Investing Perspective: Are Negative Bond Yields Crazy?

As I did three issues ago, I am not talking about the stock market, which is the usual focus of this section. You have likely read or heard that some German and Swiss government bonds now have negative nominal yields, as low as -0.75%, even on bonds that mature as far out as ten years. Short-term “real” yields on U.S. Treasury debt are also negative since the interest rates are less than the rate of inflation. However, we still don’t have to pay the U.S. government to hold our money. So the natural question is why would anyone pay a government to take its money and promise to pay back less in the future? Are they crazy? Why not just put the money under a figurative mattress or just leave it in a checking account that does not pay interest? Part of the reason is that firms and institutions with millions in cash do not have the functional equivalent of a mattress or checking account available to them. However, there usually are “parking spot” alternatives other than government debt.

I recently ran across an article by two of the managers at PIMCO, which one of the leading bond fund companies. It discusses four logical reasons why yields on government bonds can be driven to negative levels. They fall into two general categories: economic and behavioral. I summarize these and then talk about what the effect, if any, negative yields, even on U.S. Treasury issues if that should come to pass, will be on my management of your accounts.

**Economic factors:**

Two of the four reasons fit this description. The first is that government central bank buying of its debt issues, so-called “quantitative easing” (QE) when done on a large scale, greatly reduces the supply, which in turn causes the prices to rise. As we know, bond prices and interest rates move in the opposite direction. So if the supply and demand for this debt is out of balance, and the available data indicate that they may be, bond prices can move up to the point where the yield is negative. The central banks want investors to move into riskier investments that presumably will contribute to economic growth. That is the reason for QE.

A second economic reason is that negative interest rates may be a forecast of a sharp downturn in the economy. If that happens, there could be significant deflation. In such a case, a bond with a negative nominal yield may have a positive “real” yield. While individuals with relatively small amounts of assets can effectively just hold cash, institutions can’t do that for many reasons. For them, as the old saw goes, return of capital is more important than return on capital. Also, there are way to trade bonds to profit from the shape of the yield curve that are available to institutions, but not usually to individual investors.

**Behavioral factors:**

Some managers of debt securities track fixed income indices or have their performance measured against such an index. By making decisions to avoid government securities with negative yields, they increase the risks of greater tracking errors or performing worse than peers who track an index. Such behavior can become a self-reinforcing “negative feedback loop” leading to even more negative yields. As short-term debt matures, the demand for replacements by those tracking indices pushes the prices higher and the yield lower. The portion of European government securities in indices, particularly those of Germany and Switzerland, that have negative yields has been steadily increasing since last summer.

The fourth reason is that investors and money managers may not think there is enough of a “risk premium” for deviating from their planned portfolio holdings. One way to avoid the negative yield would be to move to longer-maturity bonds, more than ten years out for Swiss government issues. If such becomes a
common practice, then the yields on these longer bonds fall, not necessarily to negative levels, which reduces the benefit and increases the risk of avoiding negative yields.

An active trader anticipating a further decline in yields may buy issues with current negative yields planning to sell them before maturity if yields fall further pushing the price of the bonds even higher.

►Effect on Managed Accounts: At times I have purchased mutual funds or ETFs that hold longer-term U.S. Treasury debt according to a model I have for trading those types of funds. No Treasury debt yet has a negative yield although some essentially has a yield of zero. I have to admit that I have tried to be “smarter than the model,” which almost always is not a good idea. Figuring that the ten-year T-note yield upon which the model is based could not go much lower, I have not been following the model’s signals for about a year and a half. While some have not worked, overall taking all of the trades would have been profitable. The model is based on the trends in the 10-year rates, so it would get out once T-rates start to climb. The more likely risk is getting whipsawed by fluctuations in those rates.

It is possible that when short-term rates begin to climb, that stocks may go into a serious decline. I wonder about the connection since just about all market analysts think that sooner or later, most likely sooner, the Fed will start raising rates. That means an increase at some point is already part of current stock prices. I think other developments will have a much more significant effect on the direction of equity values. The models I use for general stock market timing are trend following. An important consequence is that I don’t need to try to figure out which news will move stock prices. When the current trend, still to the upside, reverses, the models will tell me that it is time to move to cash. I like to say that I don’t try to tell the market what it should do, but want to let the market tell me what to do.