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Interventionary central bank policies may come with detrimental effects

by Alexander Engeln

Over a decade after its beginning, international bond markets still suffer from the consequences of the last financial crisis: a stagnating global economy has given rise to the fear of an economic downturn in the not-so-distant future. With the intention of stimulating the struggling economy, many central banks have repeatedly decreased key interest rates at which banks may borrow money from them in the last decade. However, with many of these borrowing interest rates approaching or already having reached negative levels, this has now led to a record-breaking global level of USD 13.6tn in negative-yielding debt (Figure 1). Assuming a positive inflation rate, with a negative yield lenders are guaranteed to make a loss if they hold that debt until maturity. While this phenomenon of negative yield has historically occurred for relatively safe parts of credit markets, it has also now been observed in traditionally riskier bonds as well. As further rate cuts are all but certain, this trend may have unintended negative effects for the economy, risking the macroeconomic stability in the event of a recession by encouraging both riskier financing behaviour and keeping unhealthy companies alive through cheap loans.

Figure 1: Total amount of global negative yielding debt in trillion USD. *Source: Bloomberg Barclays Global Aggregate Negative Yielding Debt Index*

In practice, the effectiveness of the central banks' strategies will only be clear in hindsight. In theory, however, their measures are aimed at incentivizing banks to profitably loan out their liquidity reserves instead of depositing them with the central banks at a cost (the ECB for example has a current overnight deposit rate of -0.4%). Other measures, such as the ECB's quantitative easing (in which central banks purchase securities, e.g. treasuries, from banks in order to increase liquidity available for lending in the system), were employed with the same intention. The goal of making loans easier to access for the economy has therefore necessitated a significant drop in their key borrowing interest rates, which in turn has seen yields fall to negative levels for an increasing number of treasuries and corporate bonds.

On its own, a negative yield in a sovereign bond may be far from the norm, but treasuries can still be considered the most likely asset to achieve them: with bonds being traditionally seen as a safer investment than stocks and governments being in principle assumed to be fiscally responsible enough and capable of fulfilling their future debt repayments, sovereign debt has always been among the lowest yielding debt instruments. This has led to their designation and use as "safe assets" by many portfolio managers, especially for treasuries from leading developed nations. At the moment, more than half of all European governmental bonds, for example those of Sweden, France, Netherlands, Germany and Switzerland, have been trading with a negative yield, as frightened investors seek safer havens for their capital. In the expectation of further rate cuts and flush with liquidity, emerging markets have begun buying Euro-denominated negative-yielding treasuries in record numbers.

On the corporate side, several firms have currently achieved the same feat of being paid to accept loans from lenders: some investment-grade multinational corporations like Apple, SAP and Coca-Cola have debt trading at a negative yield, with negative yielding corporate bonds approaching a global level of USD 1tn. While default risks on bonds for companies of these brands may appear unlikely due to their sheer size and reputation, rating companies beg to differ: McDonalds for example is rated near the lower end of the investment-grade spectrum, being rated as BBB+ by S&P, just two notches above junk-status. This month, however, has seen even stranger things on bond markets, in the birth of a misnomer: over a dozen 'high-yield' bonds, rated BB+ (S&P, Fitch) or Ba1 (Moody's) and lower (representing the riskiest bonds on public credit markets), have been observed trading at a negative yield as well.

As the Bank of International Settlements noted in a quarterly review in 2018, one negative effect on the economy caused by prolonged periods of low debt servicing costs and easy access to new funding, is that companies, which would otherwise be unsustainable in the long-term, are able to stay afloat. These so-called "zombie" companies have a detrimental effect on the overall economy, as they are diverting flows of investments away from more competitive and productive companies. Although bonds from junk-rated companies achieving negative yields cannot directly be linked to the existence of such zombies, it is an indicator of investors' acceptance of a significant risk even in supposed "safer" assets. This in turn may be contributing to a rising number of zombie companies during the currently stagnating global economy. Should an economic downturn occur despite the central banks' interventionary policies, such zombie firms are expected to default due to unsustainability (caused by unprofitability, high financing costs etc.), having also weakened others in the process of staying alive. Instead of encouraging growth as intended, cutting key interest rates too deeply would therefore inadvertently weaken the economy.

The risk of such times seems to be growing: while both investment-grade and junk-grade companies are currently delighted to take advantage of the low cost of debt, market expectations for the coming years are far from optimistic. Despite interventionary policies by the world's central banks, economic growth rates have slowed to a crawl and industry outlook has dropped to a multi-year low in export-oriented economies like Germany. When looking at the average NUS-CRI Forward 1-year Probability of Default (PD) for both investment-grade and junk-grade companies offering a significant amount of negative yield bonds[1] (Figure 2), fears of such an event seem warranted, as a rise can be observed for both groups in the next five years. This forward PD can be interpreted similar to a forward interest rate (for example, the 7-month forward 1-year PD is the probability that a firm will default during the period from 7 months onwards to 1 year plus 7 months, conditional on the firm's survival in the initial 7 months from the point of calculation).

[1] It should be noted that junk-rated companies which see demand for significant amounts of negative yielding debt, are among the safer-rated junk bonds.

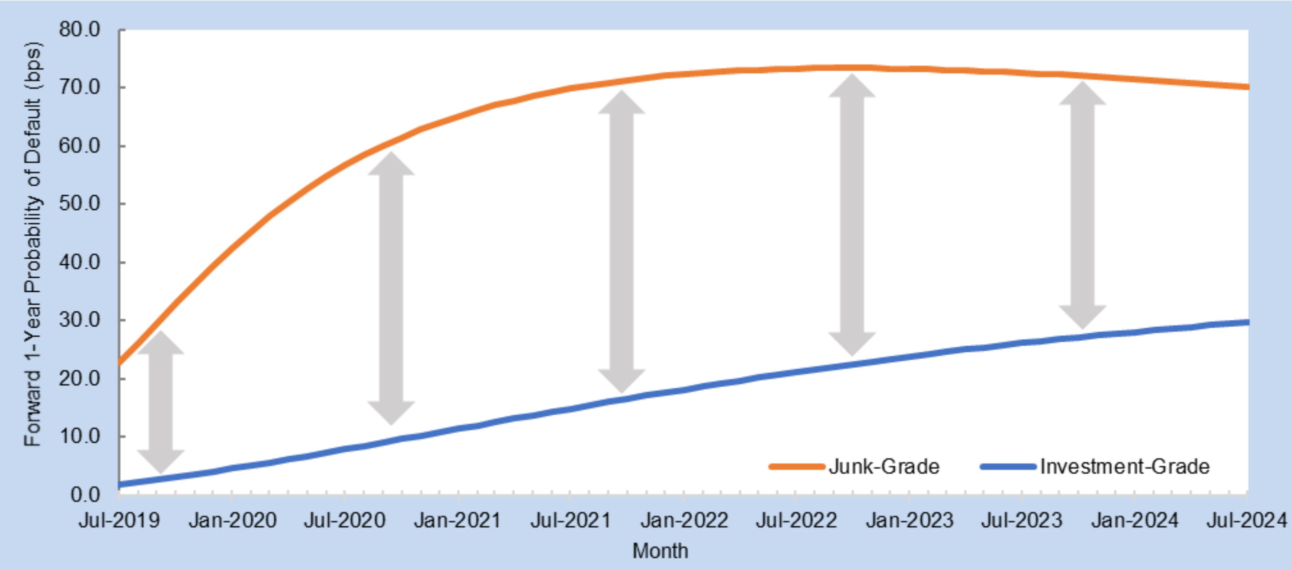

Figure 2: Forward 1-year PD for a selection of significant issuers of junk-grade and investment-grade bonds. *Source: NUS-CRI*

As shown in the widening spread between the two groups, the coming two years are expected to provide significant economic hurdles for junk-rated companies, despite current market expectations of further rate cuts. Investment-grade companies will be faced with a significant increase in PD as well, but are expected to cope better with the changing conditions, as their rise in PD is more gradual. Even though all companies are currently incentivized to take on additional debt, in the event of an economic downturn especially the lower-rated firms would be faced with severe repayment difficulties. This may lead to an increased number of defaults, which would affect lenders more strongly because of increased levels of current debt for such risky companies. In the long-term, the difference between the two groups is expected to reduce again, but the average PD is not predicted to recover to lower levels for either of them.

Although the discussed potential consequences are partly why these central bank policies have been controversial among economists, as it stands, further dovish policies are expected and make a future increase in negative yielding debt likely. While these actions may aim at encouraging growth in an anaemic economy, they increase the risk of zombification and may lead to a weakening of economic resilience through riskier investor and financing behaviour instead. If central banks will be able to achieve their intentions of preventing an economic downturn by walking such a fine line, remains to be seen.

Credit News

Chinese high-yield debt is a rare bright spot for bond investors

Jul 28. Bond yield around the world have fallen so much that global investors are shifting their attention to Chinese junk bonds, as most of the Asian high-yield bonds are from Chinese companies with average yields of more than 7%. Asian dollar-denominated high-yield debt issuance is on pace to hit an annual record this year, and Chinese companies account for about USD 38bn of this, or more than two-thirds of the USD 59bn raised so far this year. On average, dollar-denominated junk bonds from Chinese companies were recently yielding 7.9% versus 6.0% for U.S junk bonds and 3.1% for euro-denominated high-yield debt, according to ICE BofaML indexes. (WSJ)

CLO market prepares for downturn by pushing to swap defaulted assets

Jul 26. Investors in US Collateralized Loan Obligation(CLOs) funds are increasingly pushing managers to include more flexibility in deal documents to address loan defaults as the market prepares for an economic downturn. Managers are being asked to include the ability to swap out defaulted or deeply distressed assets with other similar loans that will perform better during the next downturn. The US CLO market, the largest buyer of US leveraged loans, is preparing for an increase in defaults, which is expected to result in lower recoveries after years of low interest rates allowed companies to pile on debts easily with loose documents and few lender protections. PGIM included so-called purchased defaulted obligation or a swapped defaulted obligation language in its recent Dryden 68 CLO that allows the manager to purchase a different defaulted loan using all or a portion of the sale proceeds of another defaulted obligation. (Reuters)

Junk bond issuers snap up chance to stretch out borrowing

Jul 26. The Brazilian meat processor JBS delivered its promise of longer-term debt and lower borrowing costs to its shareholders: its US arm sold USD 1.25bn of high-yield bonds on July 23, 2019, repayable in 2030, to refinance existing debt due in 2023 and 2024. It joined several companies – with low scores from credit rating agencies – that took advantage of ultra-low interest rates and strong demand from investors to load up on cheap money and issue longer-dated debt, a trend mimicking the post-financial crisis era. Expectations of rate cuts have raised concerns among investors that companies will be encouraged to take on more debt than they can handle, which means that investors are lending to risky companies at low rates. The long maturity of new bonds have also been a subject of debate. On one hand, longer-term maturity exposes investors to higher default risks but on the other hand, it could alleviate pain, reducing likelihood of an issuer defaulting as it may not need to refinance during an economic downturn. (FT)

The municipal-bond market is now controlled by just a few firms

Jul 24. A few firms are now increasing their dominance in the municipal market, lowering prices for many investors but also sparking concerns about concentration and influence. People are increasingly using professional money managers to invest in both high-and low-grade state and local government debt. Individual investors can benefit from the concentration. By buying a share of the fund, rather than owning a single municipal bond outright, they increase diversification and can reduce their losses in case of a default. And when asset managers increase their base size, they pass down benefits such as lower fees. Despite concerns that money managers may dominate the markets, muni-bond funds are on track for big years. High-yield funds have secured USD 11bn in new money this year and are on track for the biggest inflows through July since at least 1992, according to Refinitiv data as of July 10. Size is a also a big advantage in muni bonds as they allow firms to buy larger bonds and therefore form closer relationships with underwriter. (WSJ)

China's credit push to small firms falters in factory heartland

Jul 24. China has been encouraging its lenders to boost loans to small firms, a tool to support the economy during the current economic slowdown. Yet banks remain reluctant to lend due to the uncertain economic outlook, the US-China trade war and tightened risk control by banks. This has chilled credit flows to private sectors – with many exporters and manufacturers struggling to pay their debt and looking to relocate their production overseas. Banks have been tightening scrutiny and imposing stricter risk controls especially on exporters affected by the trade war. In response, Chinese policymakers are calling on the Big Five state banks to head the lending stimulus, setting a target to increase loans to small firms by 30% and cut their rates by 1 percentage point. Yet some small companies' appetite to borrow has diminished as economic prospects dim. All these serve to undermine the stimulus measures designed to cushion the impact of slowing down. (Reuters)

India bond yields fall as finmin backs rate cuts, reaffirms foreign bond issue plan (Reuters)

China's embattled Jinzhou Bank courts investors as bonds tumble (Bloomberg)

Negative yields see record euro borrowing from emerging markets (Reuters)

Regulatory Updates

House passes bipartisan debt-limit, budget deal backed by Trump

Jul 26. The house passed a two-year debt ceiling extension and budget bill that will lessen the chance of a shutdown this fall and put any risk of a U.S. government default off until after the 2020 elections. The measure would allow a USD 324bn increase in discretionary spending over two years over existing budget caps. Most Republicans did not back the vote despite President Trump's having urged them to support it. Congress will still need to scramble in September to pass spending bills adhering to the new USD 1.3tn spending cap to fund the government when the new fiscal year begins Oct.1. Congress will work in September on passing spending bills to avoid a shutdown. There is also the outstanding risk that a dispute over a specific funding proposal, such as a border wall, between the Democrats and Republicans could cause another shutdown. (Bloomberg)

The euro area bank lending survey – second quarter of 2019

Jul 23. According to the July 2019 bank lending survey, credit standards tightened in Q2 of 2019 for loans to enterprises (net percentage of reporting banks stood at 5% versus 1% in Q1), marking the end of the net easing period started in 2014, as concerns about the economic outlook and increased risk aversion translated into tighter internal guidelines and loan approval criteria despite favourable funding conditions. Credit standards also tightened for consumer credit (net percentage of reporting banks increased to 4% from 2% in Q1), in line with developments in the previous quarter, while they remained broadly unchanged for housing loans after a tightening during the previous quarter (net percentage of reporting banks at -1% versus 3% in Q1). Loan demand continued to increase across all loan categories. The tightening of credit standards on loans to enterprises and consumer credit to households is mainly due to banks' risk perceptions and risk aversion. Banks' tightening overall credit terms and conditions for new loans affected margins on average NFC loan, potentially signifying the end of a favourable cycle since 2013. (ECB)

U.S. bank regulators sign off on 'living wills' for 82 foreign banks (Reuters)

ECB faces key decision over launch of fresh stimulus (FT)

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