SOVEREIGN DEBT & NEGATIVE YIELDS

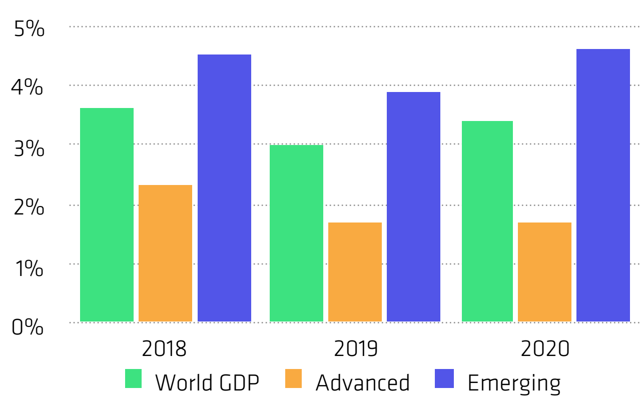
Recession alarms have yet to fully go off, but stagnation warning signs are coming to the forefront on the back of heightened financial instrument risks, potentially affecting the economic health of advanced and emerging markets alike. The many intertwined moving parts now driving global financial markets are facing headwinds that have hit global economic growth projections. Headlines are now presenting fears that the European and US economies might be going the way of Japan, who continues to face low growth 30-years after the country began adopting unconventional monetary policies. These vulnerabilities will be analysed further in this third part of CoinShares Macro Perspectives – In Search of Yields.

Global Economy Risks in a Cheap Cash Environment

- Record Global Debt Levels
- Negative Bond Yields
- Slowing Global Economic Growth
- IPO Valuations
- Corporate Debt

The latest Global Financial Stability report by the International Monetary Fund (IMF) paints a questionable picture on the state of economic affairs and sustainability: Global debt has surged past $250tn this year. $15tn of debt worldwide, notably from advanced economies, bear negative interest. Banks are facing profitability issues in Europe. The IMF has made its fifth cut in a row for 2019 global growth forecasts. And as the cherry on top, there are fears of risky corporate debt whose interest expense alone could prove difficult to tackle [1].

Fig. 1 IMF Global Growth Projections (%)



Source: International Monetary Fund (November 2019)

Cheap Money, Cheap Trick?

The latest out of the IMF point to multiple pockets of the financial system which will likely face strain after an extended period of low borrowing rates. These rates have served as a double-edged sword, fuelling the need for higher risk-taking measures by non-financial institutions in order to meet return requirements. As a result, these institutions could soon have to face and address a slowing global economy as returns further diminish in line with falling rates [2].

This position is also shared by the European Central Bank (ECB) who says that "[non-bank financial intermediaries are] facing profitability headwinds in the current environment. As a consequence, they are searching for yield in riskier assets. Given their increasing importance in financing the real economy, their increased risks and vulnerabilities highlight the need for the development of a macroprudential framework for this sector" [3].

And it's no small sum. The ECB places assets held by the non-bank financial sector at €46tn, nearly double the number at the start of the global financial crisis in 2008 [3].

The thesis behind the elevated risk-levels in both banking and non-banking financial entities has been the need for higher returns. Traditional assets and financial instruments are simply not as profitable as they once were. Key to this are the negative interest rates that have 'blessed' major economics from the EU to Japan for a near decade [4][5].

"Gregative"

No more than a few years back, Greece was on the brink of sparking what was at the time being coined as 'the beginning-of-the-end for the European currency project' due to its stupendous debt levels. In October 2019, it raised money offering -0.02% interest, meaning investors would receive less than they put up, yet still face risk.

> *"Greece selling at negative yields is absurd. It shows you the extent to which markets are distorted." [6]"*
>
> *- Mohammed El-Erian, Chief Economic Adviser, Allianz*

To B or not to B

In their effort to raise capital, negative yields in advanced economies has aided the rise of external debt-exposure to emerging markets since they offer much more competitive (and risky) returns.

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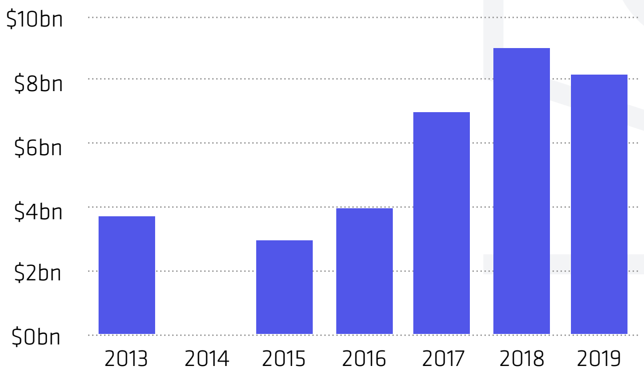
Tobias Adrian, Director of the IMF's Monetary and Capital Markets said that "among emerging and frontier economies, external debt is increasing, as they attract capital flows from advanced economies, where interest rates are lower. External debt has risen to 160 percent of exports on average, up from 100 percent in 2008." [7]

Case in point is the latest out of Egypt where the country is nearing last year's record raise of $9Bn off of Eurobond issuance (see Fig 2). The North African state lured investors with a huge 8.15% coupon, resulting in an oversubscription of seven times the offering [8]. Not far behind was Ghana which also saw its Eurobond issuance this year six times oversubscribed, earning hungry investors between 7.875-8.95% [5].

Both Egypt and Ghana have been marked as a substantial credit risk by S&P Global with a 'B' rating [3][5][8][9].

Fig. 2 Egypt's Eurobond Issuance (USD)



Source: Bloomberg (November 2019)

Irrational Exuberance Comeback

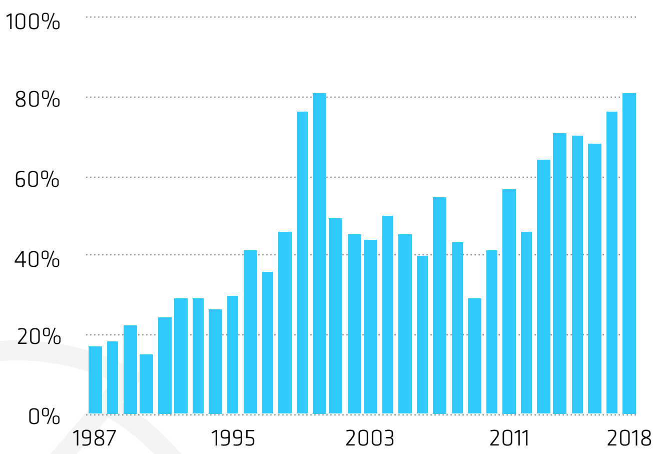
The irregularities haven't stopped at ballooning sovereign debt, risky emerging market bets, or banking profitability struggles. Investors are using every opportunity to squeeze out what they can in tightening markets with the latest exuberance observed in Initial Public Offerings (IPOs).

The number of unprofitable businesses that are floating has returned to levels last seen during the 'Dot Com' bubble of 2000 (see Fig 3). In fact, 2019 has hit a new record with nearly $30Bn raised for unprofitable IPOs within the first three-quarters alone [10].

Not odd after all?

The cocktail of issues facing global financial markets are evident but not everyone seems worried by these policies.

Fig. 3 Record % of IPOs with Negative Earnings



Source: Springtide Partners (November 2019)

> *"You know things are ridiculous but don't want to miss out, and suspend your disbelief. But eventually bubble investors realise the emperor has no clothes.[10]."*
>
> *- Mike Loewengart, VP of Investment Strategy, E-Trade*

While until recently, negative bond yields and over-subscription of barely investment-grade sovereign debt from emerging markets would have been ranked as patently bizarre, today, both extremes are considered part of the new normal – albeit, to some at least, perhaps an alarming one.

Add to the mix a set of monetary policy tools that, also until recently, would have been deemed completely unreasonable – quantitative easing, discouraging savings and negative interest rates – and we're sure that any real guidance on the likely direction of global finance from here on out would be received with sincere gratitude by analysts.

It's already morning in Tokyo

Perhaps there is indeed something to be learned by looking east. Our dawning reality of slow growth despite unprecedented stimulus has been the prevailing norm for decades in Japan, ever since its spectacular asset bubble burst in 1990s. Already then, the country was forced to adopt near zero-rates policy in order to jump-start economic growth and recapitalise its banks (see Fig 4).

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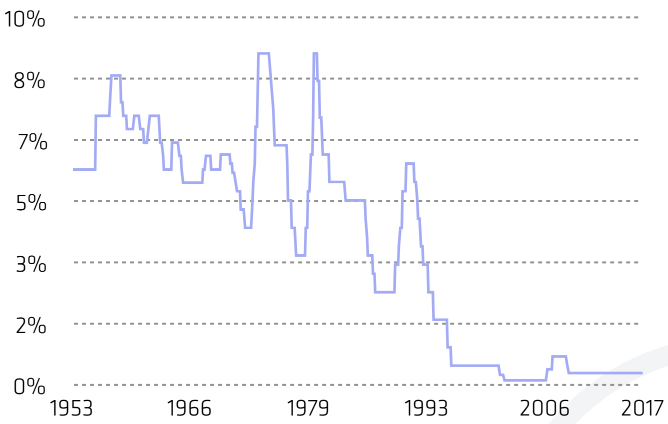
Fig. 4 Interest Rates, Discount Rate for Japan



Source: FRED (November 2019)

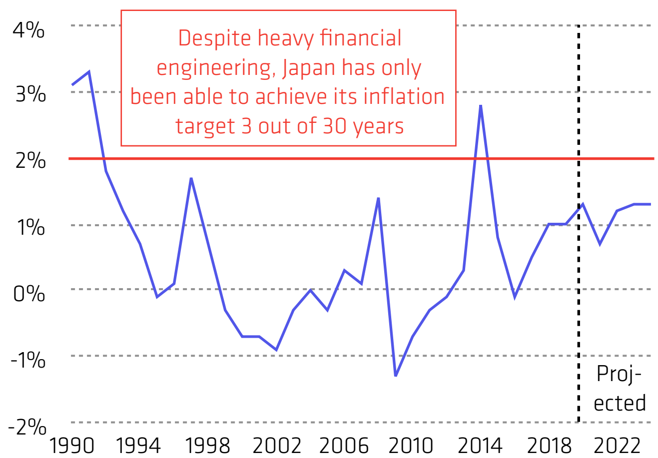
The results from this exercise (or is it experiment?) have yet to turn out in the country's favour as Japan continues to suffer from anaemic growth and recurring bouts of deflation even 30 years on (see Fig 5).

Economists are taking notes and the discussions of world economies going the way of the 'Land of the rising sun' are on the increase. The resulting economic quagmires have been dubbed as 'Japanification' (see Tab 1).

Recession vs Stagnation?

The concerns of a different economic reality taking hold of advanced economies, akin to that of Japan, are hardly unwarranted. There's a rather striking resemblance between Japan, Europe and the US in their respective Central Banks' inabilities to hit a 2% inflation target, slowing economic growth, low unemployment and 'cheap money'. Indeed the similarities are not exactly hard to spot [4].

Fig. 5 IMF's Inflation Projections up to 2025 for Japan Fall Short of 2% Target



Source: International Monetary Fund (November 2019)

Tab. 1 Trending Narrative: 'Japanification'

Publication	Narrative	Date	Source
Financial Times	'Japanification' stalks the US and Europe	Oct-19	[12]
The Economist	The Japanification of bond markets	Aug-19	[13]
Bloomberg	Draghi's Stimulus Shot Is No Cure for Europe's Japanification	Sep-19	[14]
Reuters	ECB must fight spectre of 'Japanification': de Guindos, Rehn	Oct-19	[11]
Goldman Sachs	Europe's Markets vs Japan's: Parallels and Differences	Oct-19	[15]
S&P Global	World-beating US economy could yet follow Europe into 'Japanification'	Sep-19	[13]

Demographics are also starting to line up between east and west; most advanced economies, much like Japan, are facing an ageing population as well as lower birth rates adding pressures on the economy.

Add to the parallels (as seen above in case of external debt) an increase in foreign asset exposure, and at least on the surface it appears the ingredients are cooking up nearly the exact same dish [16]. In fact, even the notoriously conservative pension funds out of Japan have for the first time ever preferred alternative assets to domestic bonds [17].

A New Normal

One could of course ask what other than these effects were ever to be expected from negative rates. While the discouragement of savings in favour of immediate consumption might seem attractive as an economic quick fix, it seemingly flies directly in the face of the demographic issues of our time, where most modern economies are in the beginning, or indeed already in the middle of, an unprecedented retirement wave.

Yet here we are: Savings rates are turning negative [18] – putting serious pressure on the profitability of financial institutions; real asset prices are skyrocketing – pricing the middle class out of the housing market and depressing lending volumes [18]; pension funds are hunting deep in alternative markets in a desperate dash for yield – adding unprecedented levels of risk to the portfolios of retirees. It is a strange new reality indeed.

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