Scarsdale Investment Group, Ltd.

All Bond Portfolios

How to Invest in Negative and Low Interest Rate Environments

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October 14, 2019

As individuals, we are always seeking certainty. However, Yogi Berra nailed it when he was reputed to have said: It is hard to make predictions, especially about the future. We personally know that we can’t predict the future.

Knowing that we know that we don’t know, gives us a firm place to stand. However, there is an entire industry purporting “to know” and encouraging you to follow their predictions.

Following the pundits’ advice, the *average investor’s gains in the S&P 500 over a 20-year period was 1.96 percent*, though the S&P 500 delivered a 5.6% compounded annual growth rate.[i] “The **average [stock market] investor’s gains over the last 20 years were much lower than a 100% bond portfolio.”**[ii] Doesn’t that argue for investing in bonds?

In January 2019, there were many financial analysts who predicted rising interest rates. This was good for their business. If interest rates were to rise, portfolios must be reorganized. The analysts recommended a three to seven-year bond horizon. They purchased high coupon bonds without regard to possible calls because the consensus was that interest rates would rise.

Many asset managers are still buying short-term bonds with 5 percent coupons in order to capture the rising rates. Yet, there is the possibility that interest rates on Treasury bonds may go negative in the US! President Trump tweeted his affirmation of this policy on September 10, 2019, hoping to influence the Fed.

The Federal Reserve, for the first time in 10 years, cut the Fed Funds rates by 0.25 percent on July 30th, then in September another 0.25 percent. Though the Fed took these actions, there was no consensus, with a threeway split on whether to hold, raise or lower interest rates. It is unclear what the next Fed action will be.

How Would Negative Rates Affect You?

Negative interest rates occur when YOU – the investor – PAY the bank, mutual fund, ETF or bond issuer to hold your money. You must be thinking that this idea is really weird! Why would an investor make such an investment? What is wrong with a mattress?

Here is a simple example of negative interest rates. You buy a one-year $100 face value Treasury bill for a price of 101. At the end of the year the Treasury pays you back $100. You lost $1 (negative interest rate of 1%). In 2008 yields went negative on United States Treasury bills and they are currently negative in Europe and Japan.

When an economy weakens, investors look for ways to protect their principal. They want to know, just like you, that the money they worked so hard for is protected. When there is too much money looking for a safe haven, things can get really wonky.

Leaders in Negative Interest Rates

Negative interest rates are not just a possibility. They are real and alive. Europe has been experiencing negative interest rates for some time. On August 22, 2019 there was $17 trillion in negative debt worldwide, up from $12 trillion on June 19th 2019. Switzerland, Denmark, Sweden and Japan all have negative rates.

In August 2019, the entire yield curve for German government bonds (from short-term to 30 years out) had negative interest rates. At that time, the German Central Bank was disappointed in the limited sale of zero rate 30-year German government bonds maturing in 2050. They previously had a successful sale of 30-year German government bonds. But this time out only 1/3 of the bonds were sold at a record low negative yield of -0.11 percent. [iii] Is there a limit to negative debt?

Bond Market Segmentation a Buffer Against Negative Interest Rates

If the Treasury yield curve goes negative, this does not necessarily mean that the municipal bond yield curve will be in negative territory as well. Municipal bonds do not have the same risk-free status as Treasury bonds. Here are some other differences.

- Sources of Payment: Municipal bonds are backed by state and local governments, or by specific revenue streams. Treasury bonds are backed by the full faith and credit of the federal government.
- Tax policy changes: The federal government makes tax policy for municipal governments. There is more uncertainty with municipal bonds because you never know what future tax policy will be and how it might impact the municipal tax-exemption.
- Demand: The Tax-Cuts and Jobs Act of 2017 made tax-exempt municipal bonds less attractive to hold for Banks and Property-Casualty Insurance Companies without diminishing the attractiveness of the bonds for Life Insurance Companies. It has increased the desirability of tax-exempt bonds for individuals.
- Supply Imbalance: The 2017 Tax Act limited state and local tax-deductions on the federal return to $10,000, which particularly impacted the blue states. At the same time the federal government eliminated advance refunding of bonds, reducing the annual supply of new issue tax-exempt muni bonds by about 20 percent. The result is greater demand for less product. That is a recipe for higher prices and lower yields.
- Liquidity Risk: The spreads between the buy and sell price is narrower for Treasury bonds than for municipal bonds.
- Optionality: Most municipal bonds can be redeemed by the issuer ten or fewer years after issuance, while Treasury bonds do not have any calls. The possibility of bond calls makes it much more difficult to plan for the future.
- Longer Maturities: Since municipal bonds can be called before their maturity date by the issuer, there are relatively fewer shorter term munis – which are in high demand- compared to a greater supply of longer dated municipal bonds.

The question that arises is: What do I do now? How do I deal with my need for income and safety of principal in the current market environment?

Reinvestment Risk

Most investors are familiar with ‘interest rate risk.’ It is the risk that the value of their bonds will decline, if market interest rates increase.

Less known and discussed is “reinvestment risk”, which is hitting savers particularly hard. This risk captures the possibility that when your bonds are called or come due you will have to reinvest at lower interest rates. This impacts pension funds, annuity rates, and you directly.

Many financial advisors told their clients to protect their principal from interest rate risk by purchasing a short-term bond ladder in preparation for higher interest rates. If you followed that strategy, the result is that you now find that your bonds are coming due and you have to reinvest at much lower yields. If you own those nice 5 percent coupon bonds then your brokerage statement might show that they have been called in and that all of the high premium you paid will never be recovered. It has gone up in smoke.

For investors who have ridden the stock market horse and are now thinking about switching to bonds, you face the daunting question: Should I buy short-term fixed income securities such as a money market fund, invest short term, or bite the bullet and invest in longer maturities at these low yields?

A Bond Ladder

For those investors seeking to enter the bond market at this time we recommend a traditional old-school bond ladder. This is a good strategy to deal with the fluctuation of interest rates and the spectrum of negative interest rates. We understand at a deep level that we cannot predict the direction of interest rates.

We advise: First, protect your principal. Second, vary the calls and maturities of your bonds, as well as the bond coupons that control the annual cash flow. In other words, diversify your bond portfolio without sacrificing bond quality. We explained why in our last article: Should You Reach for Yield (September 16, 2019).

Currently we try to purchase kicker bonds - bonds that sell at a premium to face value paying an attractive yield to the call with a pickup yield to maturity. High coupon bonds in general are attractive to knowledgeable bond buyers because they act as a cushion against rising interest rates, since you receive a return of some principal with each interest payment. The downside of this strategy is that many investors would like to do the same thing, driving up the relative prices of the bonds.

Though cash is king when interest rates are rising, it is not so in falling interest rate scenarios. Money market funds invest in short-term instruments that roll over quickly, leading quickly to lower yields. Short duration bond funds, ETFs and CDs experience a similar drop in rates.

If you own a bond ladder, you may note that the value of all of your bonds have increased. Since the price of bonds moves inversely to yield – as interest rates move down, the value of the bonds moves up – you may enjoy seeing the increase in the value of your bond portfolio if you own one. It is tempting to pat yourself on your back.

For those of you who have been working with us for a long period of time, you have a well-developed bond ladder with securities ranging from short-term to 20-year bonds. We have also laddered the call schedules, so that all the bonds are not callable in the same year. You are prepared to ride the waves and weather the storms.

Conclusion

According to Carmen Reinhart, Professor of International Financial Systems at Harvard University, negative interest rates today is a form of 'taxation' on savers as the central banks try to "liquidate the huge public-and private-debt overhang and ease the burden of servicing the debt."[iv] Such policies are known as financial repression- "an opaque tax on bondholders and on savers more generally."

What is different this time is that inflation has not been sparked. Instead, we are in a more deflationary environment. Dr. Reinhart sees this as a "slow-burn path to reducing debt. Absent a surprise inflation spurt, this will be a long process."

In light of 2019 politics and the state of our current interest rates, it might be wise to see if you can retire gradually if you are still working. Your working paycheck is still the best cushion for the financial unknowns.

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[i] Jared Dillan. *Mauldineconomics.com,* September 25, 2019.
[ii] Dillan. Op. cit.
[iii] John Ainger. "Germany Regrets Size of Bond That Pays Nothing as Auction Flops. *FA News*, August 22, 2019.
[iv] Carmen Reinhart. "What's New About Today's Low Interest Rates?" *Project Syndicate*, July 28,2016.