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Negative Yields: The World Turned Upside Down

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Negative Yields: The World Turned Upside Down

Negative yielding bonds are a curious phenomenon. With somewhere around \$13trillion in negative yielding bonds outstanding in the global marketplace today, who and why would anyone buy these bonds? Well the answer is “it’s complicated” and it also may surprise you.

First, lets address the bigger picture about these bonds:

- Most of the negative yielding bonds have been issued by governments such as Japan, Germany, France, Spain and Austria. Central banks are pushing money into the economic systems to fuel economies and preempt recessionary fears. Lowering interest rates is the primary lever central banks have to combat potential recessionary risks.
- Some of these strange bonds have been issued by high quality European corporations. These corporations are taking advantage of low-cost debt for various purposes such as share buy-backs, to fund operations, for capital expenditures as well as for R&D.

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Why oh why would anyone buy these bonds?

- **Buyers of these bonds are often seeking quality, liquidity, and alternatives to volatile assets like equities. There simply are not a lot of alternatives.**
- **Some buyers of these bonds also don't have very many options, in other words they are captive buyers of negative yielding bonds.**
- **Some buyers are making a wager that the central banks will push yields even lower, driving prices even higher. This is a shorter-term tactical exposure to negative yielding bonds.**
- **Other buyers are overlaying negative yielding bond exposure by using currency swaps overlays. The goal of these swaps is a positive cash flow when all is netted out. This is not feasible in all cases and can be costly.**

September 19, 2019

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So who buys these bonds?

- **Banks:** Banks have obligations to maintain high quality assets to offset liabilities. Exposures to high quality government bonds, even negatively yielding bonds, helps them maintain their required regulatory ratios. European banks are “captive” buyers of negatively yielding bonds as a result of these ratios.
- **Pension funds:** These funds need to own high quality and liquid assets to offset future obligations.
- **Insurance companies:** Insurance companies own negatively yielding bonds to ensure they have funds to meet future liabilities.
- **You and I!** Yes, if you own a global bond index ETF or an index fund you probably own negatively yielding bonds. Index rules are designed to meet specific objectives such as exposure to high quality global bonds. In that circumstance, the index is selecting bonds for inclusion based on quality and diversification....not the yield. The fund or ETF tracks the index and follows suit. The result: surprise, you own negatively yielding bonds!

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