Negative-Yielding Debt: Now Nearly $20 Trillion!
So... What’s the Deal with Negative Rates/Yields?

WARNING: This tutorial is more “opinion-based” than some of the others here – it explains a market trend and then gives my views on it.

It also gets into somewhat conspiratorial territory, so if you don’t like that, stay away!
The Short Answer: Central Banks Gone Wild

• **Negative Interest Rates** make no economic sense, and have terrible effects for banks, consumers, and anyone with common sense

• **Negative Yields** on bonds are also foolish, but there’s *sometimes* a quasi-rational explanation for them

• The **fundamental problem** is that Negative Rates and Yields *misprice risk* – which leads to asset bubbles, unproductive investments, and no economic benefit for the average person

• **None of this is natural**; Negative Rates and Negative Yields are the direct result of *central bank manipulation*
Topics in This Tutorial

• **Part 1:** Why some people – who are *not* insane – “invest in” bonds with negative yields and/or negative coupon rates

• **Part 2:** Why are central banks doing this? (AKA, how many Ph.D.’s does it take to lose all common sense?)

• **Part 3:** How this *circus of negative rates* is likely to end in a dramatic crash or market meltdown

• **Part 4:** Not “investment advice,” but what I’m doing to avoid or reduce some of the damage
Why Would You Buy a Negative-Yielding Bond?

• **Definitions:** Coupon Rates, Interest Rates, and Yields are all different ... which most sources mix up or fail to acknowledge

• **Coupon Rate:** This is the (typically fixed) rate that a corporate or government bond pays, such as 3% or 5% per year

• **“Interest Rates”:** These usually refer to the rates banks charge to lend to one another, such as the Fed Funds Rate in the U.S.; central banks manipulate set these

• **Yields:** There are different yields, but here we’ll assume that “Yield” = Yield to Maturity, i.e., the IRR if held to maturity
Why Would You Buy a Negative-Yielding Bond?

• **So...** you can have a bond with a *Negative Coupon Rate* that has a *Positive Yield*... or a bond with a *Positive Coupon Rate* that has a *Negative Yield*... or any other combination

• **In most cases**, countries like Germany and Switzerland have been issuing zero-coupon bonds where the market price gets bid up, resulting in a negative yield:

  The bund, set to mature in 2050, has a zero coupon, meaning it pays no interest. Germany offered 2 billion euros worth of 30-year bunds, and investors were willing to buy less than half of it, with a yield of minus 0.11%.

• **Bond Prices** equal the Present Value of future cash flows from bonds: Linked to the Purchase Date, Maturity Date, Coupon Rate, “Prevailing Yields on Similar Bonds,” Redemption Value, and Payment Frequency
Why Would You Buy a Negative-Yielding Bond?

- **Bond Yields** and **Prices** move inversely – so if yields “turn negative,” prices shoot up! (and “bidding up bond prices” can also *make* yields negative)

- Excel’s **PRICE** function doesn’t even work with negative market yields, but we can calculate the price manually in Excel

- Investors might buy a Negative-Yielding Bond if they believe that overall interest rates, and therefore “market yields,” will fall even more – so they can sell the bond at a higher price in the future

- This applies whether the **Coupon Rate** is negative, positive, or zero
Why Would You Buy a Negative-Yielding Bond?

• Traditional bond investing is *supposed* to be about earning modest interest income, with some possibility for capital appreciation.…

• ...but Negative Rates and Negative Yields **turn bond investing into a casino** where the buyer is waiting for the “greater fool”

• And the longer the **maturity of the bond**, the more sensitive its price is to small changes in market yields (see the Excel table)

• Don’t believe me? Just look at that 100-year Austrian government bond issued in 2017 and its price movement since issuance…
About Those Austrian 100-Year Bonds...

- **Up** 70% this year! Trading at 200%+ of par value as of late August 2019

- These bonds still have a low, but positive yield... but since they mature in 100 years, their **duration** and **convexity** are very high, making them extremely sensitive to small changes in market yields.
Part 2: What Are Central Banks “Thinking”?

• **Short Answer:** They’re not – Japan has experimented with QE and super-low / negative rates for 20+ years, and none of it worked

• **My Guess:** Central bankers think that cutting interest rates even further will “stimulate the economy,” especially in regions like Europe with extremely low growth

• **“Logic”:** “Make rates negative so people *lose money* by depositing it in the bank! Then they’ll have to spend it on something!”

• **Conspiracy Theory Time:** *Coincidentally*, many governments and companies have also racked up massive Debt balances that would be impossible to service with “honest” interest rates
Part 2: What Are Central Banks “Thinking”?  

• The Problem: Offering negative rates doesn’t encourage people to spend – it encourages them to take their money out of the bank, or to chase yield with extremely risky assets:

Negative rates haven’t had the desired effect on consumers such as Nick Altmüller, 42, who works in marketing in Berlin. “I’m not spending much more money and I’m not saving much more money,” he said. “I’m just moving it around.” He spreads his roughly €50,000 ($55,800) in savings between mobile banks based in Munich and Bulgaria, chasing a few tenths of a percentage point in extra yield. “This has become normality for me.”

But negative rates have failed to do one big thing they were supposed to do: Spur spending durably and stimulate growth and inflation across Europe.

One reason is that big investors such as insurance companies and pension funds are limited in how much risk they can take with their money. They can’t borrow more at today’s rates and invest heavily in instruments such as infrastructure and loan products that would tend to spur capital spending, create jobs and help economic growth, without setting aside more money for regulatory requirements.

In Switzerland, some individuals are putting cash into real estate, prompting fears of overbuilding. “Holding cash,” said Swiss Bankers Association chief economist Martin Hess, “is simply more expensive than building an empty house.”

Sweden’s Riksbank, the world’s oldest central bank, first went negative in February of last year in an effort to import inflation. It hoped that a weaker Swedish krona would make goods coming into the country more expensive, raising domestic prices. But it hasn’t hit its 2% inflation target in more than four years, and any significant uptick in prices has yet to materialize.
Part 2: What Are Central Banks “Thinking”?  

• **Negative rates** also **crush** commercial banks by making it harder to earn net interest income and encouraging them to chase yield by “investing” in riskier assets

• **And**, of course, negative and super-low rates allow “zombie companies” that shouldn’t exist to... exist and keep tricking investors:
Part 3: So, What’s the “Endgame” Here?

• **Good question**… perhaps we should ask Thanos since he’s an expert at destroying half of all life in the universe

• **Simple Answer:** If you hold bond with a negative yield to maturity, you lose money (so who would do that?)

• **But:** You also lose money if prevailing yields on similar bonds suddenly rise, pushing down the price of the bond

• **And:** Many things could cause that… huge sell-off in the bond market, something that forces interest rates back up, economic recovery, higher inflation, sovereign debt crisis, etc.
Part 3: So, What’s the “Endgame” Here?

• **My Prediction:** There will be a massive “correction” (50%+) in the bond market that causes bond prices to fall back to earth

• **Timing:** No, I don’t know when, but *at some point*, there will no longer be “greater fools” to buy negative-yielding bonds in anticipation of even lower yields

• **Likely Outcomes:** European Debt Crisis II, or possibly a worldwide currency/inflation crisis (inflation always solves debt, right?)
Part 4: What I’m Doing

• **NOTE** that this is *not* “investment advice” – the usual disclaimer, don’t just mindlessly follow this, etc.

• **My Strategy:** Stay away from *all* bonds except for U.S. Treasuries and U.S.-based municipal bonds, which still have positive yields.

• I’m *highly* skeptical of all corporate bonds worldwide and negative-yielding European / Japanese sovereign bonds.

• **Overall:** Relatively low Equities allocation (~40% total), high Cash/UST/municipal bonds (~40%), and 20% in **Gold** – which has been my top performer YTD.
Recap and Summary

• **Part 1:** Why some people – who are *not* insane – “invest in” bonds with negative yields and/or negative coupon rates

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