Outlook for Financial Markets

Bond yields – why all the negativity?

"It's only a matter of time."

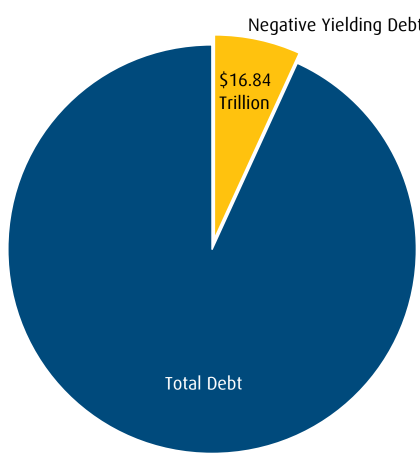
– Alan Greenspan (9/4/2019) on the prospect of negative interest rates in the U.S.

First, the punchline. We disagree with former Fed Chair Greenspan's implication that interest rates in the U.S. are headed into negative territory. The likelihood of this happening in the absence of a U.S. recession is very low, and although recession odds have increased recently, they remain modest. In this month's Outlook we discuss the phenomenon of negative interest rates, the drivers and implications, and our expectation of the path ahead.

The amount of negative-yielding global debt has garnered significant media attention (perhaps justifiably), so some perspective is useful. ***Exhibit 1*** shows negative-yielding debt as a percentage of global sovereign (i.e., country) debt. Yes, the absolute amount of negative yielding debt is large, but the majority comes from Japan where negative yields are not a new phenomenon. Behind Japan, Germany and France are the next largest contributors to the negative debt pile, and other developed European countries including Denmark, Sweden, and Switzerland also find investors willing to pay for the security of money. The overwhelming majority of negative yielding debt is government issued.

Negative yields, mathematically speaking, arise because the market value of the debt – or price if it were bought and sold – is greater than the promised stream

Exhibit 1 » Negative-Yielding Debt as a % if Global Debt



Source: Source: Bloomberg Financial, Institute of International Finance (IIF), BMO Wealth Management

Executive Summary

A mix of global economic forces, along with Central Bank action and demographics, have contributed to the phenomenon of negative-yielding debt in Europe and Japan

In the U.S., we do not expect interest rates to turn negative in the absence of a recession

While the manufacturing sector faces headwinds, the service sector remains healthy on the back of labor market strength of income provided through coupons and the final maturity payment. Investors purchasing debt at negative yields are essentially paying a fee for the "safe-keeping" of their money. Various explanations exist for why yields have gone negative in these areas, and it's difficult to tease out which are the biggest contributors. One explanation is that the global demand to own safe assets has grown very large relative to the supply of safe debt, and this mismatch has pushed down interest rates. Aging demographics, a global economic slowdown, and the liability-matching needs of insurance and pension companies are often cited as contributors to this outsized demand. More generally, a global "savings glut" may contribute to low or negative yields as countries with large amounts of domestic savings aggressively buy safe assets with little regard to price.

Central bank action, particularly by the European Central Bank (ECB), also looms large as a contributor to negative interest rates. In an attempt to stimulate lending, the ECB charges banks for funds on deposit (currently at an effective rate of -0.50%). The ECB has also had a significant program of buying longer-maturity debt (i.e., quantitative easing, or QE), that has not begun to reverse course the way the Fed's QE program did. In fact, ECB QE may get larger in the near future. This international landscape matters for U.S. markets because interest rates, like inflation, have a global component. In a world of global capital flows, similarly safe sovereign bonds will generally move up or down together.

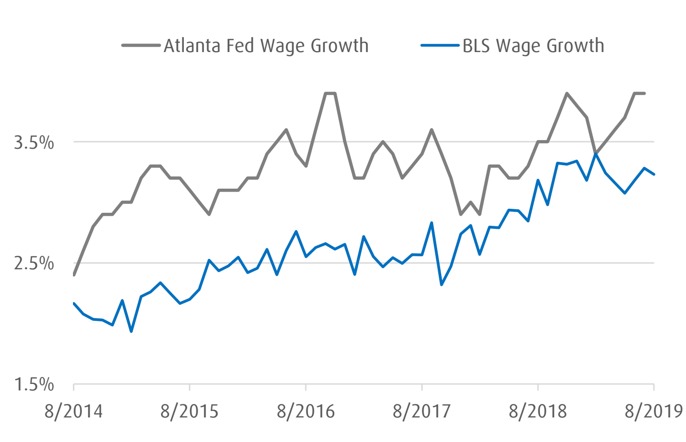
However, two other more concerning possibilities also exist as possible contributors to negative yields. One is that the bond markets in countries with negative yields are pricing in a forthcoming recession that they expect will lead to a significant deterioration in demand and corresponding price deflation. A negative yield on a safe bond suddenly becomes attractive if a steep recession causes prices to fall further than the aforementioned yield. And, finally, in a redux of dot-com era labeling, bond yields could be negative based on the "greater fool theory." That is, although prices are high and yields negative, market participants may have the expectation that the bonds can be resold to a "greater fool" later. This deeply speculative aspect doesn't appear to be a primary driver of negative yields. But, admittedly, if there is one asset in the world that appears bubble-like, it is these negative-yielding debt instruments.

The preponderance of negative yielding bonds has implications for other markets as well. Absent an impending recession, the paltry or negative bond yields make equities look relatively attractive and helps support the stock market. Investing in gold also becomes more attractive in a world of low or negative interest rates. A long-standing knock on gold has been that it provides no yield, but in today's world no yield sounds perky relative to the negative returns faced by some global bond investors.

Nonetheless, safe debt does not carry negative yields in all developed markets – the U.S. being a prime example. This takes us full circle to our punchline that yields in the U.S. will not turn negative. U.S. yields have been pushed down by global interest rate pressures, and there are signs of those global rates approaching their negative limits. Germany recently tried to sell 30-year bonds at a yield of -0.11%, which was in line with secondary market pricing. The issuance, however, was met with extremely weak demand and received bids for less than half of the two billion Euros offered. While accepting slightly negative yields may be a necessary evil for some investors, the more negative yields go, the more appealing other options become. If Europe is bumping up against downside "limits" then perhaps global pressures are also peaking. Additionally, the U.S. is an extremely large and expanding issuer, so supply and demand dynamics are not identical with Europe. Many countries and institutions are already heavily exposed to U.S. debt, which suggests they may not have the same appetite for adding exposure at a near-zero return, particularly if it also involves foreign exchange risk or hedging costs by foreign investors.

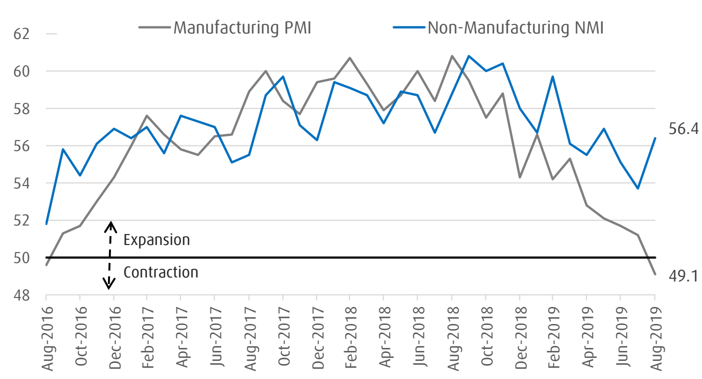
A steep economic recession in the U.S. could indeed turn yields negative. And we expect U.S. growth to suffer from the global growth slowdown, the trade war, and the struggling manufacturing sector. But consumer support from healthy wage growth **(Exhibit 2)** and service sector strength ***(Exhibit 3)*** looks sufficient to keep GDP growth in the 1.5% to 2% range. Signs to the contrary could come in the form of increased initial unemployment claims or large declines in consumer sentiment. Say what you will about the American consumer, but he/she is not easily spooked.

Exhibit 2 » Wage Growth



Source: Bureau of Labor Statistics (BLS), Federal Reserve Bank of Atlanta, BMO Wealth Management

Exhibit 3 » U.S. Purchasing Managers' Index



Source: Bloomberg Financial; BMO Wealth Management

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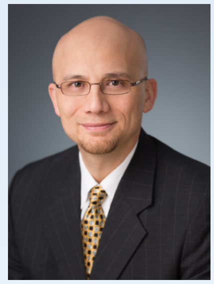
As Chief Investment Officer and National Head of the Investment team, Michael chairs the Personal Asset Management Committee and is responsible for setting investment policy and strategy for our clients throughout the United States. He joined BMO Wealth Management in 2013 as a Managing Director of Investments for our Ultra High Net Worth group, and became National Head of Investments in 2015. In January 2018, Michael took over the role of Chief Investment Officer. With close to two decades of experience in money management, Michael has a deep background in economic analysis, portfolio construction and risk management.

Michael earned a BA in economics from Northwestern University and an MBA with distinction in finance and decision sciences from the J.L. Kellogg Graduate School of Management at Northwestern University in Evanston, Illinois. He is a member of the Beta Gamma Sigma International Honor Society, holds a Chartered Financial Analyst designation, and is a member of the CFA Institute, CFA Society of Chicago, and the Chicago Quantitative Alliance. He is also a graduate of the American Bankers Association – National Trust School.



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As Chief Investment Strategist, Yung-Yu is responsible for performing macroeconomic analysis, valuation modeling and market analysis across asset classes to guide strategic and tactical asset allocations for client portfolios.

Prior to joining BMO Wealth Management, Yung-Yu was a finance professor at Lehigh University, where he taught courses in fixed income, equities and derivatives. His academic studies have been cited in the *Wall Street Journal*, in leading finance journals, top law journals, the *Handbook of High Frequency Trading*, and in *Oxford Handbook of Corporate Governance*. During his tenure at Lehigh, he was awarded the Staub Outstanding Teacher Award, awarded to one faculty member by a vote of faculty and students. Prior to his academic career, Yung-Yu worked for a global consulting firm performing financial and market analysis for global companies with operations in Hong Kong, Taiwan and Mainland China. Later, he oversaw the operations at a Fortune 500 subsidiary in Taipei and Mainland China.

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Written: September 16, 2019