

We've discussed negative interest rates in prior reports, but thought it would be appropriate to further the discussion in light of the recent move down in yields. The benchmark 10-year Treasury is trading at a yield-to-maturity of 1.52% (as of August 26th). The markets are watching this closely. The narrative a year ago was that interest rates were beginning to "normalize" as the 10-year yield was trading above 3%, and seemed to be steadily trending higher. But during the last quarter of 2018, amid heightened market volatility, the Federal Reserve reversed course and suggested that lower interest rates were likely, given a slowdown in global economic growth.

Since November of last year, the 10-year Treasury has essentially fallen by half (i.e. 3% to roughly 1.5%), and it appears that we're likely to retest the all-time lows of reached in 2016. The general perception a year ago was that the global economy was in a "synchronized" expansion. But as mentioned before, the narrative has changed rather quickly. If we do indeed enter a recession, which the current inverted yield curve might suggest, then there is a real possibility that nominal yields across the curve could break through the zero bound. Former Fed chairman Alan Greenspan has stated that going forward, there is no barrier to Treasury yields falling below zero. The current coupon on the 10-year Treasury is approximately 1.6%, but due to overall demand, the price is trading above par at roughly 100.88, which pushes the yield-to-maturity down to its current level of 1.52%. So, how would a negative yielding bond work?

A negative yielding bond typically would carry a very low coupon (perhaps close to zero). If the demand for the bond goes up, the price will rise and the yield-to-maturity will go down. For example, assume a bond with a 1% coupon over one year. At maturity you receive \$101. If you pay \$102 for that bond today, you're guaranteed to lose money if you hold the bond to maturity. Hence, the term "negative yields". Why would any rational investor choose to pay \$102 today to receive \$101 a year from now?

There are a few theories as to why yields could gap down below zero. First, from a purely speculative point of view, some investors might be wagering that yields will decline well below zero, particularly if we enter a recession. For example, consider a 10-year bond issued at a yield-to-maturity of 0% trading at par. If yields suddenly dropped by 100 basis points (go negative), then the value of that bond would rise to roughly \$105. Some investors are perfectly willing to buy a bond issued at 0% yield-to-maturity if they think in the future rates will continue to go lower (obviously, speculators aren't looking for income).

Another reason is that from an investment policy standpoint, many large institutional pools of money are required to allocate a percentage of their portfolios to bonds, such as U.S. Treasuries, regardless of the yield. That is, a portion of their portfolio can't be subject to credit risk, which implies a set allocation to U.S. Treasuries. Changing an investment policy can take time, so these large pools of money can't suddenly reallocate to other assets, such as dividend paying stocks. Furthermore, some investors might see deflation over the intermediate to long term. Again, we don't necessarily see this happening, but some investors are willing to "lose less" today than to risk greater loss down the road. And finally, some portfolio managers use bonds as hedges against equity market risk, and are perfectly willing to allocate to bonds as part of a larger investment strategy.

Despite a likely rebuttal from president Trump, the Federal Reserve would likely step in with measures to mitigate the degree to which yields would fall below zero, such as selling some of its repository of Treasury bonds. This additional supply of bonds would help prop up longer-term rates. However, it's difficult to gauge the eventual demand. Given that the U.S. is essentially the only game in town, investors around the globe would likely snatch up the additional supply provided by the Federal Reserve. Thus, any action by the central bank might have short-term implications, but do little in the long run to avoid negative rates.