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The rise of negative yielding debt

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Sector
Multiple

Issuer
Various

Bonds
Various

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Since mentioning the negative yielding German government bonds in our weekly publication, we have had a lot of reverse enquiry on the topic. In this week's note we will take a look at negative yielding bonds and the implications for Australian bond investors.

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Background

Over the course of the last few months the outstanding balance of negative yielding debt has skyrocketed. The volume of outstanding debt with negative yields is now a staggering USD16tn, compared to USD7tn a year ago, which is an increase of over 130% in 12 months. This has been fuelled by a global collapse in inflation expectations and central bank rate cuts.

The majority of outstanding negative yielding bonds are either Japanese or European debt. In mid-August, Germany issued negative yielding bonds with a 30 year maturity but it's not just governments issuing negative yielding debt. Last week Siemens AG became the first corporate issuer to join the club. Siemens issued a two-year bond at swaps plus 22bps, resulting in a record low euro corporate yield of -0.315%.

Source: Bloomberg

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In practice, a negative yield does not mean investors pay the issuer to hold the bond, it just means that they receive back a smaller amount than the initial outlay. In the case of the Siemens bonds, the bonds were issued at a price of 100.633 and pay 0% coupon. The investors would receive back 100.000 at maturity in two years.

Why is there a market for negative yielding bonds?

As expected, the big question here is why would investors put their funds in securities that generate negative returns? There are a few considerations to bear in mind when answering this.

Firstly, as with any investment the choice of investing in negative yielding bonds comes down to the available investment universe and the desire for capital preservation. If at any given time, negative yielding bonds are the most attractive investment choice then investors will pick that over other riskier or more volatile investment choices.

Secondly, if as an investor you hold a view that yields still have potential to move lower, then there is value in these bonds as their capital price would appreciate as yields move lower.

Finally, as noted above, when compared to alternative riskier investment choices, negative yielding government bonds still seem attractive as these bonds are considered a safe haven investment.

What does this mean for Australian investors?

While our local interest rates and bond yields have sharply contracted over the course of the year, these rates are nowhere near as low as our Japanese or European counterparts. Furthermore, while it is highly unlikely that the RBA would adopt a negative interest rate regime, the current environment does not warrant such a drastic loosening of the monetary policy.

It is, however, worth noting that yields (while staying positive) are likely to move lower and stay lower for a protracted period of time.

It is also worth noting that the majority of FIIG's investor base has fixed income investments in corporate bonds. These bonds pay a credit margin over and above the base rate, hence clients are likely to receive a positive yield on these securities.

There are a number of investment options available to clients and our model portfolios are a good place to start when building a portfolio. As at the latest rebalance date of 30 August the Conservative portfolio had an indicative yield to maturity of 3.29%, the Balanced portfolio 4.62% and the riskier High Yield portfolio 5.95%.

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