PRUDENTIAL
INVESTMENT MANAGERS

Lynn Bolin
Head of Communications and Media

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What's driving negative bond yields?

It's an unprecedented phenomenon in global financial markets. According to Bloomberg, some 30% of government and corporate bonds around the world valued at around US$17 trillion are currently trading at negative yields (that is, yields below 0%). This means that investors are *actually paying* governments and other entities to be able to lend to them by buying their bonds, knowing that they will receive less money at the end of the term. And on the other side of the coin, borrowers are being paid to borrow. This is contrary to the general rules of finance.

The bonds being affected are primarily those issued in the European Union (EU) and Japan, while US bond yields are still positive, but low in historic terms. Here we look at some of the main reasons why yields have gone negative and what it means for investors.

What's behind negative yields?

Bond yields are linked to central bank interest rates, as the latter serve as the base rate against which other bonds are priced. Since the 2008 global financial crisis (GFC), the world's central banks have

helped to stimulate growth and avoid deflation by cutting interest rates to very low levels and keeping them low. Central banks have also been buying large amounts of government, semi-government and investment-grade corporate bonds at various times as another way to inject cash into their economies, called quantitative easing (QE). This extra demand has pushed bond prices higher and yields lower (the two move in opposite directions).

With the economic recovery since the GFC having been so gradual and lacklustre, central banks have been forced to cut their base interest rates to historically low levels – even below zero – to discourage banks from sitting on their cash. They have also broadly maintained their QE programmes, buying record amounts of bonds. The US has been one of the only countries to have achieved sufficient growth and inflation pressures to have been able to start hiking interest rates again, only to have to reverse some of its increases in the past year. Still, US yields are again hovering near all-time lows.

At the same time, there has been an increasing demand for bonds from a growing number of retirees, pension funds and insurers as the “baby boomer” generation retires, for the purposes of capital preservation and income generation. Prudential regulations in some countries also dictate that retirement funds hold a certain percentage of their assets in bonds. As more money has flowed into bonds, bond prices have risen and yields fallen further. And on top of this, inflation has remained so tame since the GFC that more investors have been comfortable holding onto bonds (inflation erodes the value of the fixed interest being paid by bonds over time). Inflation expectations generally have dropped sharply.

These factors have all worked together to push demand for bonds higher, inexorably sending yields into negative territory. Demand has been particularly strong for bonds with high credit ratings. This is why you see German, Swiss and other highly-rated bonds with especially large negative yields. According to Bloomberg, 80% of

Germany's federal and regional government bonds offer negative yields, and almost the entire Danish bond market is trading at negative yields. For some investors the need for the safety represented by these assets has been so high that they have been willing to lose some money over time to be able to invest in them. Other investors are still buying in the belief that more central bank buying will push yields even lower, so they could possibly make a profit.

What does this mean for South African investors?

The breadth and depth of the negative yields in global bond markets is unprecedented, so no one really knows what the future impact might be. Many commentators believe that this is not a market bubble, but opinion is divided. Should there be any sudden change in conditions, where the outlooks for inflation and/or economic growth suddenly turn up, bonds could sell off sharply. This would impact investors around the world, including South Africans, given the global nature of bond markets. However, most analysts agree that central banks would respond aggressively to support bond prices, therefore likely limiting investor losses.

At Prudential, because we are always looking to invest in the best-valued assets for our clients, we are avoiding all bonds with negative yields in our client portfolios. We know that we can get better returns from other assets. Global equities currently offer much more attractive yields in many different countries, particularly emerging markets. As value investors, we are overweight global equities and underweight global bonds in our client portfolios. Where we do hold bonds, we prefer investment-grade corporate bonds. Because South African investors are not required to hold any foreign bonds, we believe it is advisable to avoid negative-yielding bonds altogether.

For more information, speak to your financial adviser or call our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.