FIXED INCOME

Why European Fixed Income Can Still Have Value Even with Negative Yield

August 16, 2019

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Amid much discussion of the inversion of the US yield curve, there's been relatively little attention paid to the situation in Europe. John Beck, Franklin Templeton's Director of Fixed Income, London, explains the reasons for a likely continued flattening of the yield curve in Europe are very different from the drivers on the other side of the Atlantic. And, as most commentators brace for further interest rate cuts, Beck argues there's still value to be found in European fixed income, even with negative yields.

Our analysis suggests there's strong justification for the continued flattening of the yield curve in the eurozone, but that it will be different from the flattening of the yield curve in the US.

That's because the economic outlook for Europe is fundamentally different from that in the United States. Europe starts from a position of slower growth, lower inflation and to some degree a lack of full structural flexibility that other markets have.

Crucially, the eurozone has strictures that don't allow significant flexibility around fiscal policy. For example, in Germany there's a constitutional requirement to ensure the structural deficit is no more than 0.35% of gross domestic product (GDP) over the cycle.

While we've seen fiscal entrenchment in the eurozone over the last seven to eight years, by contrast we've seen fiscal expansion in the United States, most recently as a result of last year's high-profile tax cuts.

Europe's Growing External Dependence

One of the main engines of growth for Europe traditionally has been net exports, in particular from Germany.

In the early part of the 2010s, a good proportion of German exports went to other European countries. But as those countries have reduced their fiscal deficits, Germany and the eurozone as a whole have become more dependent on net exports outside the bloc—crucially infrastructure and cars to Asia.

Europe is stuck in the vortex of structural problems that are not fully resolved in the euro system, from weakness of external dependence. And that has implications for how the European Central Bank (ECB) can respond and for investors.

Looking for Yield Further Down the Curve

The ECB is an inflation targetter. With eurozone inflation still someway shy of its target, the ECB has been clear it's not in a position to be hiking interest rates in the short-term.

Couple that situation with a positive yield curve—albeit starting from negative interest rates—and we think it's perfectly logical that investors might consider extending down the yield curve to pick up what yield they can.

That brings us to a real conundrum of investing: the concept of negative absolute bond yields.

In Germany, two-year and 10-year bund yields are negative and that doesn't seem unreasonable to us.

We agree with those commentators, including ECB governing council member Olli Rehn, that have said there's no point in the ECB cutting rates by 15 basis points. We think any action has to be meaningful.

So, we consider there's justification for two-year German bunds trading at negative 90 basis points, and 10-year bunds trading at negative 60 basis points.

Sticker Shock – the Fear of Negative Rates

The issue for investors in Europe in our eyes is "sticker shock". Many investors had not previously experienced negative interest rates and may have been uncomfortable investing in negative yields.

That reticence is understandable: who would buy negatively yielding bonds and hold to maturity knowing they'll lose money? In our view, only someone who thought they could find a buyer at a higher price.

Many investors will conclude that with their recent actions and words, central banks have sent a signal that they're prepared to be that buyer.

At the moment, the ECB can buy up to a third of any outstanding issue, and some commentators are predicting it could raise that cap at some point in the future.

As investment managers, we need to recognise that central banks are a non-price sensitive buyer of a good that is in lesser supply than it was at the start of the financial crisis—because fiscal debt is less. Therefore, it should be possible for prices to go up.

Europe and the US: A Different Dynamic

Our analysis tells us that from a fixed income perspective, Europe is fundamentally different from the United States.

That stems in part from specific weakening growth in Europe and in part from the eurozone monetary policy targeting regime which makes it almost impossible for the ECB to raise rates

However, we believe that with the combination of an expected ECB rate cut in September and a positively shaped yield curve, European bonds could still remain attractive in global terms and that European fixed income has value even at negative yield.

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