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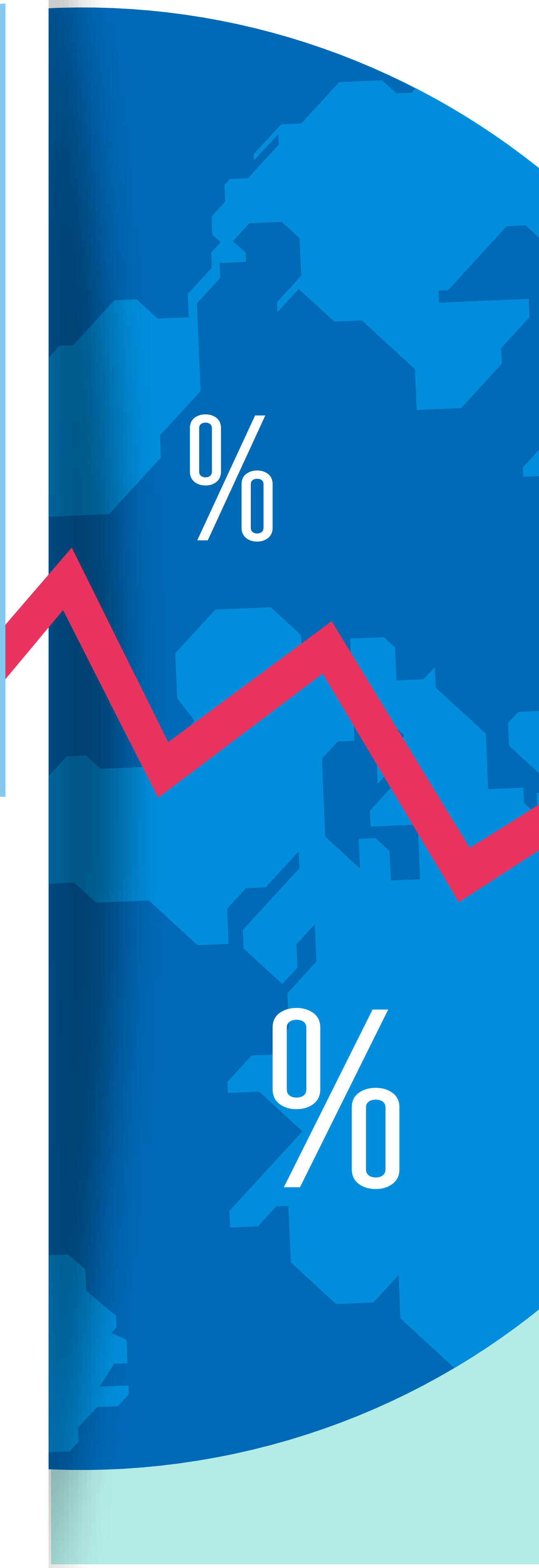
Global Interest Rates in 2020:

From ZIRP to NIRP?

- **In a sluggish growth environment, there is scope for policy rates to drift lower**
- **Without a growth spurt and inflation to accompany, long rates will have little impetus to rise**
- **A supply surge won't push yields higher either, if Central Bank remain the buyers of last resort**



The global economic recovery, initiated with much ado by central banks around 2008 and fanned intermittently thereafter, is still with us. Despite the odd potential hiccup, it looks like it is here to stay for at least a substantial part of 2020, if not a bit longer.

In this past decade, the market has witnessed an unprecedented policy experiment: Central Bank quantitative easing (QE) on an industrial scale, coupled with lower official interest rates than ever before. Some have described this as "Japanification", in reference to the experience of Japan post the property and stock market collapse which sent interest rates – short and long – plummeting. Also, that proving to be insufficient to lift the economy, the government become a major holder of its own debt via asset purchases carried out by the Bank of Japan.

In some form or another, this pattern has now played out in most of the major economies across the globe. The current stance of all the major Central Banks is to be on easing mode, and also to be considering further QE. For the year 2020, the outlook is for official rates to have a downward bias.

If this is indeed the case, and if our presumption is correct that global inflation is likely to remain low, there is an important implication for rates expectations: prepare for even more negative rates. Where we were looking at a ZIRP before (zero interest rate policy), the next level might be NIRP: negative interest rate policy.

The thought that more countries will see negative rates is not so shocking. First, many countries are already at or below zero rates. Second, to keep yield curves positively sloping, further reductions in official rates to even more negative levels cannot be ruled out. The Bank of Japan has been trying to do this: keep the curve positively sloped, and for a variety of reasons.

The Yield Curve, Then and Now

One of the temporary drivers of growth pessimism in the second half of 2019 was the partial inversion of the US yield curve whereby long rates are lower than short rates. The market has a long-held view that an inversion triggers an economic recession in relatively short order: something like a year or so. This is one reason policymakers prefer not to run an inverted curve for too long (assuming they have control over it in the first place); another is the fact that an inverted curve, if embedded for a long enough time, can wreak havoc in the financial sector.

"This time is different" is the usual way in which analysts preface an error. More often than not, it is a way to try to rationalise away the obvious: debt expansions are followed by default spikes, excessive equity valuations tend to deflate, etc. Mostly, things are never really that different. So, it is with caution that we hazard the statement that the 2019 inversion was in fact quite different from previous ones. The main difference, of course, was that there was a major new buyer in the market not seen in previous cycles: the neighbourhood Central Bank.

Pointing out this difference, and claiming that there will not be a recession, is not the same thing. Undeniably there is evidence of global slowing from many regions. Most are avoiding it, and the US looks to be on a stable path at the moment. Avoiding a recession, however, may not be enough to return bond yields to the levels seen before the crisis, or even through the midpoint of the current expansion.

Say's Law: Supply creates its own demand.

Or: You can create your own demand as long as you supply to the Central Bank.

The Japan experience has taught that it is possible for governments to issue bonds to their hearts' content without risking higher interest rates in the process. Those who are advocating a rise in the long end of the curve due to excessive issuance had best heed this lesson.

The next step in this process is to expand the purchase programme to non-financial assets, a thing dismissively referred to in orthodox economic circles as "helicopter money". The BOJ has dipped its toe in the water here by extending its purchases not just to government bonds, but also equities. From there it is a short journey to other assets.

A further factor is the absence of inflation. Bond investors are well aware of the fact that a part of the return accruing to bonds is due to inflation risk. If there is no risk of inflation in the immediate future, it stands to reason that long bond yields should not carry much of a premium for this risk.

A neat way for the market to signal its view on inflation is through the breakeven rate of inflation priced into the US TIPS market. In the period before 2008, the very rough rule of thumb was that the breakeven would generally average in the 2.25% to 2.5% band. Post-crisis, it has seldom been near these levels, and at the time of writing it is hovering closer to 1.6%. This is below the informal 2% target that the Fed has. It probably explains why the Fed has signalled that it would require something quite substantial to shift it back to a tightening mode.

We Expect Low Rates in 2020

Thus, the core view for 2020 on rates short and long is that absent a big growth surprise (to the upside), coupled by a surge in inflation (not currently discounted by the market), we should not be too surprised if rates remained low. Government bonds are the prime source of duration in portfolios. Finding other sources of duration when the prime source is clearly as expensive as it has ever been will be a challenge for 2020, and maybe beyond. As a hedge against outright deflation, few other assets are superior. So selectively and into whatever weakness the market provides, we would suggest adding some duration in USD portfolios, or at least not to reduce duration too aggressively.

Other markets: Europe and Japan

For the past years, neither European core government bond markets nor Japanese bonds have been high on the list of desirable investments for investors. In Europe, the occasional political hiccup creates entry opportunities, but right now even the one-time profligate Italy and Greece have seen yields plummet: 1.23% and 1.41% respectively, in the 10Y maturity. We see little reason to invest. These yields are too low to be taken seriously.

Likewise, all the countries where yields are negative. With the ECB on standby to ease policy even further, the market expectation is for yields to remain low for quite a while. The same argument applies to Japan. More easing is likely, and to soak up the supply to keep rates low there is the Central Bank buying. According to Bloomberg estimates, the BOJ already holds a whopping 97% of issued government and agency paper in Japan.

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