Turning negative interest rates on their head

Negative interest rates are no new notion. First deployed by Sweden in the summer of 2009, other European nations and Japan followed in an effort to provide relief in the wake of the global financial crisis.

As a result, the amount of negative-yielding debt globally is substantial, and investor concern that the US could follow suit is mounting.¹ So far, Federal Reserve Chairman Jerome Powell has pushed back on the possibility of US rates going negative anytime soon.²

Yet with negative rates in 12 countries and the universe of global negative-yielding debt at around $12 trillion, US investors may be asking themselves “why would I ever invest in overseas bond markets?” On the surface, the avoidance of home-country bias and a commitment to fixed income diversification seem prudent but a less obvious motivation also exists.

Brendan Murphy, manager of the BNY Mellon Global Fixed Income Fund, explains: “When global interest rates are low and US rates reside moderately above them, there may be alpha to uncover by hedging international bond investments back to US dollars (USD). Doing so allows investors to pay the short-term interest rate of the foreign currency and receive the short-term rate of their home currency, potentially picking up yield via the spread between both rates, also known as the “carry”. In some instances, investors may even receive higher yields than comparable duration Treasuries by using this method to access foreign-denominated bonds.”

Through this process, hedging back to USD can possibly turn situations like Japan, where the short-term policy rate is -0.1%,³ or Europe, where the deposit facility rate is -0.50%,⁴ into opportunistic ones due to the difference between those rates and the US short-term interest rate, which is currently a target range between 1.50% and 1.75%.⁵

How long can this go on?

Central banks usually hike rates if their economy is in good shape to avoid it overheating and to curtail undesired inflation. Likewise, they cut rates to stimulate inflation and to provide monetary ‘easing’ if the economy is deemed to be stuttering. Since both Europe and Japan have seen little evidence of inflation, it can be perceived there is slim likelihood of their central banks hiking rates in the near term. In fact, Bank of Japan governor Huruhiko Kuroda recently said Japan holds the ability to deepen rates past -0.1,⁶ which is not entirely unimaginable, since Japan’s core inflation rate in September was 0.3% versus its 2% target.⁷

Murphy says:

¹ Bloomberg: Wall Street is wrong about negative interest rates. November 13, 2019
² Reuters: Fed chief Powell pushes back on negative interest rates. November 13, 2019
³ BOJ: The bank’s semiannual report of currency and monetary control. November 19, 2019
⁴ European Central Bank: Key ECB interest rates. November 2019
⁵ Federal Reserve: Monetary Policy Press Release. October 30, 2019
⁶ Reuters: BOJ can still deepen negative rates, within limits: Kuroda. November 18, 2019
⁷ Reuters: BOJ members voiced concerns about ability to hit inflation target, minutes of October meeting show. November 11, 2019
“If I had to rank them, Europe and Japan would probably be the least likely to see inflation picking up any time soon.

“Japanese rates may rise but I don’t believe they will rise as much as the US or Canada,” Murphy says. “That makes Japanese government bonds pretty attractive because on a hedged basis investors may have the ability to pick up extra yield, perhaps even higher than comparable duration Treasuries.”

The flipside

Despite finding opportunity in the low-growth environment exhibited in much of the developed world, Murphy says it could be signaling increased threat of a global recession.

“In a period where metrics of economic stability are constantly defying historical norms, investors are walking on egg shells as they attempt to identify recession indicators and navigate potential tipping points,” he says.

With an abundance of political risk in multiple markets, he does not believe it is a time when investors are being rewarded by taking a lot of risk.

As a result, his team is attempting to keep risk budgets low and trying to maintain diversified sources of risks.

“This is an environment where you don’t want to be over your skis because more volatility is likely to present itself,” he concludes.
Risks

**Bonds** are subject to interest rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. **Currencies** are can decline in value relative to a local currency, or, in the case of hedged positions, the local currency will decline relative to the currency being hedged. These risks may increase fund volatility. **Management risk** is the risk that the investment techniques and risk analyses applied will not produce the desired results and that certain policies or developments may affect the investment techniques available to managing certain strategies. Investing in **foreign denominated and/or domiciled securities** involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

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