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Sub-zero yields reset the risk compass

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In Brief

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- Yields on almost a quarter of all EUR denominated government bonds are in negative territory.
- Investors now face the prospect of taking a loss on investments that would normally offer capital protection.
- This could change their behaviour and lead them into taking on even more risk.

As the European Central Bank prepares to launch its own brand of quantitative easing, yields on many developed government (and some corporate) bonds have turned negative. Investors looking to lend money to sovereign borrowers now face having to pay for the privilege. Financial repression has clearly extended its reach, marking a new phase in the hunt for yield.

The hunt for yield is entering new territory. The European Central Bank's landmark decision to unleash quantitative easing marks the beginning of a precarious phase in this erratic financial cycle. Precarious because the move appears to eliminate the distinction between what is risky and what is safe. Government bonds may have been tolerable investments when their yields were near zero, but they are unlikely to be so now. Buying sovereign debt today means locking in a loss at redemption.

That's not to say yields cannot dip further into negative territory. The ECB, some tightly-regulated financial institutions and banks could continue to buy government debt whatever the price. And should deflation prove a more stubborn foe that central banks envisage, sovereign bond yields could indeed fall further.

But the predicament facing investors in need of some capital protection is the toughest in living memory.

Thanks to central banks' increasingly aggressive financial repression - the deliberate driving down of interest rates to levels below inflation - negative bond yields have never been so widespread. After the ECB went public with its QE plan, nominal bond yields turned negative across vast swaths of the sovereign debt market. At one point, about 16 per cent of the bonds in JP Morgan's government bond index, some USD3.6 trillion, and one in four euro zone sovereign bonds were offering negative yields. Meanwhile, investors wishing to lend money to the Swiss government over a period up to 10 years have found themselves having to pay for the privilege. The trend has also spread to the corporate debt market, where yields on consumer good giant Nestle's four-year euro bonds briefly fell to minus 0.008 per cent.

Not even in deflation-plagued Japan did the situation get this bad. Yields may have bumped along near zero for long periods during the 1990s and 2000s but they never turned negative – until now.

It is doubtful that investors can put up with this for much longer. To avoid an almost certain loss, it is possible that they will end up taking on more risk.

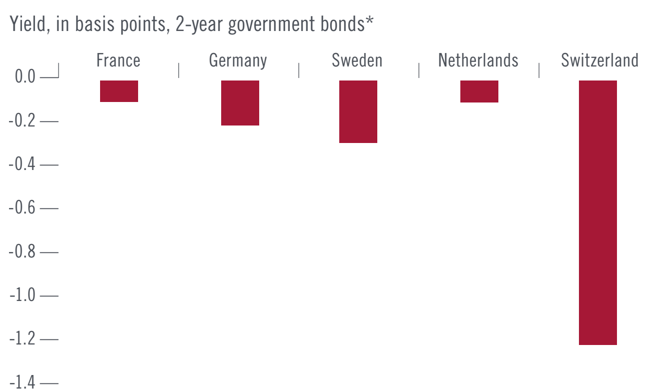
There is a large body of evidence testifying to investors' extraordinarily powerful aversion to loss. This tendency was most famously demonstrated more than 30 years ago in experiments conducted by the behavioural economist and Nobel laureate Daniel Kahneman.[1]

Through a series of detailed studies, Kahneman found that individuals were prepared to take on more risk than normal if the alternative - doing nothing - meant accepting a loss. For example, when given a choice between a guaranteed USD1000 gain or a 50 per cent chance of a USD2500 gain, research subjects tended to opt for the first, low-risk option. However, when having to choose between a certain loss of USD1000 and an alternative scenario offering a 50 per cent probability of zero loss and a 50 per cent chance of a USD2500 loss, research subjects took the second, riskier option. In other words, when the probability of suffering a loss is high, individuals' natural aversion to risk gives way to a powerful risk-seeking impulse. This is the central tenet of Prospect Theory.

Viewing present trends through the prism of Prospect Theory, it is easy to see how investors might respond to central banks' latest dose of financial repression. Asset classes once considered risky could potentially acquire haven-like status.

VANISHING GOVERNMENT BOND YIELDS

Yield, in basis points, 2-year government bonds*



Source: Bloomberg, as of 23.02.2015

There are certainly plenty of candidates vying for the title of new haven. This is another distinguishing feature of this financial cycle: unlike the deflationary periods of the past, investors are spoilt for choice when it comes to fixed income investment options. Emerging market sovereign bonds are contenders – developing economies remain less indebted than their developed counterparts, possess favourable demographics and are generally better governed than they have ever been. Corporate bond markets, meanwhile, are evolving into a rich hunting ground, particularly in Europe, where bonds are replacing loans as the funding vehicle of choice for a broader array of investment- and speculative-grade companies. And so far, default rates have remained well below the historical norm. Dividend-paying equities – or quality stocks with bond-like characteristics – clearly lie at the riskier end of the spectrum but, as investment flow patterns show, they are favoured for their defensive attributes. Since 2011, net inflows into global equity income mutual funds have averaged at EUR4.2 billion per year.[2]

So the blanket search for yield will evolve into a flight from near-certain loss. That is sure to underpin the prospects for credit securities and defensive stocks over the medium term. Indeed, investment grade and high yield corporate bond funds have already attracted more than USD18.2 billion of new investments in the first six weeks of 2015, more than treble the flows seen in the same period last year.[3]

Longer term, the picture might not be quite so healthy. Taking on additional credit risk will require investors to be more discriminating. The credit standing of high yield companies, for instance, is hardly set in stone.

What is more, as central banks continue to experiment, inflation expectations will probably become more volatile over the long run. Bonds may prove the asset of choice if inflation remains low, but they will not offer capital preservation should it accelerate. Shrewd tactical asset allocation will be a must.

Percival Stanion, Head of Multi-Asset

Percival Stanion joined Pictet in 2014 as Head of Multi Asset.

Before joining Pictet, Percival spent 13 years at Baring Asset Management as Head of Multi Assets. He previously worked at BNP Paribas Asset Management, spending three years as Head of Asset Allocation, and at Pictet Asset Management for six years, with responsibility for global diversified accounts. Prior to this, Percival held equity portfolio management roles with Invesco and National Provident Institution. He started his career in 1980 as a research analyst covering UK equities.

Percival holds an MA in Philosophy, Politics and Economics from Pembroke College, Oxford University.

[1] See Kahneman, D and Tversky A, Prospect Theory: An analysis of decision under risk; Econometrica, Vol 46 (1979)
[2] Source: Lipper SalesWatch; data covering period 31.12.2010-31.12.2014
[3] Source EPFR Global, as of 11.02.2015

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