Late cycle investing: Navigating negative rates

This is the fourth and final instalment of a multi-part series on investing amid a challenging time for investors

At a glance:

- Negative interest rates are classified as unconventional monetary policy tools
- Some companies may benefit from stimulus measures as the focus shifts to fiscal policy
- Global investors can still generate a positive return in a world of negative interest rates

Why have negative interest rates entered the financial markets?

Central banks in many developed countries, including major ones like the Bank of Japan and the European Central Bank had previously cut interest rates up to levels near zero to bolster the economy during the last global financial crisis in 2008.

Because these central banks have limited scope to slash rates further down, negative interest rate policy was introduced as unconventional monetary policy.

How do negative interest rates work as part of monetary policy?

Financial institutions are required to pay interest for parking excess reserves with the central bank. In doing so, there is less incentive to hold cash which encourages financial institutions to boost lending. The idea is that this will stimulate economic activity, which some economists and government policymakers welcome during this time of muted global growth. The increase in lending and spending is likely to boost economic activity, leading to growth and inflation.

For some central banks, a welcome side effect is the downward pressure on their domestic currency. Amid a trade war which has dented manufacturing activity and global supply chains, it theoretically boosts the relative attractiveness of export reliant countries' currencies, and in turn, stimulates external trade.

What opportunities are we looking at amid negative interest rates?

Equities

With interest rates below zero, central banks have little room to deploy further monetary policy. Hence governments would likely turn the attention onto fiscal policy– that is, spending and taxes to stimulate the economy. Germany is debating a fiscal program to bolster consumer spending and stimulate its domestic economy. Meanwhile, the US has begun discussing a payroll tax cut to stave off economic weakness. It could be worth investing in companies that have the potential to benefit from the increased fiscal stimulus.

FX

Opportunities can exist with emerging markets such as Indonesia and Turkey which are traditionally considered to be high-beta, that is, with high interest rates and a high degree of exposure to global risk. Previously in a risk-off environment, these high-beta currencies would fall as investor dump high yielding assets. However, with negative interest rates and amidst a desperate hunt for yield, these EM currencies have instead rallied or traded sideways.

Bonds
In a sub-par growth and disinflationary world, long duration plays are likely to pay off. (which leads us to the next section)

How can bond investors profit with negative interest rates?

While negative interest rates are controversial, it does not mean that bond investors will be unable to generate positive returns. FX carry provides the opportunity for global investors to generate positive returns in bond markets.

Foreign investors may find negatively yielding Euro area or Japanese bonds attractive, as some investors (e.g. USD based investors) can take advantage of the cross currency basis as well as differences in funding rates. US investors can buy a 10-year German bund yielding -0.52%, and still pick up 24 basis points (1.96%-1.72%) over 10-year US Treasuries. Japanese investors can achieve around 55 basis points of pick up in negatively yielding 10-year Spanish bonds against Japanese government bonds.

	Government Bond Markets															
10-year bond	Germany	US	Japan	UK	Switzerland	Canada	Sweden	Denmark	Australia	New Zealand	France	Italy	Spain	Mexico	Brazil	Korea
Unhedged	-0.52%	1.72%	-0.21%	0.63%	-0.80%	1.38%	-0.80%	-0.49%	1.16%	1.15%	-0.22%	0.92%	0.23%	6.97%	3.84%	1.47%
FX hedged yield (Investor domicile)																
Euro Area	-0.52%	-0.82%	-0.33%	-0.69%	-0.40%	-1.00%	-1.19%	-0.23%	-0.42%	-0.63%	-0.22%	0.92%	0.23%	-1.13%	-1.15%	0.05%
US	1.96%	1.72%	2.15%	1.83%	2.06%	1.55%	1.29%	2.22%	2.10%	1.88%	2.26%	3.40%	2.71%	1.55%	1.38%	2.68%
Japan	-0.42%	-0.70%	-0.21%	-0.57%	-0.30%	-0.88%	-1.08%	-0.14%	-0.31%	-0.52%	-0.12%	1.03%	0.34%	-0.72%	-1.08%	0.42%
UK	0.78%	0.52%	0.96%	0.63%	0.89%	0.34%	0.08%	1.06%	0.90%	0.68%	1.08%	2.22%	1.54%	0.25%	0.26%	1.48%
Switzerland	-0.92%	-1.20%	-0.72%	-1.09%	-0.80%	-1.39%	-1.59%	-0.64%	-0.82%	-1.03%	-0.62%	0.53%	-0.16%	-1.48%	-1.60%	-0.02%
Canada	1.80%	1.55%	2.00%	1.66%	1.90%	1.38%	1.11%	2.04%	1.94%	1.73%	2.10%	3.25%	2.56%	1.23%	1.22%	2.70%
Australia	1.04%	0.77%	1.23%	0.89%	1.15%	0.60%	0.34%	1.29%	1.16%	0.95%	1.34%	2.49%	1.80%	0.61%	0.42%	1.92%
New Zealand	1.23%	0.98%	1.43%	1.10%	1.34%	0.80%	0.57%	1.50%	1.36%	1.15%	1.53%	2.67%	1.98%	0.71%	0.63%	2.14%
Sweden	-0.13%	-0.41%	0.07%	-0.32%	-0.01%	-0.59%	-0.80%	0.15%	0.00%	-0.20%	0.17%	1.32%	0.63%	-0.71%	-0.80%	0.76%
Norway	1.80%	1.57%	1.99%	1.68%	1.89%	1.34%	1.12%	2.06%	1.91%	1.72%	2.10%	3.24%	2.56%	1.39%	1.21%	2.69%
Denmark	-0.75%	-1.09%	-0.57%	-0.97%	-0.65%	-1.24%	-1.44%	-0.49%	-0.65%	-0.86%	-0.44%	0.70%	0.01%	-1.38%	-1.39%	0.11%
China	2.80%	2.68%	3.06%	2.74%	2.99%	2.51%	2.24%	3.17%	3.04%	2.86%	3.10%	4.24%	3.55%	2.56%	2.38%	3.63%
Singapore	1.68%	1.44%	1.88%	1.54%	1.78%	1.27%	1.02%	1.95%	1.81%	1.60%	1.98%	3.12%	2.43%	1.25%	1.10%	2.51%
South Korea	0.88%	0.52%	0.77%	0.62%	0.68%	0.14%	-0.66%	0.78%	0.74%	0.68%	1.19%	2.33%	1.64%	0.05%	-0.06%	1.47%
Taiwan	-0.73%	-1.03%	-0.49%	-0.93%	-0.63%	-1.19%	-1.39%	-0.45%	-0.58%	-0.92%	-0.43%	0.72%	0.03%	-1.39%	-1.39%	0.15%
Brazil	4.23%	4.12%	4.47%	4.11%	4.46%	3.94%	3.64%	4.56%	3.72%	4.24%	4.53%	5.67%	4.98%	4.05%	3.84%	5.22%
Mexico	7.00%	6.86%	7.17%	6.88%	7.10%	6.62%	6.35%	7.23%	7.16%	7.00%	7.30%	8.45%	7.76%	6.97%	6.92%	7.94%

Source: Bloomberg, as of 20 September 2019

The example above involves investment horizons over an extended 10-year period using FX hedges over the shorter term (1 year). Though we illustrated positive implied yields, there may be risks associated with yield and FX movements, as well as roll-over risks.

Why are investors still actively buying negative yielding bonds in the market?

Investors may find negatively yielding bonds attractive after FX hedging is accounted for (see example above). Additionally, this includes other momentum-based investors who are price-based rather than yield-based investors. The negative yields do not matter as much as it is unlikely the bonds would be held to maturity, as central banks step in to purchase them. Finally, there are insurance companies and potentially pension funds that may be forced by regulations to buy bonds amid de-risking.

How might investor behaviour shift over the medium to longer term as a result?

In the hunt for yield as interest rates fall below zero, investors are likely to look to the positive yielding part of the risk-free universe, such as US Treasuries and the least risky part of risk assets. This is also likely to result with inflows into dividend yielding equities (e.g. REITs) which act like bond proxies.

Important Notice & Disclaimers

This publication shall not be copied or disseminated, or relied upon by any person for whatever purpose. The information herein is given on a general basis without obligation and is strictly for information only. This publication is not an offer, solicitation, recommendation or advice to buy or sell any investment product, including any collective investment schemes or shares of companies mentioned within. Although every reasonable care has been taken to ensure the accuracy and objectivity of the information contained in this publication, UOB Asset Management Ltd ("UOBAM") and its employees shall not be held liable for any error, inaccuracy and/or omission, howsoever caused, or for any decision or action taken based on views expressed or information in this publication. The information contained in this publication, including any data, projections and underlying assumptions are based upon certain assumptions, management forecasts and analysis of information available and reflects prevailing conditions and our views as of the date of this publication, all of which are subject to change at any time without notice. Please note that the graphs, charts, formulae or other devices set out or referred to in this document cannot, in and of itself, be used to determine and will not assist any person in deciding which investment product to buy or sell, or when to buy or sell an investment product. UOBAM does not warrant the accuracy, adequacy, timeliness or completeness of the information herein for any particular purpose, and expressly disclaims liability for any error, inaccuracy or omission. Any opinion, projection and other forward-looking statement regarding future events or performance of, including but not limited to, countries, markets or companies is not necessarily indicative of, and may differ from actual events or results. Nothing in this publication constitutes accounting, legal, regulatory, tax or other advice. The information herein has no regard to the specific objectives, financial situation and particular needs of any specific person. You may wish to seek advice from a professional or an independent financial adviser about the issues discussed herein or before investing in any investment or insurance product. Should you choose not to seek such advice, you should consider carefully whether the investment or insurance product in question is suitable for you.

UOB Asset Management Ltd Co. Reg. No. 198600120Z

To find out more,
please visit www.uobam.com.sg

RIGHT BY YOU