The Adverse Effects of Low Interest Rates

The implications of low interest rates on fixed income markets.

April 2019

KEY INSIGHTS

- The current environment of low interest rates has led to unattractive valuations in some parts of the fixed income market.
- Balancing credit allocation with a yield curve steepening position can help to reduce risk.
- There is the potential for the U.S. mortgage-backed security market and European banks to underperform.

With the global economy slowing, the era of historic low interest rates looks set to continue even as some officials have started to question its negative side effects. During our latest policy week meetings, the investment team discussed the implications of this for fixed income markets.

It has been a strong 2019 so far for government bonds as markets have been anticipating softer monetary policies from several major central banks and possible rate cuts in some cases. However, it remains to be seen whether a new wave of quantitative easing would actually benefit the global economy. "Without a fiscal framework, it's not obvious that further easing by the European Central Bank (ECB), for example, will help the eurozone economy," said Saurabh Sud, a portfolio manager and member of the global fixed income investment team.

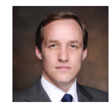
This comes at a time when the International Monetary Fund and other institutions are questioning the side effects of the current ultralow interest rate environment. In bond markets, for example, yields have fallen considerably and curves now offer much less maturity premium as the ultra-accommodative monetary policies from major central banks have led to significant curve flattening. "The prospect of an even longer period of easy monetary policy has pushed more of the fixed income universe into negative yield territory," said Mr. Sud, pointing to the fact that almost USD 9.5 trillion[1] worth of global fixed income securities now have a yield below zero.

Against this backdrop, implementing rate curve-steepening positions as a complement to investing in credit markets has become an attractive proposition. "With its negative correlation to credit markets, a yield curve steepener could

[1] Bank of America Merrill Lynch.

Global Fixed Income Team


Arif Husain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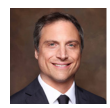
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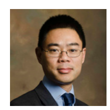
Quentin Fitzsimmons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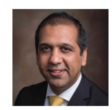
Saurabh Sud

Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

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>
> — **Saurabh Sud**
> *Portfolio Manager*

> The last two rounds of the TLTRO program have not significantly boosted lending to corporations in Europe.
>
> — **Saurabh Sud**
> *Portfolio Manager*

help to diversify returns for a credit portfolio if the global economy enters another soft patch," said Mr. Sud.

The investment team noted that the decline in Treasury yields, combined with the pickup of interest rate volatility, has also made mortgage-backed securities less appealing. Agency mortgages with 30-year maturities tend to be closely linked to long-term Treasuries, which means that, if yields decline, there will be a risk of early prepayment as refinance activity picks up at lower interest rates. This, together, with the Federal Reserve's plans to reinvest proceeds from maturing mortgage-backed securities into Treasuries from October, may result in the sector underperforming U.S. government bonds over the next few months.

The investment team also discussed possible risks for homebuilders. There are, for example, concerns over the affordability of new homes given that consumer incomes have lagged house prices for more than half a decade, while interest rates are another concern. "Homebuilders essentially need a Goldilocks scenario—an economy that is not running too hot or cold," said Mr. Sud. If the U.S. economy becomes too cold, Mr. Sud noted, potential buyers might step back from the housing market even if interest rates fall; if, on the other hand, the U.S. economy runs too hot, rates will rise and we may see a repeat of 2018, when the market ground to a halt. Buying protection on specific low-quality U.S. homebuilders with high debt levels and exposure to more volatile real estate regions therefore makes sense.

In other parts of the corporate sector, bank profits have taken a hit from the historic low rate environment, particularly in Europe. Faced with the possibility of deflation, the ECB adopted a negative interest rate policy in 2014, forcing banks to pay for the privilege of holding excess liquidity with the central bank. Almost half a decade later, this policy remains in place and officials are now wondering whether this is truly effective. Brussels-based economic think tank Bruegel estimates that it is currently costing European banks more than USD 8 billion annually while in the U.S., where rates are positive, banks are estimated to earn about USD 36 billion[2] from parking their excess liquidity at the Federal Reserve. "From a country perspective, we favor U.S. banks over Europe," said Mr. Sud.

There also seems to be a debate currently about the benefits of offering a new targeted longer-term refinancing operation (TLTRO) program to European banks. "The last two rounds of the TLTRO program have not significantly boosted lending to corporations in Europe," added Mr. Sud. Credit research indicates that, for many European banks, a new round of cheap lending might not make much difference in terms of boosting profitability unless its accompanied with a rebound in economic activity. "Buying protection on specific European banks vulnerable to a global growth slowdown is attractive from a cost standpoint," concluded Mr. Sud.

[2] T. Rowe Price estimates.

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