). This was the strongest monthly gain since November 2017 and brought the yearly gain to 2.6%.
- » During the week, Denmark's long-term mortgage rate traded at zero, the entire German yield curve traded negative, 10-year Spanish and Portuguese bonds traded within 20bps of 0% and Austria's 100-year bond price rose to a high of 192 vs 117 at the start of the year. The bond has delivered a 64% return so far this year.
- » European equities continued their fall over the week, dropping by 1.2%.

UK

- » For the first time in seven years the UK economy contracted, with the Office for National Statistics reporting a 0.2% fall in GDP over the second quarter.
- » Sterling continued to depreciate as a result of elevated uncertainty around Brexit talks and the greater potential for a general election following the October leave date.
- » UK equities declined 1.7%, bringing their decline this month to 4.0% so far.
- » UK gilts matched the previous week returning 1.0%, while investment grade bonds returned 0.3%.

Rest of the World/Asia

- » Gold crossed the \$1,500 level during trading on Wednesday.
- » China asked that state-owned companies suspend imports of US agricultural products in response to the tariff the US had imposed on China at the end of the previous week.
- » Japan's Q2 GDP data was higher than expected at an annualised rate of 1.8%, although real wages fell for their sixth consecutive month.