On Negative Interest Rates

Not a day goes by without someone asking about bond yields, and when they might go higher. And this has been the question of the day for many days, stretching from the high hundreds into the low thousands. When will rates go higher? The answer is incredibly simple, and yet has inputs numbering in the dozens.

First, the answer. There are two rates to concern ourselves with, the short term policy rate, as set by the local Central Bank, in our case the Bank of Canada, and the market rate for bonds. The policy rate is the easier of the two to pinpoint, rates will be higher when inflation trends above the Bank of Canada's 'neutral' policy target of 2% per year, as measured by the Consumer Price Index. The question of for how long that trend may have to be, or how much higher than 2% the data might have to be are drivers of the decision, but the answer is plainly that. Only if and when, and only then. Market rates for securities tend to move alongside, but higher than, their Government of Canada counterparts. If the Canadian 'curve' drops in yield, rising in price, this can be a reflection of low inflation, a strong demand for Canadian dollars, or a demand for risk-free Canadian dollar assets. Banks, utilities, railroads, and telecom companies all issue debt to meet either regulatory demands or to finance ongoing activities, and the market charges each issuer in turn a different rate. This rate will reflect the view of investors as to their likelihood to pay off or default, this return over and above what Canada is charged to issue bonds is risk premium, and assuming the premium is appropriate, investors are then fairly compensated for their risk.

So investors in fixed income demand premium for risk, which is why high-yield debt has proven so popular of late. High yield issuers tend to be highly leveraged to the economy, and often outperform during periods of economic expansion. They are also subject to the largest swings in volatility, as investors like the premium, but hate the risk, and often try to perfectly time downturns in the market. Premium can be used as an expression of the level of risk, and volatility of fixed income investments.

So what to do about Finland then? Finland recently sold a billion Euros of their 4.375% due July 4, 2019 at $119.30 per $100 face. Paying above par value is not uncommon in the fixed income market, typically investors will receive an above-average coupon for doing so, and through some capital erosion plus coupon come out with more dollars to spend on maturity. Except now. This particular Finnish government bond is a guaranteed money loser. New buyers are guaranteed, before taxes and inflation, to lose 2 basis points annualized over the term of the bond. That may not sound like a great deal, a basis point on a thousand dollar investment is all of a penny, which seems immaterial except for the fact that investors rushed to guarantee their losses on this particular bond. The Canadian investor lives a charmed life on a relative basis.

And how can it be that Finland is so lucky, being paid to issue bonds rather than paying bondholders? Remarkably, Finland is hardly the only rower in this particular boat. The Kingdom of Sweden and Germany are both able to issue bonds of short duration and get paid to do so. It is an enviable place to be as a debtor – getting paid – until we dissect the root causes. The economies of Europe are sputtering under a massive debt load, largely undertaken to save the Southern European members, with Greece being the worst debtor of the lot. Great pains are being taken right now to either guarantee a way for the Greeks to grow their economy and pay their way out of debt, or to amicably and orderly arrange for the Greeks to leave the common currency. Neither of these scenarios is particularly fruitful, defending against the Greek exit brought Germany and Greece to a war of words of late, and for now the 'Grexit' scenario has passed.

And that has to be a good thing, for now. If Greece is permitted to leave the European compact, the value of their readopted Drachma will likely plummet compared to the Euro, making their debt worth less if not worthless. Spain, Italy, Portugal, and even Ireland and Iceland will take note, and each in turn could default out of the Euro or languish as weak provinces inside the European state. The Grexit is a dramatic, and hardly remedial, solution. Greek bonds are priced accordingly.

The only solution, inside the Euro compact, is for economic growth, and growth comes not from saving but from spending. And so the savers are punished. The European Central bank charges banks for holding cash, they want it lent. The banks like cash on their balance sheets, because it reduces their risks. Negative rates rule the Eurozone – where the risks are minimal. Deposits at Danish banks, guaranteed by the state lose a quarter percent a year. Deposit in Swiss Francs are charged 1.25% a year in Swiss banks – making your best short term investment there the proverbial cash under your mattress; short term deposits in Switzerland are sixty-three times more expensive than the Finnish bond mentioned above, there is no incentive to save in most of the Eurozone. In fact, if the recession is to start – or in the view of many to continue, the cost to save money in the form of negative rates on bank deposits may go higher. On the backs of the savers and fixed income investors, the broken economies of the Eurozone are being held fast, in the hopes that growth will begin, and the hope is for that to begin in short order.

And so it will go, for now. The richer, safer, Northern members of the European Union will charge depositors and fixed income investors. Not because they can, but because they need the money in the economic system, stimulating. The poorer nations of the South will continue to sputter, until they either default, partially default, or growth begins again, and it is best not to ask where the betting money might go.

The size of the European investor base, clamouring for fixed income, is far larger than the demand for corporate debt. Apple issued bonds in Swiss Francs and they immediately reverted to negative yields, on demand for an asset deemed safe – relative to losing 1.25% per annum in the bank anyway. Pity the asset manager who simply has to be invested in fixed income securities, like an insurance company attempting to match a future payment – a liability off against a maturing bond - an asset. Negative yields, as absurd as they seem on their face, can represent a value when compared to a deposit in the bank. If you only lose two basis points per annum investing in Finnish Euro debt, many will find that preferable to watching a bank balance bleed lower by six basis points a month for immediate liquidity.

Until recently, if you had asked a fixed income investor whether they would pay to own debt, the resounding answer would have been no. The European Central Bank declines to comment on how low, precisely how punitive to savers, they are prepared to take their rates. With that in mind, savers might do well to take their trivial losses for Government guaranteed debt and be happy for it. Or perhaps just slightly unhappy.

When will rates be higher in Canada? On a comparative basis, we are already there.