



Kashi Trathen
Associate Director,
Debt Investments



Jo Niall
Senior Investment Writer

INSIGHT

Will Australian interest rates go negative?

by Kashi Trathen and Jo Niall

June 2020

DEBT INVESTMENTS

In our September 2019 paper *'Negative interest rates - why they persist and will Australia ever get there?'*, we explored the potential for negative interest rates. We concluded that they were unlikely to occur in Australia without an extraordinary level of central bank intervention or a sustained reversal in our current account balance.

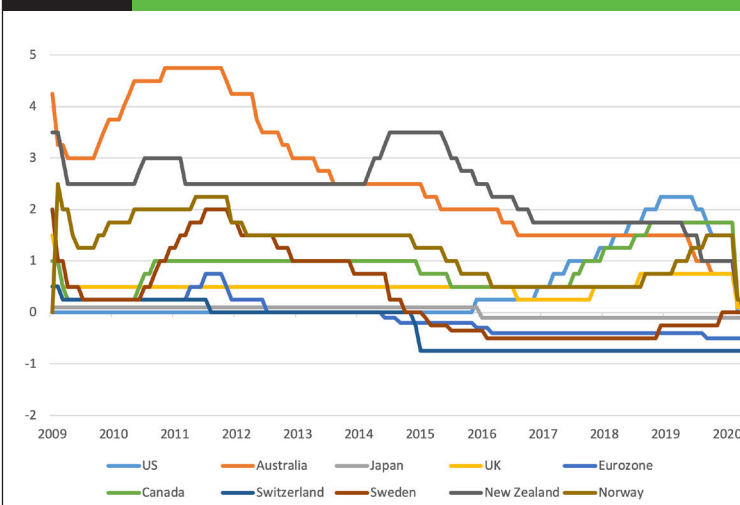
Since then, the COVID-19 pandemic has caused unprecedented economic disruption, leading central banks to slash interest rates and implement a range of unconventional monetary policy tools. In Australia, this has driven short-end yields very close to zero, and in some cases below the official cash rate target¹.

Globally we have witnessed central bank responses of a similarly large magnitude, and several countries now have negative official interest rates as shown in Figure 1.

In countries that previously had relatively high bond yields, such as the US and Canada, interest rates have declined significantly. Meanwhile, some negative yielding sovereign bonds have moved back towards zero as investors switched into US Treasuries given their somewhat predictable outperformance. This has resulted in a convergence of global yields towards zero, from above and below, as shown in Figure 2.

While Australian 10-year bond yields remain at around 0.9%, the short end of the domestic yield curve is around 0.25% away from negative territory. We therefore thought it timely to revisit the issue of negative interest rates in an Australian context.

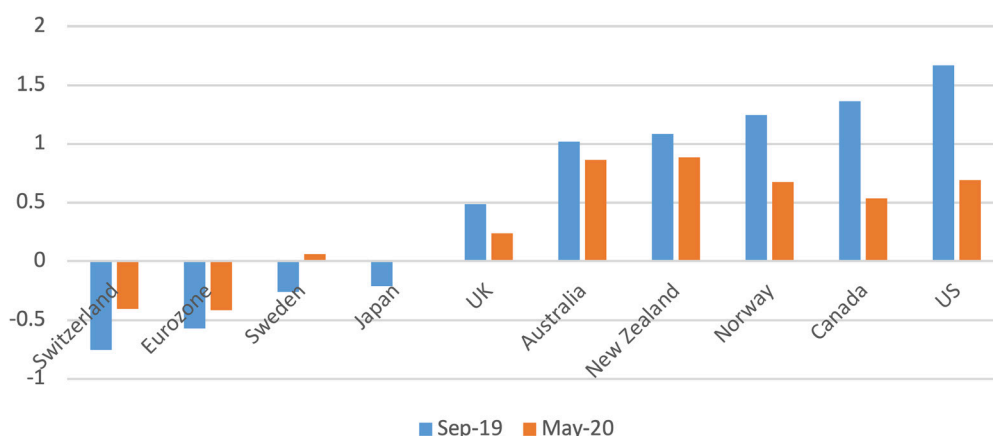
FIGURE 01 CENTRAL BANK REFERENCE RATES



Source: Bloomberg, June 2020

¹ For more information on the Australian interest rate markets and Reserve Bank of Australia's policy response to COVID-19, please see our previous paper *'Cash in a Post COVID-19 World'*.

FIGURE 02 10-YEAR GOVERNMENT BOND YIELDS – SEP 2019 VS MAY 2020



Source: Bloomberg, June 2020

In this paper, we make the distinction between the macro and market related factors that affect interest rates and may influence the Reserve Bank of Australia (RBA) in its decision on whether to adopt a zero or negative official cash rate target (OCR). We also compare Australia to countries that have already adopted negative interest rate policies and revisit the cross currency basis, which we believe is a major factor preventing longer-term bond yields from going sustainably negative even if the cash rate does.

Macro factors - what could make the RBA cut official rates below zero?

To date, the RBA has been consistent in its message that 0.25% would be the terminal cash rate. Furthermore, in a recent speech, RBA Governor Philip Lowe pointed to early evidence that the measures put in place in response to COVID-19 have been working as expected. He noted that the bond purchases conducted as part of the Yield Curve Control (YCC) policy, totalling around \$50 billion, have been scaled back to zero in recent weeks. He explicitly stated that the RBA remains “prepared to scale up these purchases again if necessary to achieve the yield curve target and to assist with smooth market functioning”².

Given the RBA’s focus on YCC, open market operations (including broadened repo-eligibility) and its support of the banks through the Term Funding Facility (TFF), we believe that a number of macroeconomic variables would need to deteriorate further

before the decision would be made to move to a negative official cash rate. The macro developments that might influence this decision include:

- 1 Inflation:** The countries/regions that have adopted negative interest rates, such as Japan, the Eurozone, Switzerland and Sweden, have been unable to generate significant inflationary pressures through other policy initiatives. Australia recently reported first quarter headline CPI of 2.2%, and core inflation of 1.8%³. It is quite likely that these numbers will fall further in the next quarter given the shock to the labour market. However we believe that the CPI would need to fall closer to zero, or remain well below the 2% target for a longer period of time, for the RBA to resort to negative interest rates as a policy tool.
- 2 Australian dollar (AUD):** All of the countries that currently have negative interest rates (except Sweden) experienced strong currency appreciation prior to adopting negative interest rate policies. Whilst the recent recovery in the AUD, from its COVID-19 sell-off, makes it easier for the RBA to consider cutting official rates again, the currency remains near its long term average.
- 3 Current account balance:** It is much easier to implement negative interest rates in countries that have a current account surplus since they do not require external funding. By contrast,

² Source: <https://www.rba.gov.au/speeches/2020/sp-gov-2020-05-21.html>

³ As at March 2020

current account deficit countries (like Australia) do require external funding, hence domestic interest rates need to be relatively high to attract investors. Whilst a current account deficit doesn't preclude a negative cash rate, longer dated government bond yields would need to remain high enough to sustainably attract investors. This suggests that any country with a current account deficit that experiments with negative interest rates (the United Kingdom and New Zealand are two such possibilities) is likely to have a steep yield curve.

- 4 Other central bank policy action:** Should the US Federal Reserve, the Bank of England, the Reserve Bank of New Zealand (RBNZ) and/or other central banks cut rates below zero, this would increase the likelihood of the RBA doing the same.
- 5 House prices:** With the TFF likely to keep bank funding cheap, mortgage holders have enjoyed unprecedented low mortgage rates and those who have lost their jobs have taken advantage of Federal government wage subsidies, mortgage relief and early access to superannuation. As a result, Australian home prices have not experienced significant declines despite the impact of COVID-19 on the labour market. If this were to change, it is possible that further monetary easing in the form of negative rates might be one tool at the RBA's disposal to prevent a collapse in house prices. However, other measures flagged by Philip Lowe would be likely to come first.

- 6 Macroeconomic shocks:** If a second wave of COVID-19 eventuates, or if geopolitical tensions between the US and China intensify, the macroeconomic consequences could be severe enough to require additional monetary easing.
- 7 Bank net interest margins (NIMs):** Negative interest rates impact bank profitability by severely compressing NIMs. Given Australian bank profits are already under significant downward pressure due to COVID-19, the RBA is likely to prefer QE measures from a financial stability perspective.

Should several of the above factors prevail over the medium-term, it is possible that the RBA could be gradually persuaded from their aversion to negative rates. However, the current environment suggests this is unlikely to occur in the near-term.

Australian bond yields – could they sustainably go below zero?

The above analysis of macro factors centres on the possibility of the official cash rate and short-term market interest rates going negative. But what about longer-term bond yields? Are they likely to go negative? To answer this question, we need to consider some market-related factors, such as interest rate parity and the cross currency basis, as well as the role of the current account balance.

Market factors – the impact of cross currency basis on global bond yields

Interest rate parity implies that the expected return of domestic assets will equal the expected return of hedged foreign currency denominated assets. This theoretical condition assumes perfect capital mobility and perfect substitution between domestic and foreign assets. If this were to hold, an investor from a country with high interest rates could buy a bond from a country with low interest rates, and in the process of hedging the foreign exchange (FX) risk, they will end up with a return equal to that of the domestic bond. This concept explains why interest rates can be vastly different between countries despite similar sovereign risk profiles. However, comparing interest rates between different countries is like comparing apples and oranges.

While interest rate parity explains some of the observed return differences between global bond markets, one of the reasons



Whilst a current account deficit doesn't preclude a negative cash rate, longer dated government bond yields would need to remain high enough to sustainably attract investors.

Kashi Trathen

this condition never holds in the real world is the **cross currency basis** spread. This is a mismatch that occurs when one borrows in one currency and then lends in another currency, usually as part of a foreign exchange hedge. This mismatch is caused by asymmetries in the supply and demand for particular currencies due to international capital flows.

Australia is a net importer of capital as there are more Australian entities borrowing money offshore than there are Australian entities lending money to foreigners. This makes our cross currency basis positive as excess demand for FX hedging drives a mismatch. This has implications for capital market transactions:

- An Australian entity (e.g. a bank) issuing a bond in US dollars (USD) has to pay a premium (the cross currency basis) to hedge this USD exposure into AUD.
- An Australian investor buying a USD denominated bond and hedging the currency exposure back to AUD can benefit from the additional pickup resulting from the cross currency basis spread. So Australians investing offshore can be rewarded with a higher potential return for swimming against the tide of capital imports.

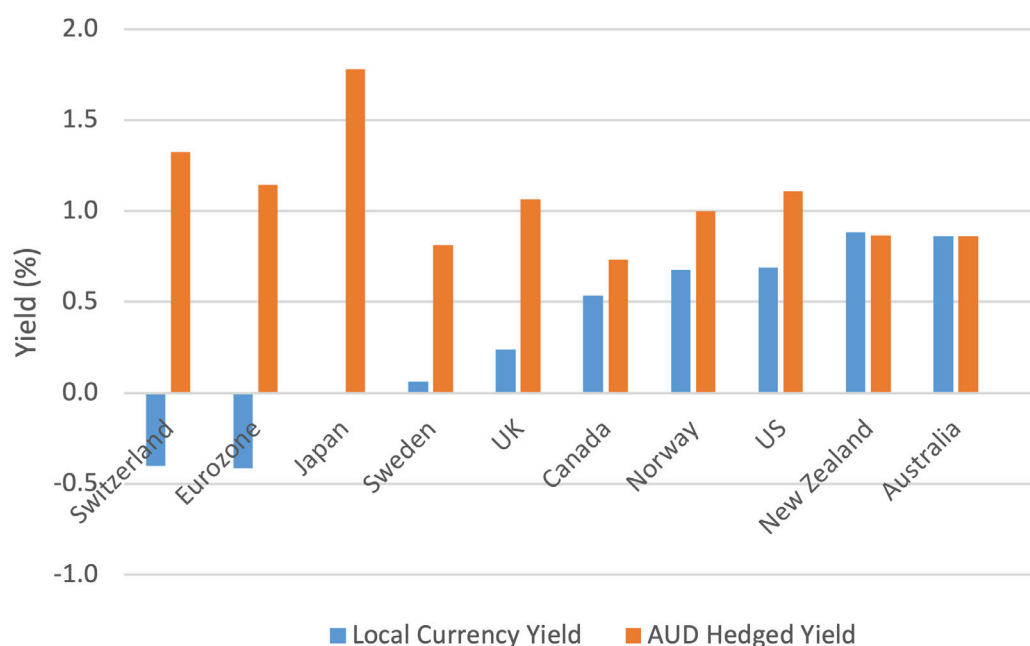
The reverse is true in Japan, where the yen cross currency basis is *negative*:

- Japan has an excess of domestic savings, so when Japanese investors try to invest in the US or Australia and hedge the currency exposure, they have to pay their negative basis spread. This is the price of trying to do what all the other Japanese investors are doing.
- Japanese government bonds can offer additional potential returns to offshore investors, for whom this negative basis offers a yield pickup.

The end result is that countries with negative yielding bonds (as measured in their local currency), are often not negative when hedged into currencies with higher prevailing interest rates and positive (or at least less negative) cross currency basis spreads. Indeed, as of June 2020, some of the highest yielding 10-year government bonds in AUD terms have negative yields in their local currency (see Figure 3).

In the next section, we look at how the current account affects the cross currency basis spread, and under what circumstances this allows negative yields to persist in a sustainable way.

FIGURE 03 GLOBAL 10-YEAR GOVERNMENT BOND YIELDS IN LOCAL CURRENCY AND AUD



Source: Bloomberg, June 2020

Countries currently with negative interest rates all have current account surpluses

Countries that maintain a current account surplus, usually as a result of positive net exports, tend to have an oversupply of domestic savings that drives interest rates lower. This relationship is shown in Figure 4, with the 'net borrower countries' in the top-left quadrant, and the 'net saver countries' mostly in the bottom-right quadrant. This makes intuitive sense as the more savers there are trying to buy domestic bonds, the lower the yield of those securities.

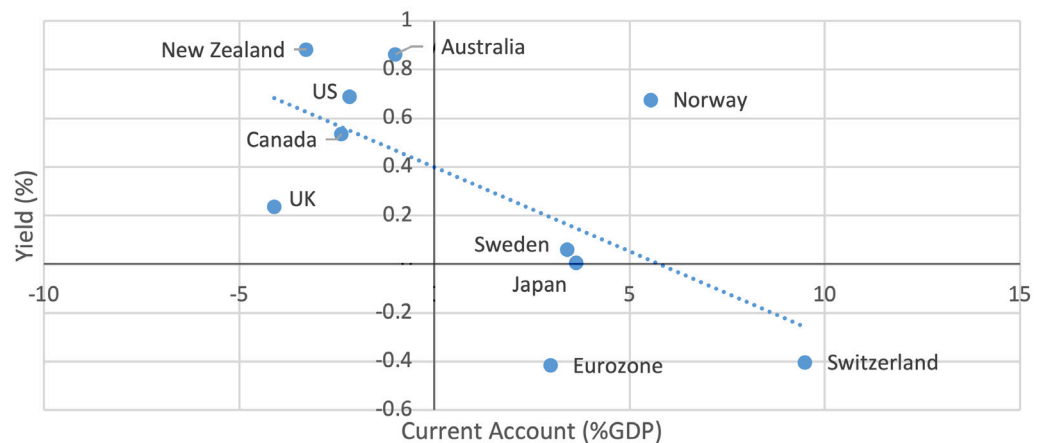
Countries with an excess of savings will, by definition, be capital exporters, since a current account surplus implies a capital account deficit. This is why countries like Japan buy so many foreign bonds.

Japan exports more than it imports, and the extra cash that is generated finds its way into the international bond markets. This international flow of capital is what determines the cross currency basis spread.

For example, Japan's excess savings means there are more Japanese investors trying to buy foreign assets than there are foreigners trying to buy Japanese assets. Since many asset purchases are hedged, Japan's cross currency basis spread becomes negative due to excess demand for these hedging trades.

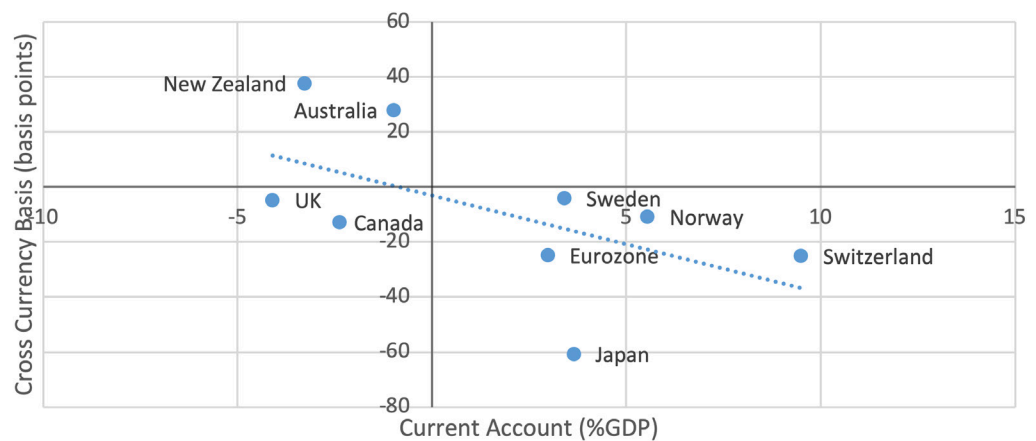
Figure 5 illustrates this relationship - countries with current account surpluses (bottom right) tend to have negative cross currency basis spreads, while countries with current account deficits (top left) tend to have positive cross currency basis spreads.

FIGURE 04 CURRENT ACCOUNT BALANCE VS 10 YEAR GOVERNMENT BOND YIELD



Source: Bloomberg, June 2020

FIGURE 05 CURRENT ACCOUNT BALANCE VS CROSS CURRENCY BASIS SPREAD



Source: Bloomberg, June 2020

What does this mean for negative rates?

If we briefly imagine a world in which FX hedging didn't affect the interest rate that an investor received, many global investors would undoubtedly choose not to invest in securities with a negative yield. After all, who would buy Swiss government bonds for a return of -0.40% when they could buy US Treasuries and receive 0.70%⁴. In this illustrative scenario, Swiss negative rates would be unsustainable, and the lack of investor demand would drive the yields higher.

In the real world, FX hedging (of which cross currency basis is a big part) is now the primary determinant of the yield received by the investor (as illustrated in Figure 3 above). It is this spread that makes negative interest rates sustainable.

If these capital market supply and demand imbalances continue – and they will, as long as some countries export more than they import and vice versa – negative interest rates can persist for a long time under certain circumstances. Empirical data suggest all countries with negative interest rates tend to have strongly negative cross currency basis spreads and current account surpluses, neither of which currently exist in the Australian context.

Figure 6 shows 10 countries and their current account balances as a percentage of their gross domestic product (GDP). The dotted line segments represent periods in which those countries had negative official interest rates (Japan, the Eurozone, Switzerland and Sweden).

To date, there generally have not been countries with persistent current account deficits that have ever had negative official interest rates⁵. This is not to say that such a scenario is impossible, but we believe it is unlikely for the reasons outlined below.

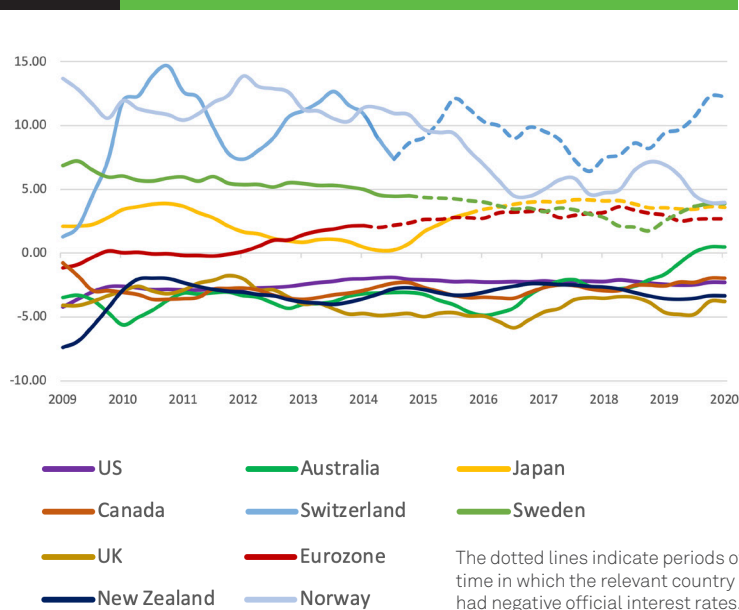
In the coming months, in response to the economic repercussions of the COVID-19 pandemic, it is possible that one or more current account deficit countries, such as the UK, could attempt to use negative interest rates to stimulate their economy. The RBNZ has already stated that “negative interest rates remain an option in the future”, and New Zealand has a long history of current account deficits⁶. But whether these countries could sustain negative rates is debatable.

What is clear from the historical data, combined with an understanding of how international capital flows help to determine global bond yields, is that long bond yields are unlikely to stay sustainably negative without the additional pickup provided by a negative cross currency basis. Since Australia is a net capital importer with a positive cross currency basis, negative long bond yields are unlikely to be sustainable in the current environment.

One caveat to this argument would be a hypothetical world in which many more countries have negative interest rates. In this situation, it is possible that current account deficit countries would have 'less negative' yields than current account surplus countries. After all things are considered, the investor has to be compensated for what they lose on the cross currency basis leg of the trade.

Given the strong inverse relationship between the current account balance and interest rates, we believe Australia is less likely than other countries to experience negative interest rates for any significant length of time. If the RBA did cut the official cash rate below zero, the yield curve would be likely to steepen. Should Australia begin to experience more regular current account

FIGURE 06 CURRENT ACCOUNT BALANCE (% OF GDP)



Source: Bloomberg, June 2020

⁴ This scenario is provided for illustrative purposes only.

⁵ Although the UK did recently issue a 3-year government bond with a negative yield in both May and June 2020.

⁶ Source: <https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Monetary%20policy/ump/May-2020-Letter-to-Banks-Negative-interest-rates.pdf?revision=19a9435a-f119-443c-90bb-999a4c1e51a0&la=en>



We are clearly living through a period in which negative interest rates feel much closer to home for Australian investors.

Kashi Trathen

surpluses (perhaps due to strong demand for raw materials), this would make negative rates more likely, and allow for a flatter yield curve.

Nominal versus real interest rates - why inflation matters

If we were to enter a world where deflation became entrenched, then nominal bond yields could remain negative while bond investors still earn a return in real terms (adjusted for inflation). Likewise, nominal GDP can be negative, but if inflation is also sufficiently negative, real GDP could still be growing. This happened for a long period in Japan, particularly in per capita terms. This is why we believe consumer price inflation is the key variable to watch in Australia, and will be likely to guide the RBA's future decision making.

Conclusion

In the midst of a global pandemic, as central banks provide significant volumes of liquidity to financial markets and experiment with unconventional monetary policy tools, the prospect of rates trading below zero is once again a topic of focus and concern for fixed income and cash investors. In short-term interest rate markets, the Bank Bill Swap Rate (BBSW)

has traded below 0.1%, so Australia is already very close to negative interest rates, making it quite possible that yields could briefly trade negative. However the more pertinent question for investors is whether negative yields can be sustained for any significant period of time.

We believe that the probability of persistent negative interest rates remains quite low in Australia, for several reasons:

- 1 The RBA has repeatedly flagged its view that the terminal official cash rate target is 0.25% per cent⁷.
- 2 The RBA has successfully used other monetary policy tools, such as bond purchases (YCC), larger than normal open market operations and the TFF to stimulate the economy and provide liquidity to the financial markets, and has expressed a willingness to increase the use of these tools should conditions deteriorate.
- 3 Our analysis suggests that it is much less likely for countries with current account deficits and positive cross currency basis spreads to experience negative interest rates for any sustained period.

For rates to go sustainably negative in Australia, we would need these factors to change – possibly due to a combination of very weak inflation, a strong AUD and potentially a global move towards more negative rates. Given the uncertain outlook and unprecedented level of central bank stimulus, we are clearly living through a period in which negative interest rates feel much closer to home for Australian investors.

⁷ Note that the actual overnight rate can be below this due to surplus exchange settlement account balances.



HEAD OFFICE

Level 29 | Casselden | 2 Lonsdale Street | Melbourne | VIC 3000
+61 3 8672 5300 | www.ifminvestors.com | investorrelations@ifminvestors.com

» Global Disclaimer

Important Notice The following disclaimer applies to this document and any information provided regarding the information contained in this document (the "Information"). By accepting this document and Information, you agree to be bound by the following terms and conditions. The Information does not constitute an offer, invitation, solicitation or recommendation in relation to the subscription, purchase or sale of securities in any jurisdiction and neither this document nor anything in it will form the basis of any contract or commitment.

IFM Investors (defined as IFM Investors Pty Ltd and its affiliates) will have no liability, contingent or otherwise, to any user of the Information or to third parties, or any responsibility whatsoever, for the correctness, quality, accuracy, timeliness, pricing, reliability, performance or completeness of the Information. In no event will IFM Investors be liable for any special, indirect, incidental or consequential damages which may be incurred or experienced on account of a reader using Information even if it has been advised of the possibility of such damages. Certain statements in the Information may constitute "forward looking statements." Words such as "expects," "anticipates," "plans," "believes," "scheduled," "estimates" and variations of these words and similar expressions are intended to identify forward-looking statements, which include but are not limited to projections of earnings, performance, and cash flows. These statements involve subjective judgement and analysis and reflect IFM Investors' expectations and are subject to significant uncertainties, risks and contingencies outside the control of IFM Investors which may cause actual results to vary materially from those expressed or implied by these forward looking statements. All forward-looking statements speak only as of the date of this information or, in the case of any document incorporated by reference, the date of that document. All subsequent written and oral forward-looking statements attributable to IFM Investors or any person acting on its behalf are qualified by the cautionary statements in this section. Readers are cautioned not to rely on such forward looking statements. The achievement of any or all goals of any investment that may be described in this Information is not guaranteed.

Economic conditions- Interest rates, general levels of economic activity, the price of securities and participation by other investors in the financial markets may affect the value of investments made or opportunities considered for prospective investment.

It should not be assumed that the investments discussed herein will be profitable or that investments made in the future will be profitable or will equal the performance of the investments discussed herein.

Past performance does not guarantee future results, which may vary. Diversification does not protect an investor from market risk and does not ensure a profit.

This Information may contain material provided by third parties for general reference or interest. While such third party sources are believed to be reliable, IFM Investors does not assume any responsibility for the accuracy or completeness of such information.

This Information does not constitute investment, legal, accounting, regulatory, taxation or other advice and the Information does not take into account your investment objectives or legal, accounting, regulatory, taxation or financial situation or particular needs. You are solely responsible for forming your own opinions and conclusions on such matters and for making your own independent assessment of the Information.

Australia Disclaimer This Information is provided to you on the basis that you warrant that you are a "wholesale client" or a "sophisticated investor" or a "professional investor" (each as defined in the Corporations Act 2001 (Cth)) to whom a product disclosure statement is not required to be given under Chapter 6D or Part 7.9 of the Corporations Act 2001 (Cth).

Japan Disclaimer This material is prepared by affiliates of IFM Investors (Japan) Pty Ltd (IFMJ) (Financial Business Operator: Kanto Local Finance Bureau Register Number 2839, a member of the Type II Financial Instruments Firms Association) for the purpose of providing

information and is not a disclosure document as specified or required under the Financial Instruments and Exchange Act (FIEA) nor is it intended as a solicitation.

This material is intended only for use by qualified institutional investors, among professional investors defined in FIEA article 2 item 31 and is not intended for anyone other than the above.

This material has been prepared based on information and databases considered reliable by IFMJ but IFMJ does not explicitly or implicitly guarantee the accuracy, timeliness or integrity of their contents. Past investment results do not necessarily give an accurate guide to future investment results or guarantee the prevention of loss. Future prospects based on current opinions and expectations may be included in this material, but IFMJ does not guarantee expected results or prevention of loss against the invested amount and this material may change and result in revisions without prior notice.

Our provision of this material should not be construed as our advice to you about any legal issues, taxation, investment or other matters.

South Korea Disclaimer Any fund or products mentioned in this document and Information (the "Fund") has not been registered with the Financial Services Commission of Korea as a foreign collective investment vehicle pursuant to the Financial Investment Services and Capital Markets Act of Korea (the "FSCMA"), and none of the interests in the fund or products may be offered, sold or delivered, or offered or sold to any person for re-offering or resale, directly or indirectly, in Korea, or to any resident of Korea except pursuant to applicable laws and regulations of Korea.

United Kingdom Disclaimer This Information is provided to you on the basis that you warrant that you fall within one or more of the exemptions in the Financial Services and Markets Act 2000 ("FSMA") [(Financial Promotion) Order 2005] [(Promotion of Collective Investment Schemes) (Exemptions) Order 2001, or are a Professional Client for the purposes of FCA rules] and as a consequence the restrictions on communication of "financial promotions" under FSMA and FCA rules do not apply to a communication made to you. IFM Investors (UK) Ltd shall have no liability, contingent or otherwise, to any user of the Information or to third parties, or any responsibility whatsoever, for the correctness, quality, accuracy, timeliness, pricing, reliability, performance or completeness of the Information.

Israel Disclaimer IFM Investors Pty Ltd is not licensed under Israel's Regulation of Investment Advising, Investment Marketing and Portfolio Management Law, 5755-1995 (the "Advice Law") and does not carry insurance pursuant to the Advice Law. This material is only intended for those categories of Israeli residents who are qualified clients listed on the First Addendum to the Advice Law. Furthermore, this material may not be reproduced or used for any other purpose, nor be furnished to any other person other than those to whom copies have been sent. Nothing in this material should be considered investment advice or investment marketing as defined in the Advice Law nor a substitute for investment marketing which takes into consideration the special data and needs of each person. This material does not constitute an offer to sell or solicitation of an offer to buy any securities, nor does it constitute an offer to sell to or solicitation of an offer to buy from any person or persons in any state or other jurisdiction in which such offer or solicitation would be unlawful, or in which the person making such offer or solicitation is not qualified to do so, or to a person or persons to whom it is unlawful to make such offer or solicitation.

Switzerland Disclaimer This Information is provided to you on the basis that you warrant that you are a Qualified Investor as defined in the CISA and its implementing ordinance ("Qualified Investor"). IFM Investors (Switzerland) GmbH shall have no liability, contingent or otherwise, to any user of the Information or to third parties, or any responsibility whatsoever, for the correctness, quality, accuracy, timeliness, pricing, reliability, performance or completeness of the Information.