

A Low Yield World

Faced with a rising tide of low or negative yielding debt, investors often seek out higher yields in other regions, at longer maturities or at lower credit ratings. In this publication we aim to dispel the misconception that investing in low or negative yielding debt cannot generate positive total returns and we outline active investment strategies that global fixed income investors can employ to potentially generate a positive return.

Charting the Rate Backdrop

p3-4

Low inflation and downside growth risks point to a prolonged era of monetary policy accommodation and in turn low (or negative) bond yields.

Currency Considerations

p5-6

Faced with a low rate backdrop, investors reaching for yield beyond their home market should be conscious of currency-hedging costs which can erode or even eliminate any yield pick-up on a currency-hedged basis. Meanwhile, investors in a high rate environment can earn a premium by investing in a low or negative yielding foreign assets.

Negative Plus Active Can Equal Positive

p7-9

Simply purchasing a bond with a negative yield and holding it to maturity will indeed incur a loss. However, the economics of active management do not change in a low or negative yield world. Active investment strategies such as relative value country exposures or yield curve shape views can still generate potential positive total returns from low or negative yielding debt.

Speed Read

Low rates look set to persist but...

Subdued inflation, trade protectionism, geopolitical tensions, uncertainty around macro variables such as the neutral policy rate and a narrow room for policy manoeuvre has led policymakers to adopt a dovish bias (page 3). As such, a low yield world looks set to persist.

...simply reaching for higher yields is not sufficient...

A common misconception is that an investment in a negative or low yielding asset cannot generate a positive return. In turn, a common investor response is to seek out higher yields in other regions (typically the US), at longer maturities or at lower credit ratings. However, on a currency-hedged basis, any perceived yield pick-up can be eroded or even eliminated (page 6).

...which is why we believe active management is essential

For investors who choose not to (or cannot) venture beyond the universe of sub-zero debt, active investment strategies, including relative value rate exposures (page 7) and yield curve shape views (page 8) can generate potentially positive returns from investments in low or negative yielding assets.



“ Low inflation, downside growth risks and uncertainty around macro variables has led central banks to view incoming data through a dovish lens.

Simon Dangoor,
Head of Macro Rates Investing



“ Currency hedging costs can enhance but also erode or even eliminate any yield pick-up for investors venturing beyond their home market.

Hugh Briscoe,
Global Fixed Income Portfolio Manager



“ Negative rates at this stage of the cycle are unprecedented. But this novel market phenomenon does not alter the ability of active investors to identify potential return opportunities.

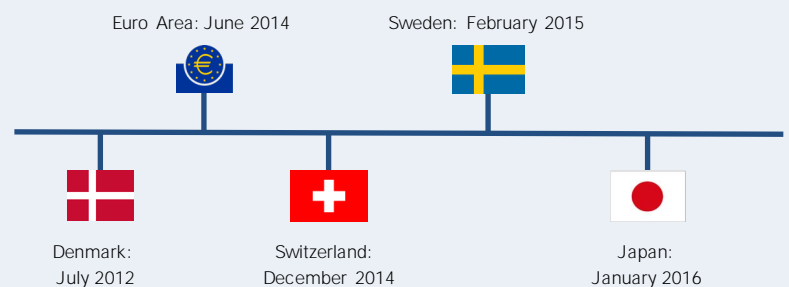
Ashish Shah, Co-Chief Investment Officer,
Global Fixed Income

\$15.6 TRILLION

The stock of global negative yielding debt or **28%** of the Bloomberg Barclays Global Aggregate Index¹.

Exhibit 1: The lower bound is not zero

Timeline of the Introduction of Negative Central Bank Policy Rates



Source: GSAM. As of August 2019.

¹ Source: Bloomberg. As of August 8, 2019.

CHARTS THAT MATTER

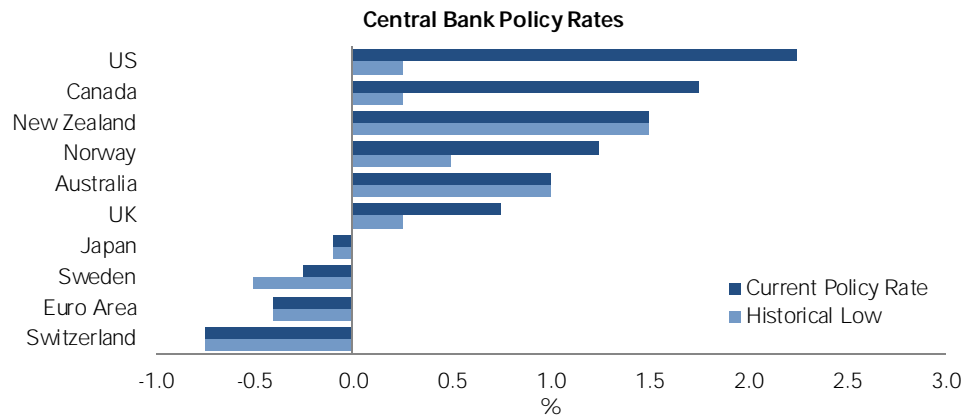
A Low Yield World

Policy rates are on track...

Central bankers are increasingly calling for a more balanced policy mix, with fiscal stimulus playing a more prominent role in supporting economies.

Nonetheless, we are more than a decade beyond the global financial crisis and policy rates are at an all-time low at five G10 central banks, several of which are in negative territory (Exhibit 2).

Exhibit 2: Central bank policy rates are at or close to all-time lows



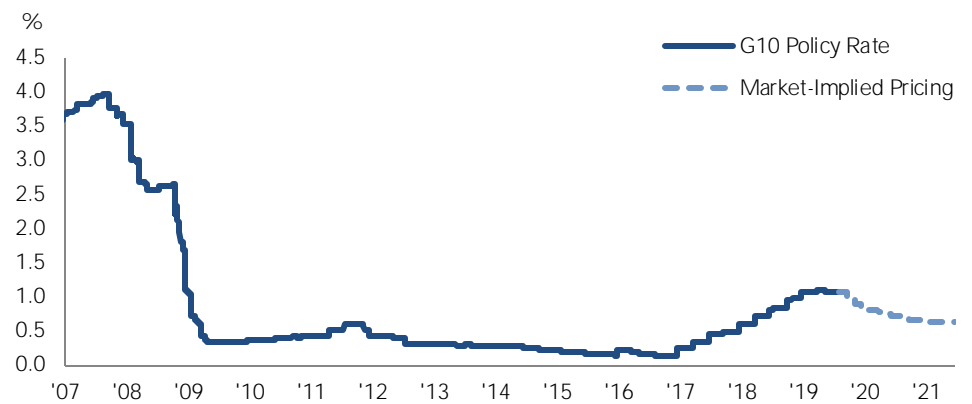
Source: Macrobond. As of August 1, 2019.

...to move even lower

Given the benign inflation but more volatile political backdrop, we expect central banks to either remain accommodative or deliver additional policy easing in order to preserve the expansion.

Indeed, market-implied pricing suggests developed market (DM) monetary policy is on track to shift from gradual normalisation to potentially rapid easing (Exhibit 3).

Exhibit 3: Dovish market expectations for G10 central bank policy



Source: Macrobond, GSAM. Nominal GDP-weighted policy rate. As of August 1, 2019.

CHARTS THAT MATTER

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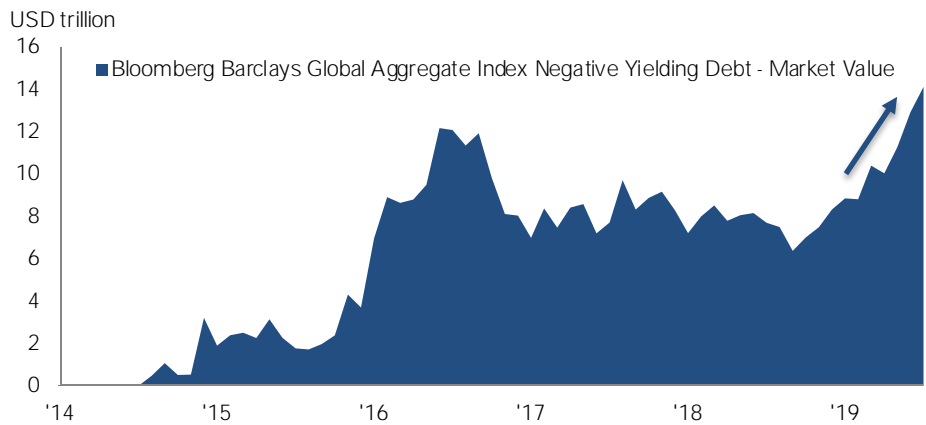
Further declines in yields...

Since the turn of the year, the proportion of central banks raising rates has dropped from over 40% to below 10%².

In response, global bonds have rallied, reigniting a rise in the stock of sub-zero yielding debt following a couple of years of respite (Exhibit 4).

² Source: Macrobond, GSAM. Based on three month rolling change in policy rates at 40 central banks.

Exhibit 4: Stock of negative yielding debt is trending higher



Source: Bloomberg. As of July 31, 2019.

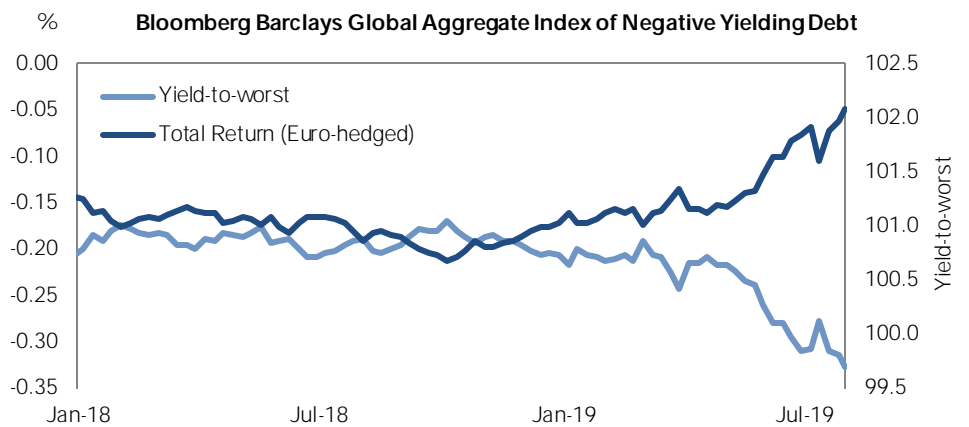
...can generate positive returns

Purchasing a negative-yielding bond and holding it to maturity will result in a loss.

But if yields move even further into negative territory, positive capital gains can still be achieved. That is the situation that has unfolded this year, with yields falling amid dovish central bank pivots and total returns (even on a currency-hedged basis) trending higher (Exhibit 5).

As such, an environment of low and negative yields across fixed income markets may be more sustainable and persistent than many investors would have thought prior to this cycle.

Exhibit 5: Lower yields, higher total returns



Source: Bloomberg. As of July 31, 2019.

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Currency Considerations

Investment opportunities for investors in higher rate markets

In short: Intuitively, an investor in a high rate environment would not typically consider investing in a low or negative yielding foreign asset. But on a currency-hedged basis, such investors can receive higher yields relative to local currency assets for doing so.

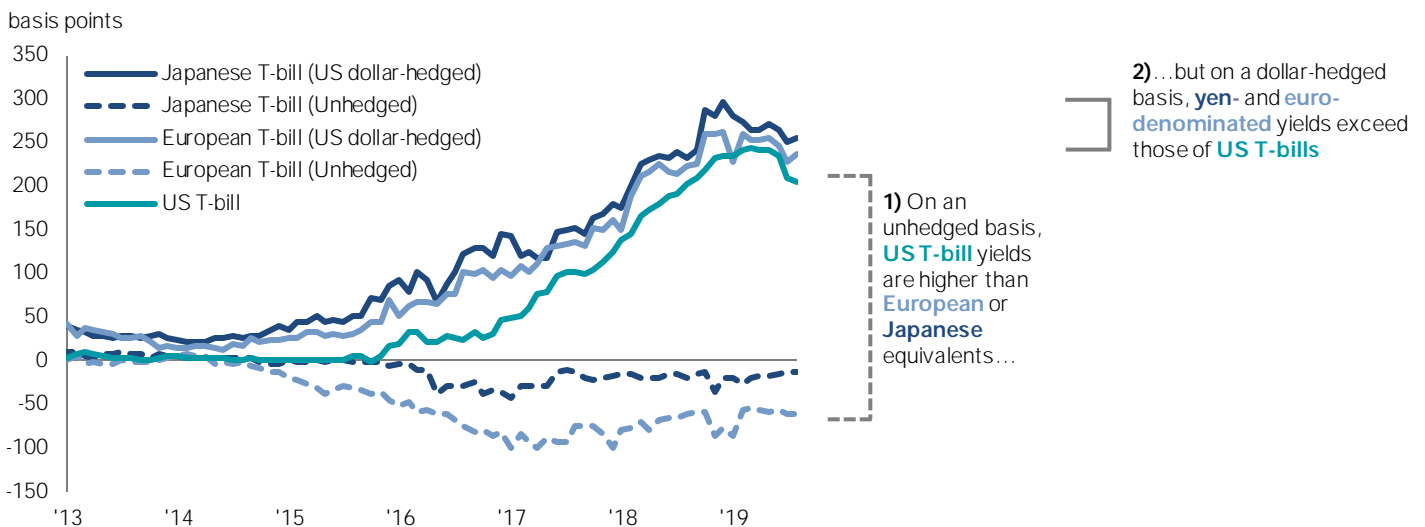
Example: Potential for attractive returns for investors who lend US dollars to purchase euro- or yen-denominated assets

For local investors, yields on euro- or Japanese yen-denominated bonds may not seem attractive. However, for US dollar investors, yields on these bonds on a currency-hedged basis can be higher than equivalent maturity dollar bonds. This is due to a premium that these investors can receive from providing short-term dollar funding in foreign currency markets.

Consider a US investor who purchases a Japanese or European three-month Treasury bill (T-bill). To hedge the foreign currency exposure associated with this purchase, an investor can enter into a foreign exchange swap whereby they borrow Japanese yen or euros while lending US dollars. The repayment amount is fixed at a foreign exchange forward rate. In recent years, a spread has been added to USD LIBOR when the US dollar is funded via an foreign exchange swap³. This spread is known as "cross-currency basis". If the cross-currency basis widens, an investor can profit by borrowing US dollars in the money market and providing them in the foreign exchange swap market, as would be the case in this example.

Overall, the dollar investor will receive the yield on their euro- or yen-denominated T-bill, the interest differential of the two currencies plus a cross currency basis. As such, even if unhedged euro and yen yields are negative (Exhibit 6, light and dark blue dashed lines), the investor can receive a higher yield than US T-bills due to the cross currency basis (Exhibit 6, light and dark blue solid lines).

Exhibit 6: Lending dollars to purchase euro- or yen-denominated assets on a currency-hedged basis



Source: GSAM and Bloomberg. As of July 31, 2019. Germany used for European T-Bill. **Past performance does not guarantee future results, which may vary.**

³ Drivers of the cross-currency basis include supply-demand imbalances in funding markets (for example, a large negative basis indicates dollar shortage or relative abundance of other currencies) and perceived credit risks.

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Currency Considerations

The importance of currency-hedging costs for investors in low rate markets

In short: Investors in low or negative rate markets tend to venture beyond their home market in pursuit of higher yields. But yield differentials alone do not determine the advantage of purchasing a higher-yielding foreign asset; currency hedging costs must also be taken into consideration. These costs can erode (or eliminate) the benefit of moving into higher yielding foreign markets. This underscores the benefit of employing active investment strategies outlined on pages 7-9 which can generate potential positive returns from investments in low or negative yielding assets.

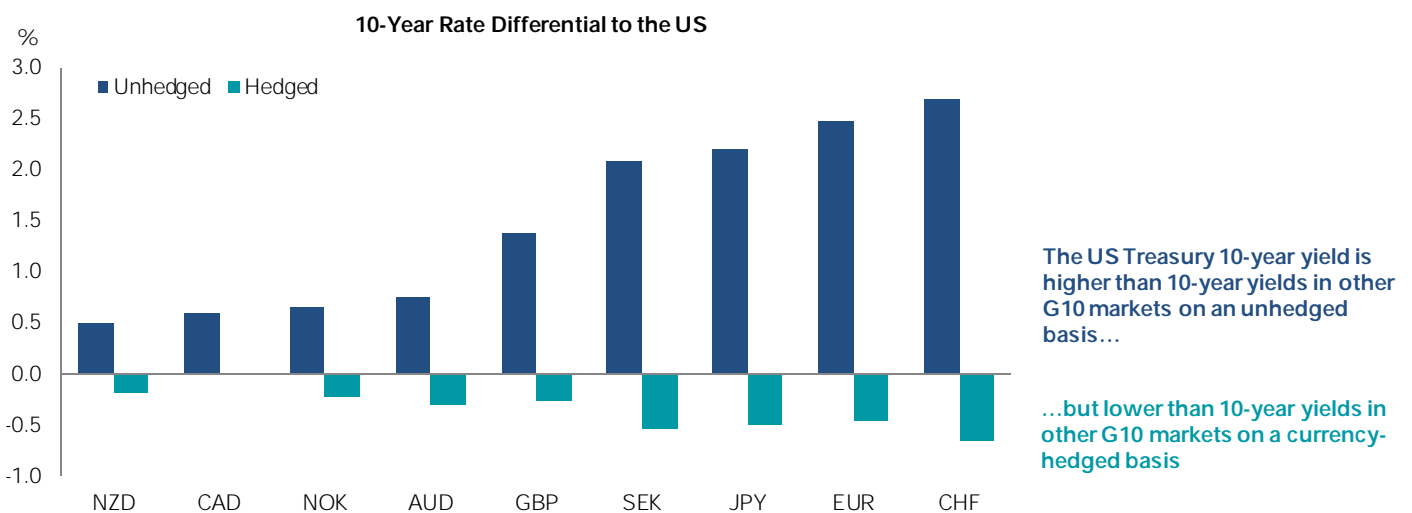
Example: US Treasury yields relative to other DMs on an unhedged and hedged basis

On an unhedged basis, yields in the US appear attractive relative to other DMs. For example, at the 10-year node, US yields are more than 200bps higher than equivalent maturity rates in Germany, Japan, Sweden and Switzerland (Exhibit 7, dark blue bars).

Unless an income-seeking investor is looking to take a view on currencies, they will access foreign rates on a currency-hedged basis to reduce volatility in potential returns. If we assume currency exposure is hedged by rolling three-month currency forward contracts, the 10-year yield differential with the US does not look so appealing. In fact, based on the current cost of hedging currency risk, the yield differential turns negative in all markets (Exhibit 7, turquoise bars).

This is due to money market rate differentials, with three-month interbank rates being relatively high in the US and lower or negative in other markets. Foreign investors pay this differential in order to hedge the exchange rate risk of US Treasury investments. After accounting for money market rate differentials, the average yield differential between 10-year US Treasuries and yields in other G10 markets moves from around 1.5% on an unhedged basis to -40bps on a hedged basis.

Exhibit 7: Currency-hedging costs can enhance but also erode or eliminate yield differentials



Source: Macrobond, GSAM, Bloomberg. As of July 25, 2019. German 10-year used for Europe.

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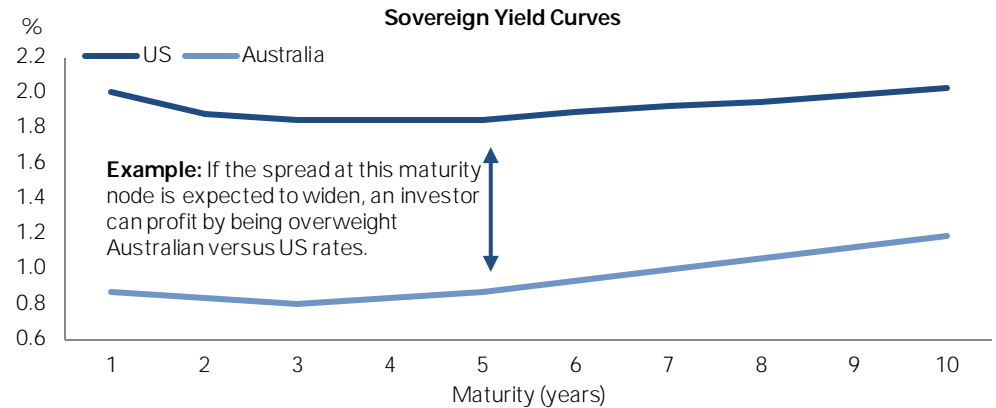
Relative Value Rate Opportunities

Relative rate moves can generate returns...

Although negative yields are unusual, the level of rates does not alter the ability of active investors to identify potential return opportunities based on relative yield curve movements.

These views are typically structured to be directionally neutral, with underweight exposure to a market where yields are set to rise relative to a market where yields will remain unchanged or fall (Exhibit 8).

Exhibit 8: Relative value rate views



Source: Macrobond. As of July 31, 2019.

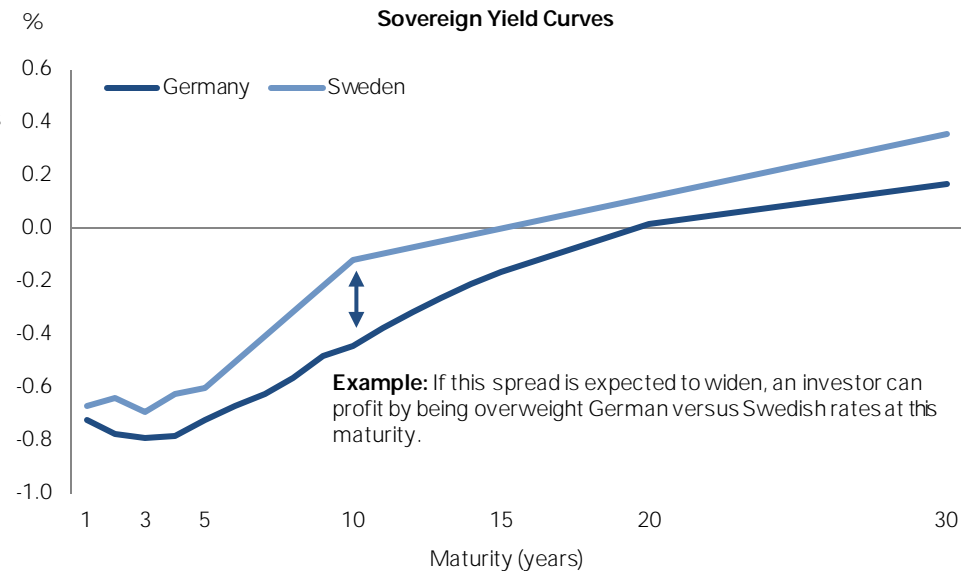
...even when rates in two markets are negative

Central bank policy paths play an important role in determining these sort views; investors can implement positions based on their monetary policy outlooks relative to market-implied pricing.

For example, an investor may anticipate gradual policy normalisation in Sweden given its closed output gap and around target inflation but prolonged policy accommodation in the Euro area due to below target inflation.

If this central bank outlook is not priced by the market and is subsequently realised, a investor will have profited from being underweight Swedish versus European rates.

Exhibit 9: Negative yields do not alter the ability to take relative value rate views



Source: Macrobond. As of July 31, 2019.

The potential return dynamics of this relative value rate exposure is similar to Exhibit 8 even though portions of both the European and Swedish yield curves are in negative territory (Exhibit 9).

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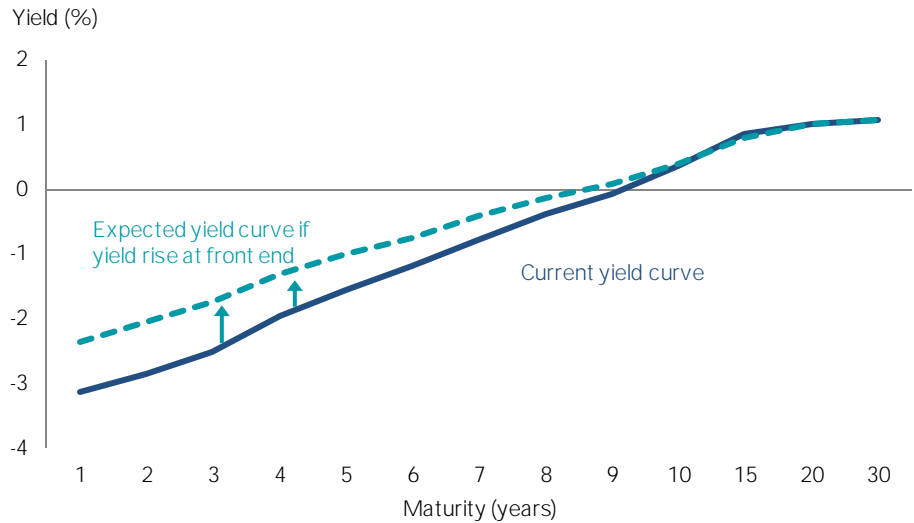
Yield Curve Shape Views

Positioning for steeper or flatter curves and...

Yield curves do not always move in parallel fashion. As such, active investors can position for their future shape. For example, if a yield curve is expected to flatten due to higher front-end yields an investor could sell shorter-dated bonds and move into longer-dated bonds (Exhibit 10).

The same view can be expressed through use of derivatives. Short- or medium-term futures could be sold and if the yield curve expectation is realised this position would prove to be profitable. Interest rate swaps could also be used; paying fixed and receiving floating rate payments would yield a similar economic outcome.

Exhibit 10: Positioning for a flatter yield curve



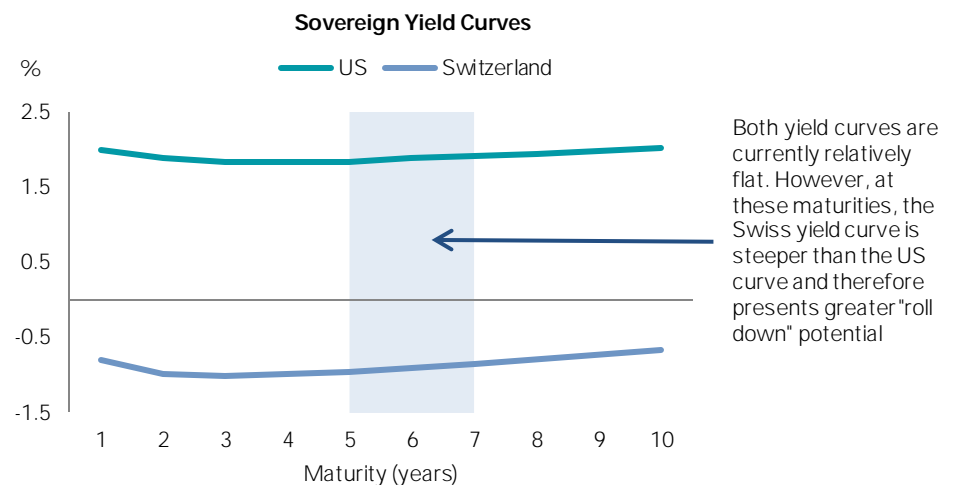
Source: GSAM. For illustrative purposes only.

...identifying roll down opportunities is still possible when yields are low or negative

Another way to position around the shape of yield curves is to take advantage of attractive "roll down" opportunities, namely the tendency for bond prices to appreciate as an investor "rolls down" an upward-sloping yield curve.

Therefore, even if the absolute level of yields are low or negative, an investor can generate returns by taking positions at steep portions of a particular markets yield curve (Exhibit 11).

Exhibit 11: Steep yield curves provide "roll down" opportunities



Source: Macrobond. As of July 31, 2019.

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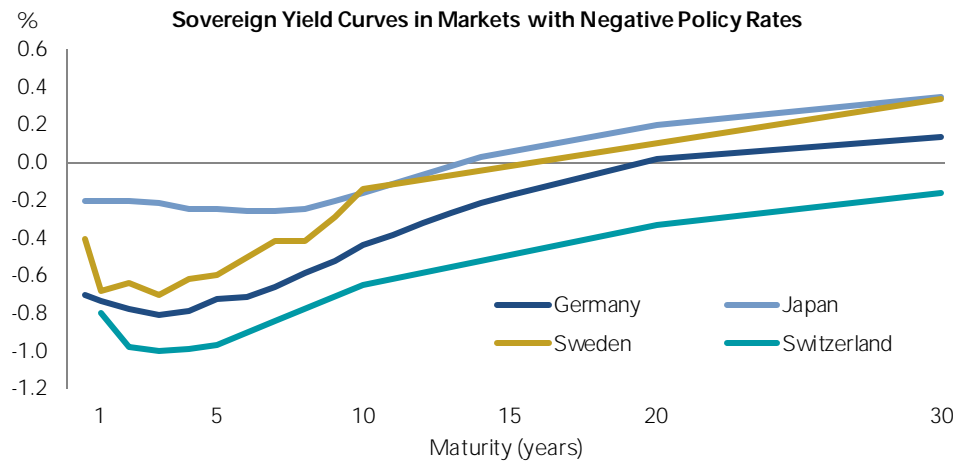
Identifying Low Funding Costs to Earn Positive Carry

Low funding costs means that a negative yielding asset...

Raised expectations for prolonged monetary policy accommodation have extended negative yields to longer maturities and down the credit rating spectrum.

At the extreme, yields across the entire maturity spectrum are below zero in Switzerland (Exhibit 12).

Exhibit 12: Negative yields have extended to longer maturities



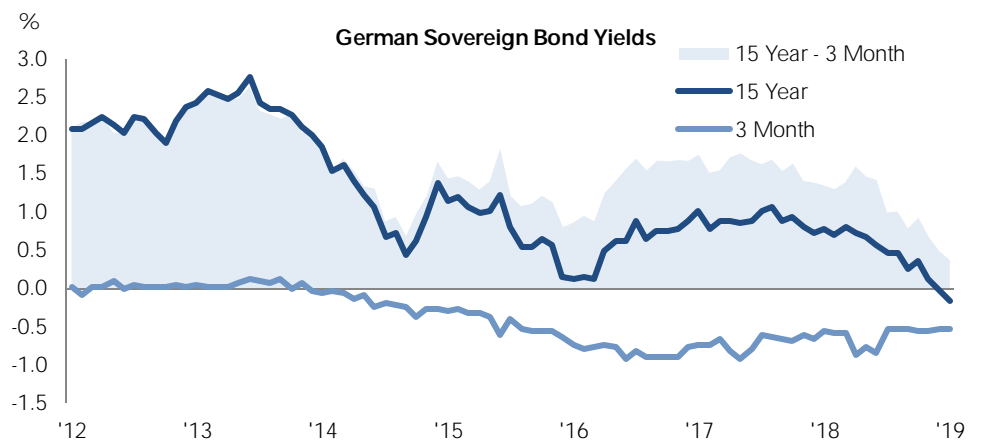
Source: Macrobond. As of July 31, 2019.

...can still generate positive carry

In an unconstrained portfolio, if the purchase of a negative yielding asset is financed at an interest rate that is lower than the bond yield, then the investor can still generate a positive return.

In Europe, for example, funding the purchase of longer-dated sovereign or corporate debt where yields are less negative than short-dated financing can generate positive carry (Exhibit 13, shaded area).

Exhibit 13: Positive carry can be generated with low funding costs



Source: Macrobond. As of July 31, 2019.

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