FROM HERO TO ZERO AND BEYOND:

THE INVESTMENT IMPLICATIONS OF NEGATIVE YIELDS

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Negative yields are seldom mentioned in economic and finance textbooks. But now that the central banks of Denmark, the eurozone, Sweden and Switzerland have set official rates below zero, investors are having to grapple with negative yields for short-dated, and indeed, some longer-maturity fixed income instruments. Much of the stock of core European government debt outstanding recently entered negative-yield territory *(Figure 1)*. This represents a new paradigm for investors in every asset class, not just fixed income.

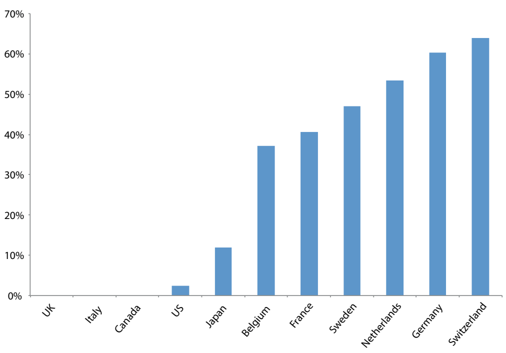
WHY WOULD ANYONE BUY A BOND WITH A NEGATIVE YIELD?

Investing in a negative-yielding bond (NYB) effectively guarantees that the bond holder will make a loss. This may seem like an irrational investment decision, but there are several reasons why investors might continue to buy bonds with negative yields. Central banks, passive fixed income funds and insurance companies have little choice but to buy the highly rated fixed income assets that may now come with negative yields, because of regulation, mandate guidelines and the need to match liabilities. There are also other rational reasons to expect demand for NYBs:

- If deflationary forces are expected to persist, buying NYBs today may still result in a positive real yield for investors.
- Investors may expect to sell NYBs for a capital gain to central banks engaged in quantitative easing.
- Similarly, investors could expect capital gains from NYBs if a central bank is expected to lower its policy rates further.
- Investors can make positive total returns if foreign-currency gains boost the return from NYBs.
- Investors demanding liquidity and safety may expect positive relative returns from NYBs during "risk-off" episodes in markets.

It is clear that investor demand for any one of the reasons above has the potential to drive yields further into negative territory. For fixed income markets, we believe the mere possibility of negative yields should lead to higher bond prices and a compression of yields across different regions and issuers. This is because bond prices should reflect a distribution of potential policy rates – positive as well as negative – over the maturity of the bond, plus an additional term premium. Given that this distribution can now extend below zero, it is reasonable for the path of expected short-term rates to be lower than previously envisaged.

Figure 1: NYBs as a percentage of government debt outstanding



As at 22 February 2015, in local currency terms. UK debt excludes Debt Management Office amounts and Bank of England holdings. Sources: Wellington Management, UBS, Bloomberg

POLICY AND ECONOMIC IMPLICATIONS

Once a central bank sets rates below zero, investors should not assume that further cuts will only be gradual. When a central bank is trying to prop up its currency or fight inflation it will sometimes use meaningful increases in policy rates to try to stem capital outflows, even at the risk of damaging the domestic economy. Policy could be the exact opposite when interest rates are already negative: further cuts will weaken the currency but also lower domestic borrowing costs, which should boost the economy. Small moves of 25 to 50 basis points (bps) are good for fine-tuning monetary policy, but currency and inflation actions really require more aggressive moves of over 100 bps.

Should investors seek lower returns, higher risk or alternative strategies?

Valuations have risen across both bond and equity markets, and until very recently volatility across asset classes has been close to all-time lows. Investors now face a higher-risk, lower-return investment environment. Liability-driven investors, such as defined-benefit pension funds and insurance companies, face particular challenges as growing mismatches between asset and liability growth are possible. Investors will either have to lower their expected return targets or increase their appetite for risk. However, we think there are strategies worth considering that can achieve aims such as risk control, return enhancement and increased diversification.

RISK CONTROL

Investors can adopt frameworks or consider allocations to lower-risk alternative strategies that incorporate disciplined risk-management tools such as:

- A targeted or managed volatility profile
- Holistic drawdown controls
- Smart beta allocations
- Tail-risk hedging

RETURN ENHANCEMENT

Investors should consider increasing tactical asset allocation flexibility and reducing reliance on market risk by increasing the share of active risk across portfolios. To help boost potential returns, investors could also allocate to alternative strategies that have explicit absolute- or total-return objectives and/or seek to benefit from non-traditional risk premia, including:

- Illiquid alternatives, for example, property, infrastructure, private equity and hedge funds
- Liquid alternatives such as single or multi-asset absolute-return funds and leveraged strategies
- Opportunistic allocations to exploit dislocations across markets
- Global Tactical Asset Allocation (GTAA) strategies

DIVERSIFICATION

Consider allocations to alternatives that are consistently uncorrelated to traditional market betas and have low exposure to common risk factors or betas. For example:

- Alternative risk-premia strategies
- Absolute-return fixed income, commodity and currency solutions
- Listed or unlisted real-asset exposure
- Managed futures allocations

The removal of the Swiss franc's euro peg and the move to negative rates by the Swiss National Bank show that central banks can take extreme measures to resist unwanted currency appreciation. These types of decisions could result in disorderly flows and unintended consequences throughout markets – but it nevertheless seems that this is the new policy among central banks.

WHAT ARE THE MARKET IMPLICATIONS OF NEGATIVE BOND YIELDS?

We believe negative yields need to be put into context in order to assess their possible effects on broader markets. For example, we believe asset bubbles are probable in an environment where yields are negative but underlying economic conditions remain robust. In this environment, we would also expect companies to issue debt and buy back their own equity, lifting stock-market valuations.

It is therefore essential to ask why yields are negative and how long this phenomenon can persist. We believe there are several different structural and cyclical factors at play, which we outline below.

In our view, unconventional policy - asset purchases, negative rates or explicit currency intervention - has been a key driver of NYBs.

Deflation risk (structural factor)

Although deflation risk has the potential to drive yields into negative territory on a persistent basis, it is interesting to note that nominal yields didn't turn negative during Japan's deflationary regime. In our view, recent deflation fears have been driven mainly by falling energy prices and, as a result, we believe markets may have overreacted to this source of downward pressure on yields. Longer-term inflation expectations do not signal deflation as the most likely outcome in Europe, Japan, the UK or US.

Global savings glut (structural)

An excess of the supply of savings over investment demand results in downward pressure on interest rates. The so-called savings glut can be attributed to demographic trends as well as a surplus of capital generated, for example, by exporting nations. Demand for high-quality assets that provide capital preservation and generate income is likely to keep exerting upward pressure on the prices of higher-yielding assets. At some point, however, we think that extended valuations and low prospective returns are likely to deter investment flows amid increased investment risk in these asset classes. We are also mindful that as populations age, the propensity to consume increases and hence the savings glut may shrink over the medium term.

Liquidity preference (cyclical)

There has been strong demand for core government bonds, which has driven term premiums lower and yields into negative territory. Undoubtedly, some investors have continued to buy government bonds for diversification properties even at a negative yield. However, US and European equity performance has also been strong and equity valuations remain elevated or are rising in many developed markets. Market indicators that track risk aversion or systemic risk (e.g., Libor-OIS (overnight indexed swap) spreads, implied volatility term structures and high-yield credit spreads) do not suggest there is a widespread flight to safety occurring in asset markets.

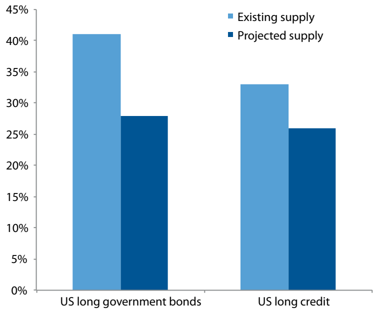
Central bank policy (structural or cyclical)

In our view, unconventional policy – asset purchases, negative rates or explicit currency intervention – has been a key driver of NYBs. Our base case is that this is a temporary or cyclical phenomenon. The central banks of South Africa, New Zealand, the UK and US have recently also argued that lower headline inflation is temporary and will act as a boost to growth and even core inflation in the coming quarters. As a result, they have thus far resisted the temptation to ease policy further. Where policy has been eased more recently, deflation risks are further entrenched, with some combination of overvalued currencies and a de-anchoring of longer-term inflation expectations posing a challenge to policymakers' objectives. That said, the taboo of negative policy rates has been broken. This alone could have persistent implications.

Mispricing (cyclical)

It is also possible that negative yields are unjustified, are likely only to be temporary and are the result of an overreaction or mispricing in markets. Markets and central banks may have extrapolated recent disinflationary trends too far, and may have discounted rates that are too low for too long as a result. We believe this explanation has many merits. It would imply that policy rates and longer-dated bonds are mispriced relative to economic fundamentals, giving rise to the potential for strong gains in cyclical assets as well as a reversal of the appeal of so-called bond-proxy assets.

Figure 2: Pent-up demand for bonds: existing and projected supply relative to demand (%)



Sources: Barclays (existing supply as of December 2014), Wellington Management (estimate of projected supply). Actual results may differ, perhaps significantly, from projections

WHAT ARE THE STRATEGIC IMPLICATIONS FOR INVESTORS?

- Investors are still coming to terms with the implications of the shift to negative yields in bonds. We believe the consequences could be far-reaching and surprising.
- From an asset allocation perspective, we think investors should ask themselves whether or not fixed income allocations can continue to provide diversification and protect capital in challenging times. With the lower bound for interest rates now negative, we believe the answer is still yes, but clearly at a higher cost: this must be compared with the cost of investing in other explicitly defensive allocations or option-related strategies.
- We would also highlight that even if yields are expected to rise, the rise may be contained because of factors such as lower structural growth estimates and – at least for the next few years – strong demand for fixed income assets relative to supply *(Figure 2).*

CONCLUSION

The onset of negative yields places us in uncharted territory, posing several tactical and strategic implications for investors. Overall, we believe there are alternative solutions that can increase the likelihood of investment objectives being met in this environment.

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