Investment Insight

THE CONUNDRUM OF NEGATIVE INTEREST RATES:

GENERATING INCOME AND RETURN IN AN UNPRECEDENTED ERA FOR FIXED INCOME

Negative interest rates have posed a conundrum for the global economy and the financial markets over the past. They have provided economic stimulus and support since the Global Financial Crisis but have upended our previous understanding of economics. The Covid-19 pandemic and the monetary and fiscal support necessary to offset its impact has increased the incidence of negative interest rates but even before the onset of the pandemic, interest rates in Japan and parts of Europe were at, or below, zero for many years.

The consequences of negative interest rates for economies and investors are dramatic, not least because they have made it all but impossible for fixed income investors to offset long-term liabilities and generate income from investment grade government and corporate debt. Unlimited liquidity and government borrowing should lead to growth but also to inflation and to higher nominal if not real interest rates, but have not so far.

Charlie Munger, the famed investor, has said that if you are not confused about negative interest rates, you are probably not thinking about it correctly. We do not purport to understand them but have to navigate them nonetheless.

In this insight we explore the impact negative interest rates have on companies and the consequences for investors. First, however, we think it is important to understand how we got to this point.

The path to low / negative interest rates

The current low, and in many cases negative, rate environment is primarily the result of monetary policy and quantitative easing (QE) measures, designed by central banks to stimulate economies after the Global Financial Crisis (GFC) in 2008-09. The policies were expected to force banks to lend to businesses and consumers and to act as a tool to depreciate currencies and to encourage trade, particularly in open economies where trade is a big component of GDP. The prospect of a global recession induced by the recent Covid-19 pandemic has prompted another wave of policy measures with the same intended impact.

Central bank actions have given rise to a pattern that has become apparent over the past decades: sharp rate cuts each time there is a recession, followed by more gradual tightening cycles, each one less pronounced than the last. Take the US, for instance, where the Federal Reserve Bank rate reached 2.5% in 2019, half of what it was in 2007 and almost a third of what it was at its peak in 2000. Meanwhile, Bank of Japan rates have been extremely low throughout this period, with negative rates first announced in 2016 as Japan tried to promote real economic prosperity.

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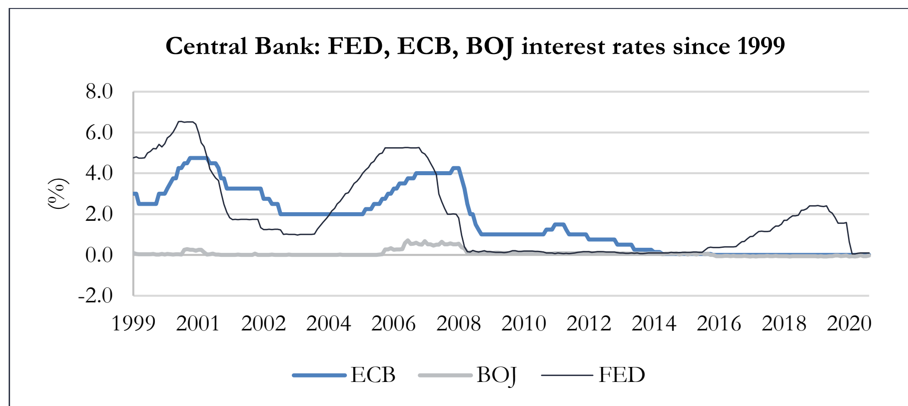


Source: J. Stern & Co. analysis, Bloomberg

Whilst not new, QE and negative interest rates arguably constitute the biggest monetary policy experiment in modern times. The effectiveness of this experiment in spurring economic growth is debatable given that global growth since 2008 has been steady but not strong and that there is no counterfactual of what would have happened in its absence. This is partly due to the fact that negative interest rates erode banks' traditional source of income, by squeezing net interest margins, which subsequently limits their ability to lend. This is of course exactly the opposite result to what was originally intended, as only a fraction of the money created by central banks finds its way into the real economy.

However, what is clearer is that the flood of cash into financial markets has been extremely supportive of risk assets. The pandemic marks the second time in just over a decade that policymakers have taken measures to avert economic collapse, and it has led many to believe that central banks will come to the rescue whenever the market falters.

The result has been to encourage investors' risk appetite, given expectations that central banks will act either as lender (e.g. during the GFC) or buyer (e.g. during Covid-19) of last resort. Expanding on this point, whilst there is a precedent for central banks providing liquidity to avert a credit crisis as seen in 2008-09, more recent measures such as the Fed's buying of ETFs (exchange traded funds) and 'junk' corporate bonds, is something we have not seen before. Meanwhile in Europe, ECB president Christine Lagarde has stated that the bank will do "everything necessary within its mandate" during such extraordinary times, which was somewhat reminiscent of Mario Draghi's 2012 statement that the bank would do "whatever it takes" to save the euro in the wake of a sovereign debt crisis.

Consequences for corporate debt

Global corporate bond issuance reached a record $2 trillion in the first half of 2020, up 49% year-on-year, as companies across the globe took advantage of low borrowing costs to refinance their debt at a record pace, and in many cases with much longer-dated debt.

Rising corporate debt levels can be concerning, particularly when companies increase their debt in order to fill the gap caused by lower revenues and increased cash burn. This is why it is imperative to distinguish between those corporates whose business model and capital structure are unsustainable, and those who are issuing debt either as part of a disciplined liability-management exercise or to fund accretive opportunities for mergers and acquisitions. Our focus has been on selecting companies that fall into the latter categories.

Take Millicom for instance, a leading provider of cable and mobile services in Latin America. We were invested in a 2025 maturity bond with a coupon of 6%. The security had embedded optionality allowing the company to call the bond early, which the company duly took advantage of. It was able to raise new debt in the current environment at 4.5% with a maturity of 2031 – i.e. cheaper for longer. Meanwhile Kernel, a Ukrainian diversified agri-business, issued a 7-year bond with a coupon of 6.75% earlier this year to refinance its notes maturing in 2022, effectively lowering its interest expense by 2% and pushing out its debt maturity profile.

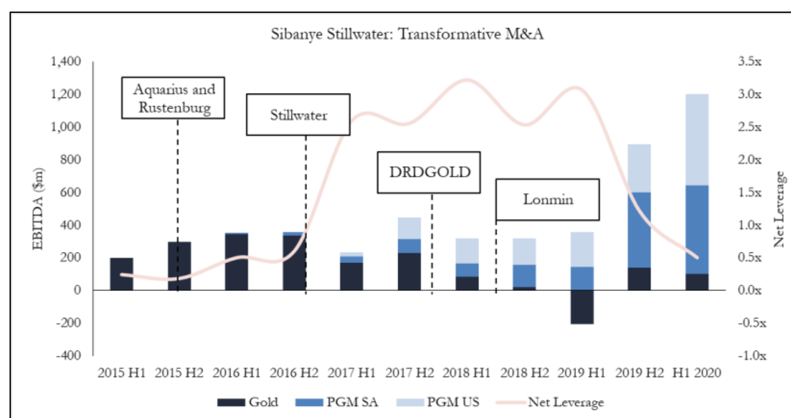
Recent Refinancing Activity

	Initial Bond		New Bond			
Company	Coupon	Duration (years)	Coupon	Duration (years)	Interest Savings	Duration Extension (years)
Millicom	6.00%	7	4.50%	10	**1.50%**	**3**
Kernel	8.75%	5	6.75%	7	**2.00%**	**2**
Helios	9.13%	5	7.00%	5	**2.13%**	**0**
IHS	9.50%	5	8.00%	8	**1.50%**	**3**

M&A is an important argument for the benefits of raising debt in this environment. The stress of the pandemic has put financial pressure on many weaker businesses. This in turn has presented good-quality corporates (with strong balance sheets and access to cheap debt financing) with some very attractive opportunities for M&A. Provided that companies are disciplined with their capital allocation and focus on value accretive deals, this will drive consolidation in certain sectors and ultimately improve long-term growth prospects.

M&A has been an opportunity for our own holdings, for example Helios Towers, one of Africa's largest independent mobile tower operators. It announced earlier this year that its medium-term target is to increase its tower count from around 7,000 towers to 12,000 towers, while expanding operations from five to eight markets across Africa. In August it released news on the first of these acquisitions, with the purchase of 1,220 towers in Senegal. This will further consolidate the African tower market, while increasing the group's market share and geographical diversification.

Another one of our holdings, Sibanye-Stillwater, which was originally a high-cost South African gold miner until a few years ago, has used cheap debt financing to acquire a number of attractive platinum group metals (PGM) and gold assets at bargain prices over the last few years. This strategy has proved to be extremely effective as the group is now the world's



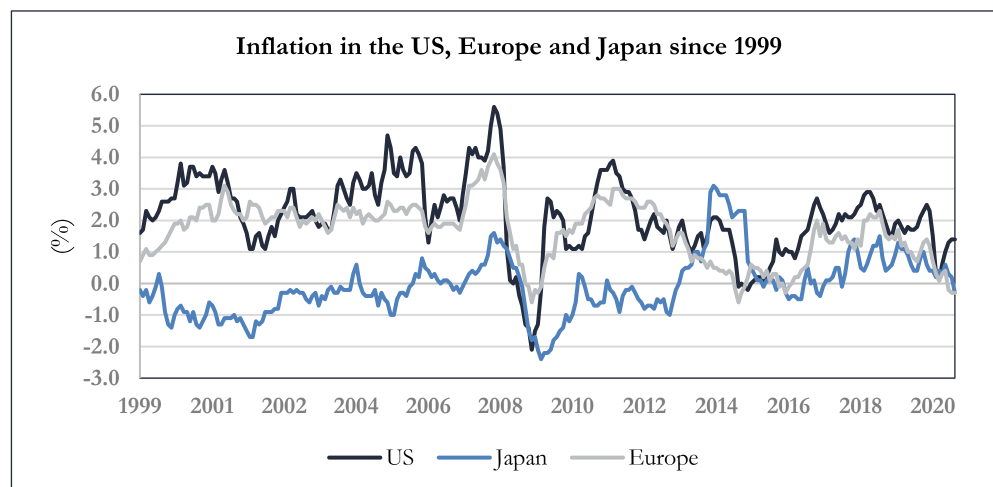
Source: J. Stern & Co. analysis, Sibanye-Stillwater

largest primary producer of platinum and rhodium, the second largest producer of palladium, and a top tier gold producer. Even more impressive is that they have used the strong cash flow which has been generated from these acquired assets to subsequently pay down their debt almost entirely.

Outlook for interest rates: Lower for longer

Given the implications on corporates, it is important to think about how long the current interest rate environment could prevail. Originally interest rates cuts to negative territory were part of emergency measures, with the moves intended to be temporary. However, with its dual mandate, Fed Chair Jerome Powell has stated that unemployment levels need to be accompanied by inflation before considering a rate hike, at the same time as loosening the Fed's interest targeting established a decade ago. Therefore, inflation is key.

Economic theory would predict that unlimited infusion of cash into the financial system would create high inflation over time. In its basic form, inflation comes about when demand exceeds supply, as arch-monetarist Milton Friedman aptly put it, "too much money chasing too few goods". Surprisingly though, despite all the stimulus measures over the last decade, global growth has been muted and US, European and Japanese inflation has not only failed to increase as predicted but has been below the Fed's medium-term objective of keeping inflation at c.2%.



Source: Bloomberg

If this were a temporary effect, it is possible to argue that although there has been disruption to the supply side of the economy, there has been a much larger hit to aggregate demand as unemployment has soared, consumers have remained at home and savings rates have risen. However, given that inflation has failed to break out of its limited range for an extended period, multiple hypotheses have been proposed which suggest inflation could be contained more permanently, with ideas around rates of innovation, robotics and change in demographics to name a few. Crucially, financial markets appear to have a similar view, as illustrated by the five year forward breakeven rates in the US, which are no higher now than they were before the pandemic hit, and well below the Fed's 2% target rate.

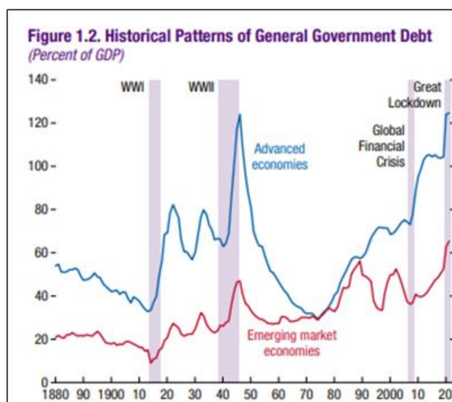
Source: Bloomberg

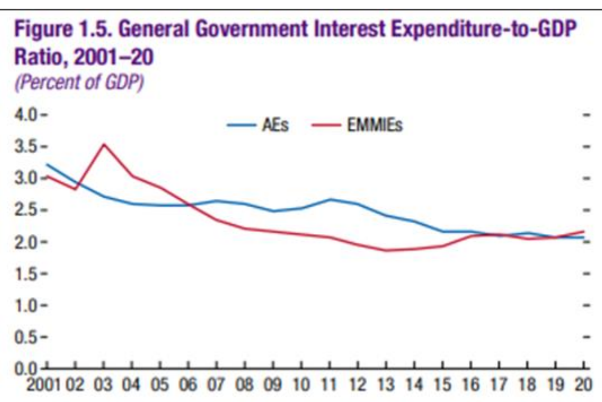
Some countries will likely find it difficult to reach their inflation targets, but they may be reluctant to follow the Japanese example of triggering negative rates, and therefore the zero rate may be a lower boundary. Either way, interest rates are likely to remain low for some time as it is hard to reverse such a policy in a low growth, low inflation world, and even harder to reverse it the longer such policies stay in place, as illustrated by Japan. Moreover, it has been argued that factors like globalization, technology and innovation have contributed to a decline in the natural rate of interest (the interest rate that supports the economy at full employment/maximum output while keeping inflation constant). If this is the case, it would suggest that rates would not go back to previous levels unless those factors change.

Monetary policy exhausted – Time for fiscal?

The lack of additional monetary ammunition has resulted in a watershed moment for economic policy, and the overarching view has now turned from central bank action to government support. Olivier Blanchard, former IMF chief economist, recently went so far as to say that "it is all about fiscal policy now". The pandemic has triggered an unprecedented fiscal response and the IMF estimates that measures announced globally have exceeded $12 trillion, adding up to about 12% of global GDP and multiple times the amount spent during the GFC.

One of the central concerns over increased fiscal stimulus is that it will lead to a deterioration in government budgets and ultimately unsustainable debt levels. Deficit spending has led to governments amassing huge debt loads over the years, with government debt to GDP trending higher in most developed countries. In the Eurozone it now stands at 84% of GDP, in the US at 106%, and in Japan higher still at 237%. Rising debt levels are not limited to





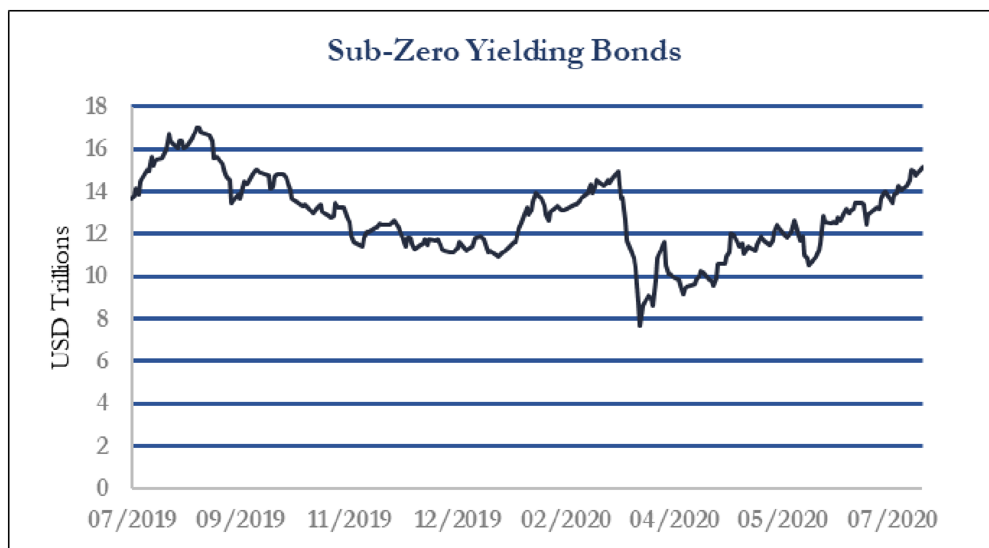
Source: IMF

governments and have also been seen across the private sector. All together, global debt rose by over $10 trillion in 2019, topping $255 trillion (according to the Institute of International Finance) and is set to rise further in 2020 with the Covid-19 fiscal response in full swing. At over 322% of GDP, global debt is now 40% ($87 trillion) higher than at the onset of the 2008 financial crisis.

Whilst the notional level of debt is high and likely to take many years to come back down to pre-Covid levels, it is far more important to look at the cost of servicing this debt, which is more affordable than ever. When GDP growth exceeds the cost of borrowing and real rates are so low it makes sense for governments to borrow in order to invest, so long as it is done sensibly and on targeted initiatives. These include healthcare, education, and digital and green infrastructure which will create sustainable, long-term growth.

Consequences for investors: How to generate income and returns

The plight of investors looking for yield has gone from bad to worse in recent years, with pension funds increasingly struggling to narrow their liability gap. Continued bond purchases by central banks have been supportive of higher prices and lower yields, but it has meant that the global stock of government debt which has a negative yield has now reached $15 trillion, or c.25% of the market. This has amplified the search for yield among investors and increased the appetite for risk taking. Additionally, it has had the impact of putting downward pressure on term premium, causing investors to seek out longer-dated assets.



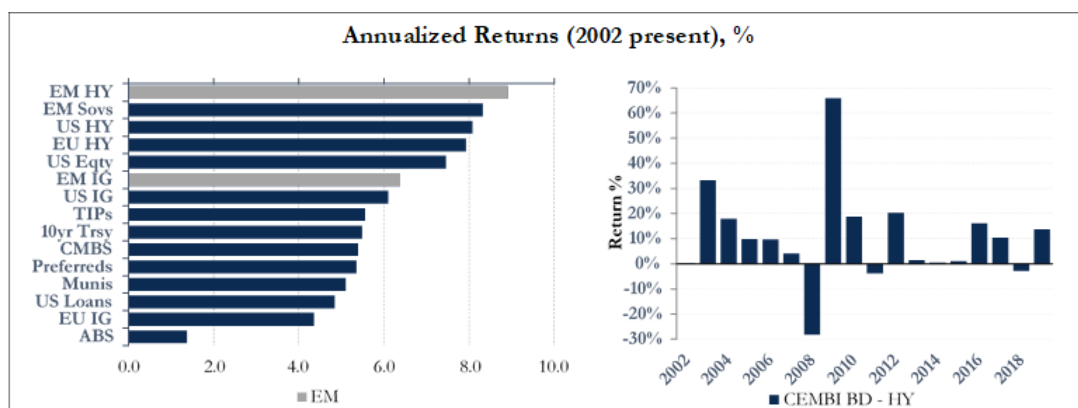
Source: Bloomberg

One of the more problematic consequences is that investors have been increasingly moving away from public markets and turning to less traditional asset classes such as private equity, private credit, real assets, and real estate in order to fulfil their yield and return requirements. Allocation to these alternative asset classes has been growing rapidly since the global financial crisis, and is forecast to increase another 40% over the next three years to $14 trillion, according to alternative data provider Preqin.

There is no doubt that investors' view of alternatives has been ever-changing. The GFC exposed the liquidity and structural risk of alternative private, leveraged and structured investments from conventional private equity and real estate to more innovative subprime mortgage CDOs and similar structures. Investors are at risk of abandoning those lessons and

embracing the wrong kinds of risk. Alternatives do have their benefits and can offer good diversification in a portfolio, but these strategies are not for everyone. Structural risks, implicit and explicit leverage, high fees and minimum investment amounts are among the common concerns but perhaps the biggest risk to the asset class is liquidity. In many cases, once money is committed it is tied up for years, and if investors are forced to sell these assets quickly through secondary transactions in distressed markets, it could only be at a steep discount.

We argue that there is still yield to be found in select areas of fixed income, in particular within emerging markets (EM) corporate debt. While EM high yield corporate debt is widely perceived as risky and volatile, it has generated 9% per annum since 2002 (Bank of America HY index), with only three years of negative returns over the period. The pursuit of income generating assets has propelled the growth of the asset class from less than $350 billion in 2008 to $1.5 trillion in 2019.



Source: JP Morgan, Bank of America

Conclusion — Knowing what we know, and what we don't

Charlie Munger also famously said "micro is what we do, macro is what we put up with". We are not economists or market strategists. Our conviction is to focus on the fundamentals of the companies we invest in and to base our investments on our analysis and our judgment of the likelihood of those companies to achieve their objectives and to generate the capital required to sustainably manage their liabilities. This focus on micro does not mean that we can avoid having macro views, but they are a consequence of our bottom-up analysis and not a top-down driver for our investment decisions.

The companies in major emerging markets that issue US dollar debt are often the leaders within their industries, exposed to a diversity of businesses, with significant scale, strong underlying fundamentals, long track records of sound management and capital allocation and importantly long experience in issuing, managing and repaying US dollar debt offerings. They are often less researched than similar companies in developed markets and offer greater opportunities for differentiation and security mispricings, not least in terms of improving communication and disclosures about financial and increasingly ESG issues.

The opportunity arises because of investors' focus on macro not micro. Corporate ratings in emerging markets are constrained by the country rating of the countries they are based in. The market for EM corporate debt is no longer a pure play on commodities as evidenced by our strategy's exposure to a broad range of industries across multiple jurisdictions. That is

why we believe EM corporate debt offers the opportunity to receive a significant premium for country and other risks.

One last word of wisdom from Charlie Munger's business partner Warren Buffett: "Risk comes from not knowing what you are doing". Our fundamental, bottom-up investment process allows us to focus on what we know and to select individual investment opportunities where the perceived risks are greater than the actual risks within this asset class.

Investing in such EM corporates requires a sound understanding of the fundamentals and a long-term approach that takes into account the occasional bouts of illiquidity and sell-offs driven by macro-events and investor flows. However, our portfolio also offers a current yield above 6% in US dollars with very short duration, without the liquidity and structural risks that are required by alternatives offering comparable results, and offering an attractive level of income and return in this unprecedented environment of low and negative interest rates.

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