QV UPDATE
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Get Paid to Borrow

A colleague recently shared an article reporting that Danish lender Jyske Bank will start offering 10-year mortgages at an interest rate of -0.5%. Note the *negative* rate on this mortgage. Under this scenario, a borrower will end up paying back *less* than the amount they originally borrowed. The existence of negative interest rates is almost hard to fathom as it effectively means someone will pay you to borrow money. The concept is at odds with the time value of money, an underlying tenant of financial theory (the idea that "a dollar today is worth more than a dollar tomorrow.") However, the reality is that negative yielding debt is becoming more common.

According to the Bloomberg Barclays Global Aggregate Negative-Yield Debt Index, there is over $16 trillion in outstanding debt yielding less than 0%. To put this amount in perspective, it is roughly 25% of all global investment grade debt. The facts surrounding the prevalence of negative-yielding debt get even more surreal when you dig deeper. Countries such as Germany, Netherlands, Denmark and Switzerland have entire yield curves comprised *only* of negative yielding debt. Some companies, such as McDonald's and AT&T, have euro-denominated bonds outstanding with negative yields. The U.S. remains one of the few outliers, with none of its $16 trillion in government debt yielding less than zero. Outside of the U.S., 43% of bonds are trading at negative interest rates, according to Deutsche Bank. How did this phenomenon come to be?

In academic circles, the idea of negative interest rates dates back to the late 19th century. Silvio Gesell is widely accredited to be the first proponent of negative nominal interest rates, or the taxing of cash. While his idea was debated by prominent economists throughout the 20th century, it was never put into practice. Zero percent was widely believed to be the lower bound for interest rates. The precursor to the current implementation of radical monetary policies, including negative benchmark interest rates, were the policies of the Bank of Japan (BOJ) in 1999. It was then that the BOJ adopted a zero percent benchmark rate to prevent deflation. This radical and unorthodox policy was considered extreme and specific to Japan. However, within the next decade, the Financial Crisis would become the ultimate catalyst spurring other central banks to utilize extreme monetary policy, including negative rates.

The economic theory is that if the central bank in a given country charges commercial banks on cash deposits, banks will be encouraged to lend money more cheaply, and savers to spend more freely, thus spurring economic growth. This flood of money within the financial system has limited the number of investment alternatives, especially in fixed income, and therefore investors are willing to pay astronomical prices.

Who is buying negative yielding debt? There are a few potential answers: central banks via other monetary policies, pension funds that need to match liabilities, and index funds. A rational investor in negative yielding debt must expect rates to fall even further into negative territory, as this is the only way their investment can generate a capital gain. If the investor holds negative yielding debt to maturity, they are guaranteeing themselves a capital loss. One possible justification for investing in negative yielding debt could be a willingness to pay someone what is essentially an insurance premium to hold one's money. In this case, the negative yield could be interpreted as the price to pay for safety, quality and the piece of mind that you will receive a return *of* capital. At QV, we think it is favourable to invest in businesses that are high quality and can offer a return *on* capital.

We seek quality by investing in companies with strong franchises that have demonstrated the ability to generate returns over a cycle, while being mindful of leverage. We try to add to these "quality" holdings at a reasonable price and still require a margin of safety, so that we aren't overpaying for this quality.

One thing is clear: such bold policy action by central banks is unprecedented and its effect over time on the broader financial system is uncertain. We don't know what the lower bound on interest rates is, but recent experience has proven it isn't zero.