Bradley, Foster & Sargent, Inc.
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Negative Yields on Sovereign Debt: What is the World Coming To?

Russia [Sovereign Debt] is a riddle wrapped in a mystery inside an enigma.
Winston S. Churchill, Radio Broadcast, 1939

Since the beginning of recorded history, money has been a scarce resource. In modern times, it has always come at a cost. Before the Reformation, the Catholic Church generally forbade charging interest on loans. The Torah did not permit Jews to charge interest to other Jews, but charging interest to pagans was allowed. Under Sharia law, Muslims are still forbidden to charge interest on loans, although renting and leasing are sanctioned. But, at most times in most places, starting with the Industrial Revolution in the West, there has been a cost associated with borrowing money. For some time now, countries have been able to borrow money at little or no cost. The U.S. Treasury currently pays 1.4% on a 5-year note. And now, Japan and many countries in the European Union (EU) can issue debt at negative interest rates. In other words, we are witnessing the spectacle of countries borrowing money and actually earning a profit on these loans. Currently, there is approximately $17 trillion of sovereign country debt with negative yields. For example, Germany recently issued a 30-year, zero coupon, €3.5 billion bond at a price of €103.61. At maturity, the investor would receive €100 back. Thus, Germany in this example earns €3,610 for each €100,000 bond that it issues. The table below shows what each country pays or earns for issuing debt at different maturities:

Sovereign Debt Negative Yield Monitor
September 23, 2019

	1 yr	2 yr	3 yr	4 yr	5 yr	6 yr	7 yr	8 yr	9 yr	10 yr	15 yr	20 yr	30 yr
Switzerland	-0.94	-0.96	-0.98	-0.96	-0.94	-0.92	-0.90	-0.87	-0.88	-0.85	-0.65	-0.57	-0.47
Japan	-0.28	-0.30	-0.31	-0.33	-0.33	-0.34	-0.34	-0.33	-0.29	-0.21	0.01	0.19	0.35
Germany	-0.72	-0.75	-0.79	-0.79	-0.76	-0.76	-0.74	-0.70	-0.65	-0.58	-0.46	-0.32	-0.09
Netherlands		-0.74	-0.78	-0.76	-0.68	-0.64	-0.61	-0.55	-0.50	-0.44	-0.33	-0.12	-0.10
Finland	-0.65	-0.69	-0.70	-0.65	-0.64	-0.54	-0.50	-0.44		-0.32	-0.14		0.14
Austria	-0.61	-0.68	-0.67	-0.64	-0.57	-0.55	-0.49	-0.46	-0.41	-0.33	-0.09	-0.01	0.23
Belgium	-0.61	-0.66	-0.69	-0.62	-0.54	-0.50	-0.46	-0.39	-0.32	-0.25	0.01	0.23	0.57
France	-0.61	-0.69	-0.71	-0.69	-0.62	-0.56	-0.50	-0.44	-0.38	-0.29	0.01	0.12	0.53
Sweden		-0.59			-0.57					-0.26		0.15	
Denmark		-0.80			-0.73			-0.67		-0.55			
Ireland				-0.52	-0.45	-0.35	-0.29			-0.04	0.26		0.79
Italy	-0.25	-0.25	-0.06	0.06	0.30	0.32	0.54	0.61	0.64	0.83	1.36	1.54	1.89
Spain	-0.48	-0.52	-0.48	-0.34	-0.29	-0.17	-0.08	0.00	0.06	0.15	0.57	0.58	1.05
Portugual	-0.43	-0.56	-0.44		-0.28		-0.05	0.01	0.10	0.17		0.75	1.09
United Kingdom	0.55	0.47	0.41	0.41	0.40	0.34	0.36	0.40	0.47	0.55	0.74	0.89	0.97
United States	1.80	1.66	1.58	1.60	1.57		1.63			1.69	1.83	1.95	2.14

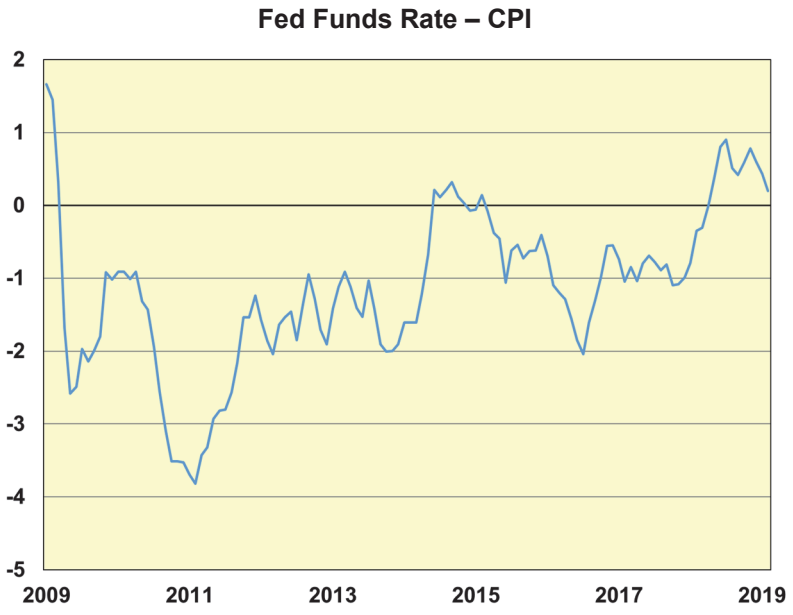
Source: Bloomberg

Interest Rate Patterns During the Past Century

During the 20th century, U.S. investors who purchased fixed income instruments sought and usually required a return from bonds which paid a yield well above the rate of inflation. In other words, if the inflation rate over the recent past had been 3%, short-term bonds and similar fixed income instruments were expected to yield 5% — a 2% margin above the rate of inflation. Longer-term bonds (10-year maturities and longer) would usually pay a yield of 3% or more above the rate of inflation. Investors perceived bond yields as comprising two components: a real rate of interest, and a premium to allow for the possibility of increased future inflation which might result in the loss of purchasing power from rising prices. No rational investor would purchase a fixed income instrument with a negative real interest rate, i.e., where the rate of inflation (measured by the Consumer Price Index [CPI]) was higher than the nominal interest rate. This would mean that the investor would realize a loss of purchasing power by buying the bond. No, investors in the last century demanded that bonds yield more than the rate of inflation — even in times of economic adversity. In the Great Depression, 20-year U.S. Government Bonds in the period 1929-1940 yielded between 2.25% and 4% — even from 1930-1932 when deflation reigned. During that three-year period, the CPI plunged 26%, yet bond yields remained at 2.25% or higher. They were a superb investment. In sum, investors or lenders did not accept negative real rates of return; they demanded robust positive real rates of return.

Interest Rate Patterns Since 2009

Since the great Financial Panic of 2007-2009, the relationship between yields on fixed income instruments and the rate of inflation has changed dramatically. Fixed income investors have often been willing to buy fixed income instruments with negative real rates of return. The chart below demonstrates the sea change that has taken place, with the Fed Funds rate (a key index for short-term interest rates) having a negative real return for most of the past decade:



Source: Bloomberg

Possible Reasons for Negative Real Interest Rates Globally

The country with the largest amount of negative yielding sovereign debt is Japan, with over $6.1 trillion in yen-denominated bonds outstanding. This is followed by France and Germany, each with over $2 trillion in negative yields on their sovereign debt. More than $200 billion of negative yielding sovereign bonds have been issued by Spain, the Netherlands, Luxembourg, Belgium, Austria, Sweden and Switzerland. While U.S. Government bonds do not currently have negative yields, the 10-year U.S. Treasury Note currently yields 1.6% — less than the inflation rate (the most recent year-over-year CPI being 1.8%). So why is the U.S. experiencing negative real interest rates for intermediate and longer-term U.S. Government bonds?

In seeking to answer this question, it is important to acknowledge that we, at Bradley, Foster & Sargent, are not economists, and most of us do not want to be. Some of our readers will remember the old joke that a philosopher is a person in a dark room looking for a black cat that isn't there, while an economist is in the same dark room looking for a black cat that isn't there, but cries, "I've found it." Well, we don't think that we know the answer to why negative real interest rates prevail in most parts of the developed world, but here are some educated guesses.

Deflationary trends globally. Over the past several decades, leading central banks have come to believe that an economy functions best with an inflation rate of approximately 2%. And they are unanimous in their belief that deflation is to be avoided at all costs. But, regardless of the herculean monetary measures that the European Central Bank (ECB) has employed, inflation in the EU has averaged .9% p.a. over the past five years. The Bank of Japan has sought to achieve the same inflation target and has fallen even further short with an inflation rate of .3% p.a. for the same period. Despite several bouts of quantitative easing and lowering the Fed Funds rate to rock-bottom levels, the Federal Reserve also has fallen short of the 2% inflation bogey over the past ten years, with the CPI averaging just 1.8%. There seem to be strong deflationary currents running in the economies of the developed world. The weakness in world oil and commodity prices reflect these deflationary pressures as well. We advance the theory that a primary cause of the deflationary trend is the advent of the internet, instantaneous global communication, and sophisticated and efficient transportation systems, which allow more than two billion people in emerging countries in Asia, Africa and Latin America to create products and deliver services at a quarter of the cost of the developed world. This puts downward pressure on prices in many sectors of the economies in Europe, Japan and the U.S.

Expansion of the money supply (quantitative easing). We have witnessed an unprecedented series of moves by central banks around the world to expand the money supply and create more liquidity. Central banks have also taken steps to punish banks that deposit their excess liquidity with the central bank rather than lend their excess reserves to businesses and individuals. In previous decades, the creation of massive liquidity and boosting the money supply generally produced accelerating inflation. We all know about the rampant inflation in Germany after World War I and in Zimbabwe more recently. But as mentioned above, inflation over the past decade has remained anemic. The probable reason for this is that the velocity of money has dropped dramatically, and the savings rate has increased, causing almost no inflation. The old explanation that inflation is caused by too much

money chasing too few goods does not seem to apply in developed countries currently. Rather, excessive liquidity appears to be putting downward pressure on interest rates.

Investor pessimism leading to risk aversion. The fear of an approaching recession has caused many investors to exit the equity markets and invest in fixed income instruments at negative real rates of return. But why would investors buy bonds with negative yields? The main reason is that in a deflationary spiral, bonds with modest negative yields will provide better returns than almost all other alternative investments. Also, in various jurisdictions, insurance companies and pension funds are required by regulators to invest considerable funds in long-dated securities issued by the government in order to match long-dated liabilities. Protests in Hong Kong, constant talk of trade wars, Brexit and unpopular governments throughout Europe have scared some investors into placing their assets in instruments which they believe will have the least losses of all asset classes.

What Does This All Mean for Investors?

Rock-bottom interest rates have the effect of enhancing the attractiveness of equities. The main reason why low or negative interest rates make stocks more attractive is that investments are not made in a vacuum; investors compare returns. If an investor buys a 10-year U.S. Treasury Note at a yield of 1.6%, this means the investor receives a return of 1.6% for ten years with no growth of principal. Stocks with a P/E ratio of 18 have an earnings yield of 5.56% (earnings of $1 divided by a price of $18). Thus, an investor not only receives a return on investment threefold greater than the 10-year note, but will often receive a dividend. With quality growth companies, both earnings and dividends can often double in ten years, leading to significant price appreciation of the stock. So why buy fixed income instruments with negative real interest rates?

Negative real interest rates can cause real problems. First, they can lead governments and companies to borrow too much because there appears to be no cost to the debt. Ultimately, too much debt can lead to investors being unwilling to buy more bonds from uncreditworthy borrowers, which could cause the collapse of a company or a country. Second, if interest rates rise, the burden of paying the interest on the debt becomes onerous. If the U.S. had to pay 6% on the $22 trillion national debt, the interest burden would increase from $389 billion now to $1.32 trillion. Third, when the next recession does come, the Fed cannot lower rates, the traditional medicine to bring a country out of a recession. Finally, negative real rates of return can lead to inflated asset prices, which could ultimately lead to a nasty bear market.

To sum it up, we are in uncharted waters with negative yields on sovereign debt, and no one knows how this experiment will end. But there is certainly a possibility that it will end badly. Accordingly, we believe that now, more than ever, it is important for investors to focus on quality companies — with great brands, sound business models, quality management, wide moats, strong balance sheets, and strong cash flows. These types of quality assets will preserve capital in times of economic adversity and create wealth in times of economic growth.