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Negative Yielding Debt

I have mentioned negative yielding debt, in passing, in previous The Polaris Perspective emails. At last count, there was over $17 trillion of negative yielding sovereign debt. That's approximately one-quarter of all sovereign debt, worldwide.

Negative yielding debt is a relatively new phenomenon. In 2009, the Swedish Central Bank offered their overnight deposit at -0.25%. Negative yields have since spread throughout Europe and Asia. Japan tops the list of governments with negative yielding debt, with $7.3 trillion negative yielding sovereign debt. France has $2.3 trillion negative yielding debt, followed by Germany ($2.1 trillion), Spain ($890 billion), and the Netherland ($650 billion) rounds out the top five countries with negative sovereign debt. But what does it mean, and what impact does it have on you as an investor?

How It Works In Theory

People and businesses tend to hold on to their cash during difficult economic times while they wait for the economy to improve. This type of behavior can further damage a fragile economy, as lack of spending causes a further slowdown economically. This can lead to job losses, lower profits, and further slowing economically. When businesses and individuals close their wallets, it can become a self-perpetuating and self-fulfilling prophecy that a weak economy turns into a recession. Central banks in Europe and Asia have taken a radical stance to fend off this type of behavior.

Central Banks, run by governments, state the rate that they are willing to borrow money overnight from banks domiciled in their country. This is known as the interbank rate. Over the past 55 years, Germany has averaged a 4.63% interbank rate. Today, the German government is offering banks negative 0.41%. The German government has taken this stance to encourage their banks to lend money, rather than losing money by investing in negative overnight rates.

Negative yields also impact individual investors who are sitting on cash, as negative rates can be carried over to deposits accounts (savings and checking accounts) at banks. Citizens of these countries have the option of leaving their money where it is and losing money, or they can pull their money out of the bank to invest or spend. In theory, individuals will spend their money or invest it, rather than leaving it in a vehicle that will lose them money.

Countries that have negative yielding sovereign debt are also trying to drive down the valuation of their currency. The theory is negative rates will deter foreign investors, thus driving down the valuation of their currency. These governments are hoping that their domestic products will then become more attractive to their own citizens and to foreigners to buy, thus stimulating their economy. The Euro has dropped in value to the U.S. Dollar. In 2014 the exchange rate was approximately €1 to $1.40 ratio. Today the exchange rate is €1 to $1.1 ratio. Imagine finding a hotel that was €100 a night. In 2014, an American would have paid $140 for that room. Today they'd pay $110 for their stay. You can also look at it the other way. Let's say a pair of Nike running shoes cost $100 in 2014. It would have cost a European €71.42. Let's say a pair of Adidas cost the same price, €71.42. If the Nike are still priced at $100, a pair of shoes would cost a European purchaser €90.90, due to the strength of the dollar to the euro. The Adidas would remain at €71.42, making them a much more attractive purchase.

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Unintended Consequences

Initiating negative yielding debt is meant to combat a deflationary spiral, stimulate economic activity and stave off inflation. There are several possible unintended consequences that could backfire on the issuer.

One potential unintended consequence is that individuals could pull their money out of their bank. All banks have reserve requirements. This is the amount of money they must hold onto to make sure they can give their depositors their money bank when requested. Banks leverage deposits above and beyond their reserve requirements by lending this money to corporations and individuals. If clients pull money out of their bank, it could lower the banks ability to lend. This is the exact opposite of what the central bank is trying to have happen.

Institutions and individuals don't have to spend their money. They could withdraw their money and invest outside of their own country. This is happening right now, as we discussed earlier. Individuals and institutions are investing their money in the safest investment they can think of, U.S. Treasuries. This is why intermediate and long-term Treasuries are going up in price, lowering their yield. This is part of the reason why our yield curve has flattened (and temporarily inverted).

These same individuals and corporations don't have to even invest the money that they pull from the bank. They can literally "put it in their mattress." They can horde physical cash, not buy or invest, but simply hold onto the cash in hopes of better times to figure out what to do with their money.

As we've already mentioned, negative yields also devalue that country's currency. This can hurt their buying power. For example, oil is traded in U.S. dollars. As we discussed earlier, the euro has dropped from a 1.40 to 1 ratio to a 1.10 to 1 ratio. This means that it costs European customers over 20% more (1.10 – 1.40 / 1.40 = -21.42%) to buy oil today than it did five years ago due to currency devaluation.

There are many other goods that people in Japan, France, Germany, and other negative yielding sovereign debt countries are reliant on that come from the United States and other countries that have protected their currency from devaluation. This means that their purchasing power could be depleted, thus buying less of their own domestic products.

Conclusion

Negative yielding sovereign debt is a new phenomenon. It is a decade old experiment that began in 2009 with one country, and now has mushroomed into $17 trillion behemoth. In theory, this risky experiment could work. But this last-ditch effort to keep these countries out of recession is pock-marked with landmines. We will be watching this experiment very closely.

As always, I welcome all questions and comments. Please feel to reach out to me.

Sincerely,

Jeffrey J. Powell
Managing Partner & Chief Investment Officer

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