



From Fixed Income to Fixed Loss | July 2016

A Look at Negative Rates

For as long as we can remember, zero was considered the lowest interest rates could go. Anyone espousing that they could go lower received as much attention as 'flat earthers.' Today, the impossibility of negative rates has become another myth that modern society has debunked.

There is currently around \$10 trillion of debt trading at negative yields, including over \$500 billion of corporate bonds. This past month, CIBC joined the list of institutions getting paid by lenders for the privilege of owning their debt.

This has left many scratching their heads trying to understand what this all means. We will attempt to make some sense of the madness.

What do negative rates actually mean?

This is most easily explained with a simple example.

Today you can buy a 5y German Government Bond for €102.50, not receive any coupon interest for 5 years and at the end get €100 back. Essentially locking in a €2.50 loss over 5 years.

How did we get here?

In an attempt to stimulate their moribund economies, the European and Japanese central banks have taken their overnight interest rate to -0.4% and -0.1% respectively. This is the rate that banks borrow or lend at for a single day. The idea was to prevent them from hoarding cash and incent them to lend.

The central banks have also embarked on aggressive programs to buy debt. They are doing this to lower term interest rates and flood the banking system with money. The sheer scale of this buying has also allowed a few select corporations the luxury of being paid by investors to borrow money.

The theory behind quantitative easing is that it spurs lending and forces people to invest in activities that create jobs and wealth rather than reap the benefits of simply investing in government securities. There are many who credit the significant equity rally since the crisis to people seeking higher potential returns than expected from the bond market.

Why would anyone accept a guaranteed loss?

If you are in Japan or Europe and have idle cash or are mandated to hold a certain amount of "cash", you are in a no win situation. You have the choice of earning negative rates by investing overnight with the central bank or losing less by buying debt. It seems investors are holding their noses and buying bonds. Of course, there are also traders doing some buying on the bet that yields will go even lower.



What does this mean for Canadian rates?

Compared to a guaranteed loss, our 1% 10y rate represents a juicy yield for foreign investors. With the pool of positively yielding sovereign debt shrinking, investors have been piling into Canadian bonds.

Furthermore,

Canada is one of only 12 countries with a AAA credit rating and is also the second largest AAA bond issuer (behind Germany whose yields are below zero out to 10 years) which enables meaningful allocations to be made. International buyers could keep a ceiling on how high domestic rates can drift.

Do bonds belong in a portfolio anymore?

What do you think? We would love to hear your thoughts, as we will be exploring this question in our upcoming commentary. Please send your response to raj.tandon@algonquincap.com

Regards,

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