Kashi Trathen, IFM Investors

Kashi Trathen, Associate Director, Debt Investments, IFM Investors, is a portfolio manager in IFM Investors' Treasury Services team, responsible for strategy and implementation within its cash and fixed income portfolios. He regularly contributes to FX strategy and execution, with experience in hedging interest rate and FX exposures using derivatives. Kashi joined IFM Investors from Barclays, where he worked in rates and FX derivative structuring. He previously worked in fixed income trading at Deutsche Bank. Kashi holds a Bachelor of Economics from Monash University and a Bachelor of Music Performance from University of Melbourne.

NEGATIVE INTEREST RATES

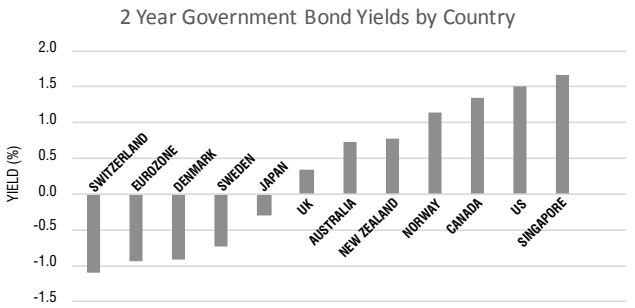
Why they persist and will Australia ever get there?

Kashi Trathen

In 1987, the then Federal Treasurer Paul Keating remarked that if you went into your local pet store, you would find the galah talking about microeconomic reform. In 2019, those same galahs (they can live up to 40 years) must surely be talking about negative interest rates.

There are currently US$16.4 trillion of securities with a negative yield[1], accounting for around one-third of the global tradeable bond universe. This includes German government bonds with a maturity of 30 years, and even some European 'high yield' bonds.

Figure 1. Switzerland, the Eurozone, Denmark, Sweden and Japan all have negative yielding government bonds



Source: Bloomberg as at 3 September 2019.

So far Australia has avoided negative interest rates (in nominal terms, ie. not adjusting for inflation). However, with the Reserve Bank of Australia having recently reduced interest rates twice, and with interest rate markets pricing the possibility of a further 25 basis point cut by the end of the year, it may be timely to ask whether or not we are likely to see investors having to pay to store their cash in Australia.

Why would anyone buy negative yielding securities?

People have a hard time getting their head around negative interest rates. Why would someone voluntarily part with their money for a period of time, potentially many years, only to end up with less of it? This seems especially odd when the investment is far from risk free. Interest rates could rise, which would reduce the value of long dated bonds. Furthermore, in the case of riskier debt, there could be a credit event or possibly even a default. Surely this is a bubble waiting to burst?

That could well be true, but it turns out that it might not be quite so simple. When you factor in central bank asset purchases, and the 'cross currency basis' that results from asymmetric global capital flows, negative interest rates might be more sustainable than many people realise.

Central bank asset purchases

Central banks are mandated to implement policies that result in price stability and economic development. In recent years they have done this by setting central bank deposit rates very low, and by buying long-

er dated bonds to push yields even lower, in the hope of incentivising borrowing and spending. The Swiss National Bank, European Central Bank, Sveriges Riksbank (Sweden) and the Bank of Japan (BOJ) have all utilised large bond purchase programs, otherwise known as quantitative easing (QE)[2]. Central banks are often price agnostic when implementing QE—they just keep buying regardless of price—hence there is no reason why the yield to maturity of a country's debt securities cannot go negative.

Why do central banks want to drive rates below zero? In short, to prevent deflation and stimulate their flagging economies. Take Japan, which accounts for over 40% of all negative yielding debt securities globally, as an example. Over the past 10 years, consumer price inflation has been below the BOJ's 2% price stability target 90% of the time, and below zero (deflation) 35% of the time[3]. The BOJ has maintained an asset purchase program since 2010, in the hope of generating inflation.

Whether or not quantitative easing is effective at creating inflation is still subject to much debate, but it is nevertheless one of the key drivers of negative interest rates. It also has the effect of providing private investors with a safety net, often described as the 'central bank put'. Yields can only rise so much while the central bank is buying bonds. Investors stand in the way of central banks at their peril.

Cross currency basis and foreign investors

One important but little known area of finance is the 'cross currency basis' market. The cross currency basis spread, (or simply 'the basis') is a mismatch that occurs when one borrows in one currency and then lends in another currency. This mismatch is caused by asymmetries in the supply and demand for particular currencies.

For example, Australia is a net importer of capital as there are more Australian companies borrowing money than there are Australian companies lending money outside Australia. This makes our cross currency basis positive as excess demand for USD hedging drives a mismatch. When an Australian bank issues a bond in USD, it has to pay a premium ('the basis') to hedge this USD exposure into AUD. Conversely, when an Australian investor, such as a superannuation fund, buys a USD denominated bond and hedges the currency exposure, it benefits from the additional pickup resulting from the cross currency basis spread. So Australian investors are rewarded with a higher return for swimming against the tide of capital imports.

The reverse is true in Japan, where the yen cross currency basis is negative. There is such an excess of domestic savings, that when Japanese investors try to invest in the US or Australia and hedge the currency exposure, they have to pay their negative basis spread. Conversely, Japanese government bonds can offer additional returns to offshore investors, for whom this negative basis offers a yield pickup.

The end result is that countries with negative yielding bonds (as measured in their local currency), are often not negative when hedged into currencies with higher prevailing interest rates and positive (or at least less negative) cross currency basis spreads. In fact, negative yielding Japanese government bonds, when hedged, currently offer a better yield to Australian investors than Australian government bonds (see Figure 2 below).

This suggests that cross currency basis markets, when driven to extremes by supply and demand imbalances in international capital flows, create a situation in which negative interest rates could persist for a long time. The quantitative data support this idea as all countries with negative rates have strongly negative cross currency basis spreads.

The importance of the current account

One factor that all negative interest rate jurisdictions have in common is a current account surplus, making them net lenders to the rest of the world. This usually occurs alongside a trade surplus, whereby a country exports more than it imports, and therefore has leftover savings to lend to other countries, often in the form of government bond purchases.

Japan, the Eurozone, Switzerland, Sweden and Den-

The quote

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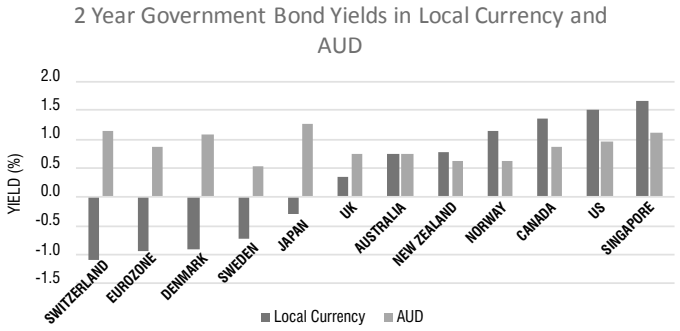
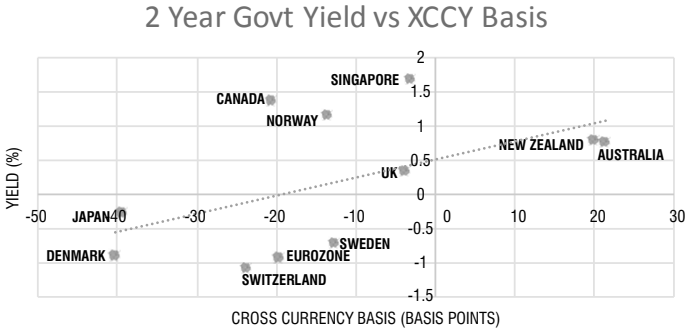
Figure 2. Some negative yield bonds provide attractive returns for AUD investors



Source: Bloomberg as at 3 September 2019.

Figure 3. Negative rates are typically associated with negative cross currency basis

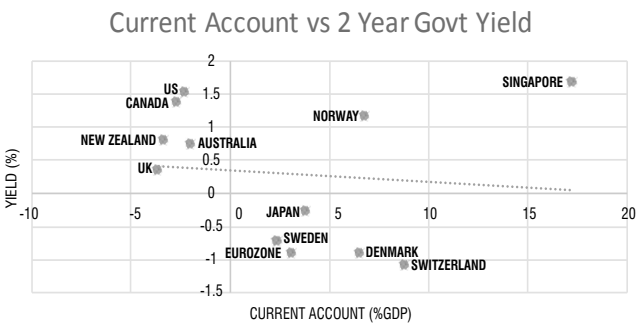


Source: Source: Bloomberg as at 3 September 2019.

mark all have current account surpluses, while the US, Australia and New Zealand have tended to operate current account deficits, with the exception of Australia's recent quarterly current account surplus. In Australia's case, our banks depend on offshore wholesale funding to finance their lending activities (mortgages). This is one of the key drivers of the cross currency basis.

Given interest rates on bonds and other investments are determined by supply and demand, it seems intuitive that countries with excess savings (such as Japan and Switzerland) would have higher demand for bonds, thus pushing interest rates lower. Indeed this is exactly what we see in the data. The countries with negative interest rates currently all have current account surpluses.

Figure 4. Countries with negative interest rates tend to have current account surpluses*



Source: Bloomberg as of 3 September 2019.
**A two-year moving average is used to calculate the current account figures.*

Will Australia see negative interest rates?

Australia has been, for the most part, a net borrower of capital from the rest of the world (a current account deficit country) and has a positive cross currency basis spread. That being said, we recently did see the first quarterly current account surplus since 1975. This was driven largely by a one off increase in the terms of trade, as well as weak imports and lacklustre consumer spending. Unless this trend of strong net exports were to be sustained—and that is unlikely—it is difficult to see how Australian government bonds could trade with negative yields in the short to medium term.

If Australian bonds were to trade below zero per cent, then the bonds of countries with a sustained current account surplus would have to trade even lower than they are now. For this to happen, there would probably need to be an extraordinary level of central bank intervention, or a dramatic and sustained increase in our current account balance.

So, we believe it seems unlikely that Australia will see negative interest rates in the near future. Nevertheless, in a weakening global trade environment with a number of negative tail risks, it would be brave to say that it could never occur.

Notes
1. *Bloomberg, August 2019.*
2. *The Denmarks Nationalbank technically doesn't undertake QE, but because the Danish Krone is pegged the Euro, it somewhat adopts Eurozone monetary policy.*
3. *Bloomberg, Japan CPI Nationwide YoY Index as of 3 September 2019.*