Government Actuary's Department

Investment News

Monthly Bulletin from the Investment & Risk Team

April 2015

Last Month in Brief

With continued ultra-low interest rates, the ECB's Quantitative Easing programme & a weakened Euro, Eurozone equity markets continued to rise in March to produce a strong quarter's growth. Meanwhile negative inflation in the Eurozone persists, although Germany announced a return to positive inflation of 0.1% providing a source of hope that persistent deflation would be avoided.

Discussions surrounding potential Greek bailout conditions continued to stall ahead of the Easter break across Europe. Goldman Sachs estimate that approximately $15bn of capital has been pulled out of the Greek economy during the last 3 months of uncertainty, adding to Greece's difficulties.

In contrast to the position in Europe, there is increased speculation about when US interest rates will rise with the Federal Reserve removing the word "patient" from their description of their approach. Many now expect the first increase to happen later this year.

In the UK, GDP growth for 2014 was revised by the ONS to a 9 year high of 2.8% driven by strong exports. Inflation continued to fall with CPI inflation falling to 0% for the first time since records began in 1989.

Chart 1: Equity Indices

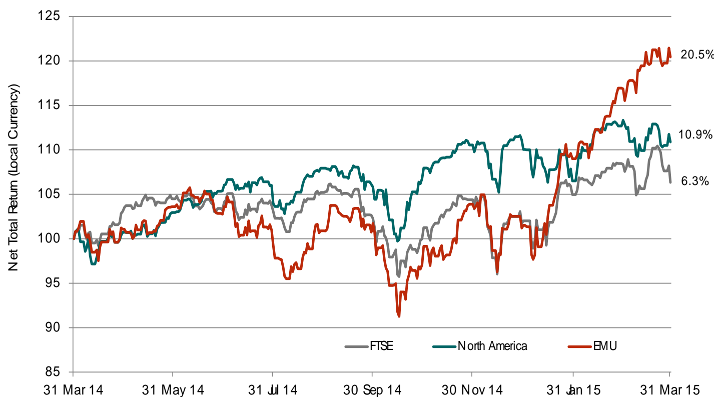


Chart 2: Sterling Credit Spreads

Credit spreads widened slightly during March

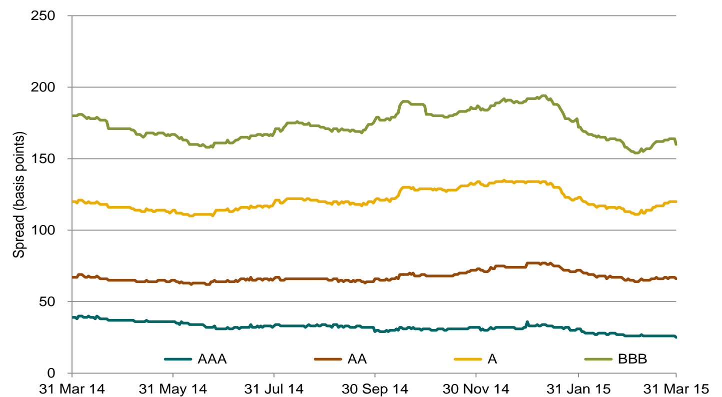


Chart 3: Gilt Yields

Gilt yields have fallen this month

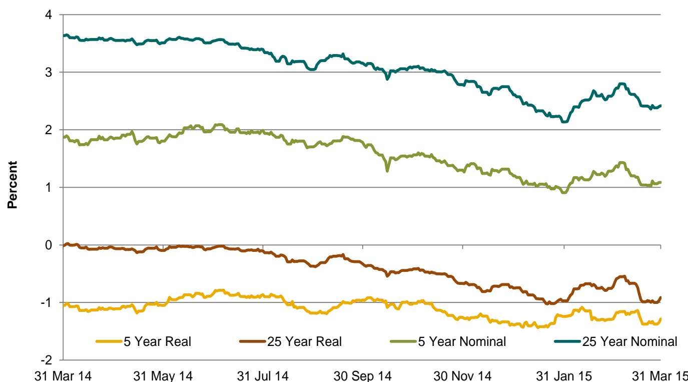
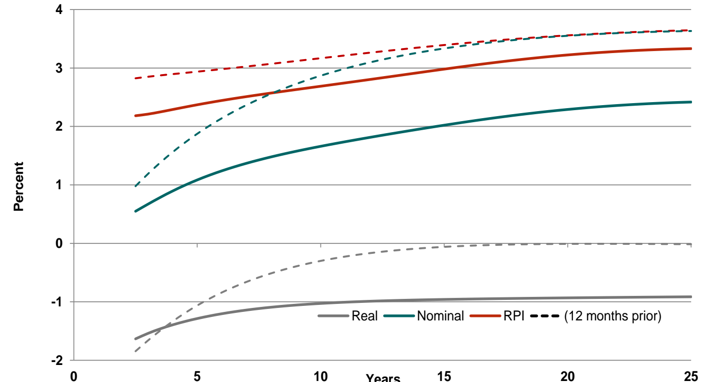


Chart 4: Gilt Spot Curves

The yield curve continues to be low and upward sloping



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0%	0.3%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	83.6%	77.6%	**QE Level**	£375bn	£375bn
Halifax house prices (monthly change)	-0.3%	2%	**VIX (volatility) index**	15.29	13.34
IPD TR property index (monthly change)	0.9%	0.8%	**$/£ exchange rate**	1.48	1.55

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

Negative Yields

Since the start of the year, the yields that investors receive on some bonds have become very low and, perhaps surprisingly, negative for several issuers. This has led many to debate why investors are accepting these low yields and, in effect, paying for the privilege of lending out their money.

Whose bonds have negative yields?

A number of bonds issued by European governments have traded at negative yields. This includes AAA rated German, Swiss and Danish bonds but also the short term debt of countries with lower credit ratings such as Ireland. And it is not just governments whose debt is yielding less than zero, private companies (albeit very large, secure ones) have also seen yields enter negative territory.

Moreover, this is not limited to secondary market trading, some countries have issued debt at negative yields - and had these yields accepted - in effect being paid to borrow. There are now significant volumes of debt trading at prices which will result in negative returns for any investor who holds such a bond until maturity.

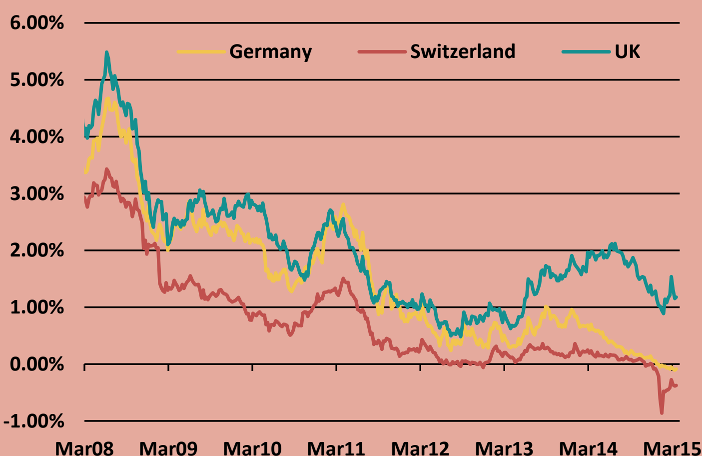
Why buy assets with negative yields?

The magnitude of debt with negative yields is a newly observed phenomenon. Indeed, many financial models have previously assumed that nominal rates would always be positive. We can, however, identify a number of factors which help explain why these sub-zero yields have emerged:

- Inflation in Eurozone economies has fallen and, in recent months, has varied from very low to negative. Fears of deflation in the future are given credence by low growth within and beyond the Eurozone. As a result, investors are accepting negative yields in anticipation of greater levels of deflation, which will result in positive real returns from these assets.
- Central bank interest rates have been set below zero. Switzerland and Denmark, for example, both have -0.75% interest rates. It may therefore appeal to banks to hold negative yielding assets rather than being charged even more to hold cash on deposit.

Box 1: How bond yields have developed.

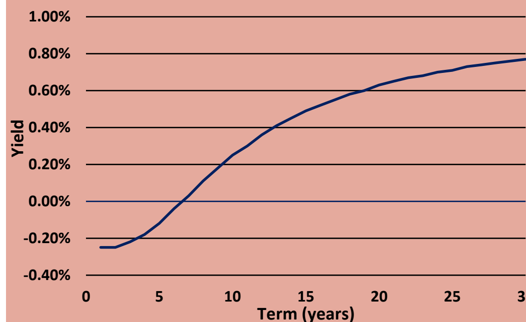
10 year yield-to-maturity for notable European issuers



Source: www.investor.com / central banks

Box 2: Bond yields for different maturities

German yield curve as at end of March 2015



The yield on German Bunds remain negative for terms up to around 7 year and remain under 1% for all maturities.

Source: www.bundesbank.de

- Some may buy bonds speculating that yields will fall (and prices rise) even further, leading to capital gains. Some traders believe that in future someone else will purchase these assets at higher prices - perhaps the ECB as part of their quantitative easing programme. Alternatively, foreign investors may believe that future currency appreciation will result in greater returns in their domestic currency.
- Holding high quality assets such as AAA rated government bonds may be seen as safer than 'hiding it under the mattress'. These safe assets have a limited supply and many large financial institutions are required to hold such assets to demonstrate financial strength. This provides a constant and high level of demand which has increased somewhat as regulation has tightened.

What next?

The current environment has led to the Euro dropping significantly against other major currencies as investors move their money into other currencies seeking higher returns. There is also a move by some investors into higher risk assets in the search for higher yields. This has seen investors move into more speculative corporate and national debt as well as asset backed securities. However, institutions which require these AAA rated bonds to match their long term liabilities either for reasons of prudence or because they are subject to regulatory requirements are likely to continue to do so.

The low yields mean that banks and providers of other financial products (such as insurance) are struggling to provide attractive services as they cannot achieve the returns previously available. This has resulted in an increase in European banks charging depositors for holding their funds. Meanwhile UK pension schemes have seen their liabilities balloon, often much faster than the growth in their assets, resulting in increased deficits.

In this new world of negative interest rates, when and how things will move is very unpredictable. The only thing that is clear is that it can no longer be assumed that yields can only be positive. Some still believe that yields have the potential to fall further. On the other hand, many think the ECB's recent announcement that it would not purchase bonds yielding less than -0.2% will act as a floor on these yields. Furthermore, some argue that exceptionally loose monetary policy will not last indefinitely and a sharp return to historic levels of yields will see holders of bonds facing large capital losses.

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