The Bond Market Turns Upside Down

When I was younger–much younger–I remember folks with stocking stuffers and presents under a tree. For some kids, the stocking stuffers included a passbook savings account, with a $100 gift from Santa. Wise parents, for sure.

Besides offering a great lesson on savings, those parents provided a simple explanation of bank savings accounts and monthly interest. In those days, FDIC-insured savings accounts earned 5%.

How times have changed! Rates are much lower today and it's an even more difficult situation for savers in many developed nations. That difficult situation is called "negative interest rates." That's when you pay the government to hold your cash.

Currently, all German government bonds offer yields below zero, while financial service providers UBS and Credit Suisse are planning to charge a small fee for clients that hold large cash balances.

We have not seen negative rates in the U.S., but in much of Europe and Japan, below-zero rates on government bonds are common, with over $15 trillion (yes, trillion, that's not a misprint) in government debt sporting yields less than zero percent, according to Bloomberg News.

Table 1: Below Zero

10-Year Govt Bond	Yield
Swiss 10-year	-1.02%
Germany	-0.70%
Denmark	-0.68%
France	-0.40%
Sweden	-0.35%
Japan	-0.28%
Ireland	-0.09%
Spain	+0.11%
Portugal	+0.13%
U.K.	+0.48%
Italy	+1.00%
U.S.	+1.50%
Greece	+1.63%

How can you buy a bond with a rate that's below zero?

Well, let's say Germany issues a 10-year bond with a par value of 1,000 euros (German currency is denominated in euros). You won't pay Germany an annual coupon. Instead, you'll buy that bond at a price that's greater than 1,000 euros. At maturity, you'll receive 1,000 euros.

It's a great deal for Germany but it doesn't seem to make much sense for an investor. Still, that's today's new global reality.

What's going on?

Today, several factors are contributing to below-zero yields.

1. Inflation in Europe is very low.

2. Growth has been substandard in Europe for much of the decade. Global trade tensions are adding to the uncertainty, and Europe may be headed toward another recession.

3. The European Central Bank has been much more accommodative than the Federal Reserve and appears set to ease again this month.

4. There's too much cash sloshing around the globe that can't find a home in viable industrial projects. So it finds a home in creditworthy government bonds.

The next question that usually surfaces: "Why should I care? I'm in the U.S."

What happens around the globe can affect investors at home.

Below-zero yields in major countries can encourage foreign investors to seek out positive returns in other nations, including in U.S. Treasuries. Since yields and bond prices move in opposite directions, an influx of foreign cash pushes up U.S. bond prices and knocks down yields.

It's one reason why the yield on the 30-year Treasury fell to a record low of 1.94% on August 28th, and the benchmark 10-year Treasury sported a yield of less than 1.50% on the same day.

Clearly, it's a far cry from the risk-free savings accounts of years ago.

Table 1: Key Index Returns

	MTD%	**YTD %**
Dow Jones Industrial Average	-1.72	13.19
NASDAQ Composite	-2.60	20.01
S&P 500 Index	-1.81	16.74
Russell 2000 Index	-5.07	10.85
MSCI World ex-USA*	-2.73	8.00
MSCI Emerging Markets*	-5.08	1.92
Bloomberg Barclays US Aggregate Bond TR	2.59	9.10

Source: *Wall Street Journal*, MSCI.com, Morningstar, MarketWatch
MTD: returns: Jul 31-Aug 30, 2019
YTD returns: Dec 31, 2018-Aug 30, 2019
*in US dollars

Bottom line

As I've recently emphasized, you must control what you can control. You can't control the stock market, you can't control headlines, and timing the market isn't a realistic tool. But you can control the portfolio. Your portfolio should consider your time horizon, risk tolerance, and financial goals.

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