Heartwood Investment Management

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Investment Insight

The global plague of negative yielding debt

Global investment markets are currently subject to record-breaking levels of negative yielding debt.

The current tally stands at around $16trn worldwide – much higher than in the 2015-2016 period, when the world economy teetered on the brink of recession. This figure has also ballooned rapidly since last October, when it stood at just $6trn.

Negative yielding debt has ballooned in recent months

Global negative yielding debt levels (US $trn)

Source: Bloomberg

Bonds which offer a negative yield effectively equate to lenders (i.e. bond market investors) paying borrowers (governments and businesses) for the privilege of giving out their capital, if these bonds are held to maturity.

Taking a step back from what has quickly become a 'new normal', this is a truly staggering place in which to find ourselves.

Why has the amount of negative yielding debt risen so sharply?

Negative yielding debt has been on the rise for three reasons:

- First, global central banks are currently engaged in a concerted effort to support the global economy. Interest rate cuts across the developed world, and most crucially at the US Federal Reserve (which recently introduced its first rate cut in years) have encouraged extraordinarily low bond yields. The market has also been driven by hints at further accommodative central bank action ahead, including from the European Central Bank (ECB).
- Second, while certain drivers of growth in the global economy (such as the buoyancy of the US consumer) have been robust, weak economic data overall has given investment markets cause for concern. Growing unease has led to a flight to safe haven assets like government bonds, as continued fears around global growth push wary investors to preserve as much capital as possible at all costs.
- Third, inflation expectations have fallen (and continue to fall) considerably, making negative yielding debt look relatively less risky.

Clear Thinking

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> Investment Director

What are the risks?

A fascinating and evolving feature of this raft of negative yielding debt is the participation of the corporate sector. The corporate bond market now accounts for $1.6trn of negative yielding debt globally, and Europe is a big proportion of that. Of this global total, $1.1trn belongs to the financial sector, with the balance made up by non-financial sectors, including 14 Eurozone non-investment-grade companies (such as Nokia).

Negative yielding corporate debt levels in Europe are substantial, and rising

Negative yielding European corporate debt levels (US $bn)

Source: Bloomberg

While the level of negative yielding debt is new, an environment of lower yields has existed for some time. Businesses have naturally been incentivised to take advantage of this environment to reduce the cost of servicing their debts, and many have been able to opportunistically extend the maturity of these debts at a time to suit them. However, a trend for issuing short-term (12-18 month) debt, which has ramped up in 2019, may pose a significant risk to issuers, who cannot now be creative about when to refinance. These businesses must accept whatever lending conditions are in situ when their near-term debt matures, which could be punitive if the landscape changes quickly.

But the greatest risks may be reserved for bond market investors. Investors who believe that long-term yields will continue to fall may see negative yielding debt as a case of ‘better the devil you know’. But given that bond yields are intended to compensate investors for the risks they take in lending out their capital, in buying negative yielding debt, investors are effectively pricing in no credit risk (the risk that the borrower defaults) or interest rate risk (the risk that changing interest rates reduce the relative value of the bond) for the duration of the bond they are buying. Time will tell whether or not this was a wise assumption.

In places where cash itself offers a negative return – such as the Eurozone, where the ECB has set negative interest rates in an effort to stimulate the stuttering economy – negative yielding bonds may appear less risky on a relative basis. In Europe, positive yields are only available on 30-year+ bonds (in some countries), meaning that investors must take on substantial interest rate risk for still only minimal yield.

Is this a global phenomenon?

While historically lower bond yields are in evidence across the globe, negative yielding debt is not, particularly in the developed market space.

Between Brexit, the 2018 US tax break sugar rush, and Europe’s decidedly shaky economy, yields in these regions have diverged materially. In the UK, where economic fundamentals are currently challenged given the fog of Brexit, yet where inflation expectations are fairly solid (in part due to a weakened currency), debt markets are still conducting themselves in a relatively orderly fashion. Though low, UK government debt remains positive-yielding, with investors still being paid to take on risk. Meanwhile, in UK corporate debt markets, ongoing uncertainty surrounding

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the seemingly eternal Brexit debacle is still encouraging positive yields in an orderly fashion across short- and long-dated debt.

In Europe, where the central bank is keen to do more to stimulate economic activity, negative yielding debt is likely to increase in the short to medium term. This is because the ECB itself will likely soon begin buying sovereign and corporate debt again, pushing yields even further into negative territory.

Happily for investors, not all debt in Europe is being issued with negative yields. Notably, asset-backed securities in the region are offering positive yields (as they are in the UK and Australia too), and yields on Eurozone financial corporate debt are also comparatively high, with banks compensating investors for taking on higher credit risk. Globally, emerging market debt can also offer compelling levels of yield, both in an absolute and relative sense.

What should investors expect next?

In the worst case scenario, where the current unease in the global economy develops into recessionary conditions, central banks would very likely slash interest rates and enact more quantitative easing. These actions would lead to a further rise in the amount of negative yielding debt globally, as well as a further collapse in yield curves (meaning that investors would require disproportionately higher compensation for short-term lending relative to long-term lending, reflecting significant near-term uncertainty).

However, in other circumstances, while negative yielding debt is here to stay, the amount of debt trading at these levels could fall quite quickly. Good news on US-China trading relations, for example, would likely provide an instant relief for the global economy, offering encouragement to nervous investors and comfort to anxious central banks.

While we are watching closely for signs of economic improvement or deterioration in this potentially very changeable economy, our stance on bond holdings is consistent either way. We firmly believe that investors should be compensated for their bond holdings, however low the available yield may be. While bonds are relatively low risk investments compared to stocks or alternative assets, no investment can ever be risk-free, and we think investors should always be compensated for the level of risk they take on, given the underlying economic backdrop.

David Absolon
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