Tortoise QuickTake Credit Podcast

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Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, Tortoise provide a timely update on trending topics in the market.

Welcome to the weekly Tortoise credit podcast. I'm Greg Haendel, senior portfolio manager at Tortoise. Prior to 1492 when Christopher Columbus sailed the ocean blue, some people in Europe and Asia believed the Earth was flat. Although Columbus sailed the ocean blue to try to find a new trade route to India from Spain, on October 12th, 1492 Columbus sighted land in North America and changed history. Although his original mission wasn't to discover North America or prove the Earth is round, he did just that. Prior to July 2009, many economists and academics believed that the theoretical floor on interest rates was 0%. Prior to 2009, an environment with negative interest rates was simply an academic and theoretical exercise with unknown consequences similar in a way to sailing to the end of the map in what was thought to be a flat world. In July 2009, Sweden's central bank cut its overnight deposit rate to -0.25%, followed by the European Central Bank breaching the zero bound in June 2014 and several other countries including Japan thereafter. In today's podcast we will discuss some of the causes of negative interest rates, the composition of negative debt globally, what negative yields are telling us, and some of the estimated repercussions, both positive and negative.

The total value of negative yielding debt globally peaked in mid-2016 at around $12.5 trillion, retreated to roughly $8 trillion early in the fourth quarter of 2018 and has since rebounded to approximately $10.6 trillion most recently, with an increase of roughly 20% year-to-date. Further, negative yielding debt now makes up almost 20% of the total market capitalization of the Bloomberg Barclays Global Aggregate Index. Japan accounts for the largest portion of negative yielding debt, at approximately $6.7 trillion or just below 2/3rds of the global amount. Eurozone debt, at approximately $3.8 trillion, accounts for most of the remaining global stock of negative yielding debt. Interestingly, although the majority of negative yielding Eurozone debt is sovereign-related, roughly $800 billion of this negative yielding debt is credit related; corporate debt or supranational debt. In fact, in Europe, Sanofi and Louis Vuitton Moet Hennessy recently issued bonds that pay zero interest and were issued at a small premium to their redemption value at maturity thereby generating a negative yield. Currently all Japanese and German sovereign bonds denominated in their respective currencies with a maturity of 10 years or less have a negative yield while the same holds for all French sovereign bonds with a maturity of eight years or less.

You may be asking yourself what causes negative interest rates or negative yields and who in their right mind would ever buy a negative yielding debt instrument, thereby essentially paying someone to lend them money. Let's start by addressing the causes of negative interest rates or negative yields.

First and foremost, negative yields can simply be a consequence of active central bank monetary policy in a world where bond supply and demand are not balanced. In this case when central banks institute a negative short term deposit rate in concert with substantially large central bank asset purchases of intermediate to longer maturity sovereign bonds it can certainly drive bond yields negative. Second, negative yields can potentially forecast a sharp economic slowdown which as a consequence could lead to an increase in defaults in the future. In this case, return of capital is more important than return on capital. In this example, bank deposits rates would have to be negative and realistically it couldn't make sense to just stuff your money under your mattress. Third, the fear or forecast of future deflation can cause negative yields whereby expected deflation pushes real yields positive. In this case, paying up now and receiving less nominal money in the future can be profitable if the price of goods falls substantially during that investment horizon. Fourth, negative yields can be the consequence of the ecology of the current market participants. For passive investors (indexers or ETFs), not owning the negative yielding bonds, if they are part of the underlying index, introduces potential tracking error. Further some financial institutions, such as banks or insurance companies face strict regulations with their balance sheet holdings. Many of these institutions must hold a regulatory minimum amount of liquid assets while some of this sovereign debt may hold a zero riskbased capital weighting. As a result this forces them to buy negative yielding bonds over what could be an even more negative yielding central bank deposit rate. Fifth, investors speculating on additional central bank monetary policy easing. In this case investors are relying upon the greater fool theory that they can make money buying a negative yielding bond as long as they can sell it with an even greater negative yield prior to maturity.

As you can see, there are several causes of negative interest rates. Further, there are a multitude of potential buyers of negative yielding bonds depending upon the root cause or causes of the negative rates. These buyers include most notably central banks, followed by regulated financial institutions such as banks and insurance companies, passive bond investors such as indexers or ETFs, speculators such as hedge funds and even some ordinary investors investing in very non-ordinary market environments.

The largest anticipated benefit from negative yields is to drive investors out of perceived safe sovereign bonds and into riskier assets. By forcing this move it is believed financial conditions will ease and economic growth will be promoted. In essence central banks are trying to crowd investors out of risk free assets and into riskier assets such as corporate loans or personal loans thereby trying to jumpstart the economy. In fact, former Fed Chair Ben Bernanke wrote an Op Ed in the Washington Post in early November 2010 entitled *"What The Fed Did and Why: Supporting The Recovery and Sustaining Price Stability*" whereby he addresses what central banks are trying to achieve with actions such as these. Another related and potential benefit to negative yields is to increase inflation in an environment of stubbornly low inflation.

Other potential side effects to negative interest rates include weakening your currency relative to your trading partners, all else equal. Negative rates can also help limit the downside to commodity prices. On the supply side, low rates decrease the opportunity cost of holding commodity reserves in the ground thereby limiting supply. On the demand side, low or negative risk-free rates push down expected returns across most assets thereby increasing the attractiveness of buying commodities all else equal.

Negative interest rates don't come without a cost. Potential negative side effects include lower bank profitability, impaired functioning of the money markets, reduced liquidity for negative yielding debt, a limited central bank toolset to address a future recession, excessive borrowing and excessive leverage (by individuals, corporations and sovereign countries) and future financial bubbles.

Today, we believe the increase in the global debt stock of negative yielding bonds is signaling a slowdown in global growth, low inflation in many regions, and a renewed aggressiveness by many global central banks to attempt to jumpstart their economies. Despite relatively low interest rates in the U.S., our sovereign government bonds remain one of the highest yielding amongst other developed countries. As a result, given the interconnectedness of global financial markets and the substantial increase in negative yielding debt globally, it will be difficult for U.S. treasury yields to trend substantially higher in the near term absent an inflation scare which we don't predict anytime soon.

Thank you for listening, we'll talk to you again next week.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseadvisors.com.

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