IIF Weekly Insight
Carousel of worries

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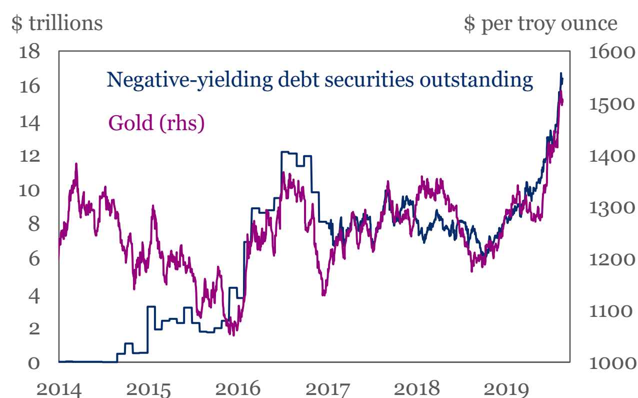
- Ballooning universe of negative-yielding debt suggests little confidence that further policy easing will help
- Lower borrowing costs will help high-debt mature economies—to a point
- Negative rates and slowing growth—headwinds for bank profitability
- We'll take a late-summer break next week—next Weekly Insight will be on September 5

Negative rates, negative sentiment: A virtual carousel of worries continues to spin—the riders may change, but the horses (no-deal Brexit, U.S-China trade, negative rates, recession…) remain the same. Despite the more hawkish tone of this week's comments from regional Fed Presidents George and Harker, the "greatest show in town" in Jackson Hole is widely expected to signal easier monetary policy ahead. However, the expanding universe of negative yielding bonds suggests little confidence that lower rates will do much to help (Chart 1). Skepticism has been particularly evident across emerging market assets. Despite attractive valuations and the projected easing in global financial conditions (which are typically associated with higher EM stock prices), economic policy uncertainty—particularly around the impact of trade tensions on China's growth prospects—continues to bite. Indeed, over two thirds of EM USD investment grade bond issuance since 2010, has been at yields of at least 3%—despite the massive increase in issuance of negative-yielding debt in mature markets (Chart 2).

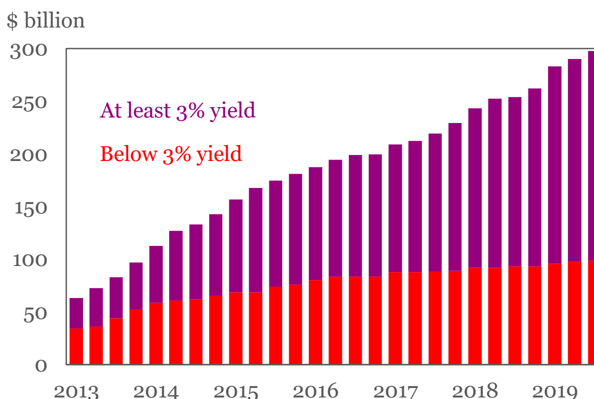
On a more positive note, low rates may well provide some breathing room for highly indebted sovereigns. However, they will also encourage further borrowing, particularly given the backdrop of structural imbalances such as increasing social security and health care expenses, exacerbated by adverse demographics trends. Case in point, updated CBO projections suggest that the U.S. federal government debt is on track to surpass 95% of GDP by 2029 from its current level of 79%. As a result, the gains from lower borrowing costs appear to be limited: we estimate a 100bp decline in borrowing costs would only reduce federal interest spending by $20-$25 billion per year over the medium term—see our Global Debt Monitor. Moreover, the CBO projections imply that the anticipated rise in federal borrowing will mean higher interest expense despite lower borrowing costs—a significant potential damper on economic growth as spending is diverted from more economically productive investments.

Chart 1: Dueling fear indices—gold, negative yielding debt



Source: Bloomberg, IIF

Chart 2: In a world of negative rates, over 65% of EM investment grade USD issuance since 2010 still yields at least 3%



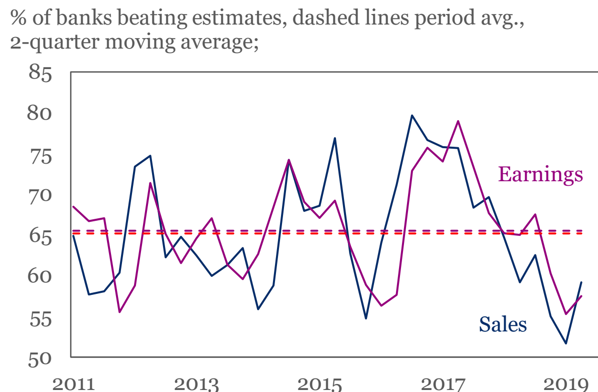
Source: Bloomberg, IIF; Includes USD-denominated EM Investment Grade bonds issued since end-2010

Pain for the banking sector: Although banks are now much more resilient to adverse shocks than they were a decade ago—thanks to stronger capital and liquidity buffers—concerns about low bank profitability have once again come to the fore as global rates fall. Shareholder fears are reflected in slumping valuations: bank price to book ratios are at their lowest since the doldrums of 2016. Euro Area banks have now spent a full decade with price/book ratios below 1, as have Japanese banks (both now near 0.5 price/book). This is a clear concern for financial stability, as low profitability constrains banks' capacity to build further buffers against unexpected shocks. The prolonged low interest rate environment and the rise in non-bank financial intermediation (amid competition from fintechs) has squeezed interest margins since the financial crisis. Although banks — particularly in the U.S.—have seen some benefit from recent years of rising interest rates, the weakening global growth outlook has put pressure on sales and earnings (Chart 3).

With a growing number of central banks looking prepared to jump on the easing bandwagon, anticipation of lower rates is weighing on prospects for future bank profitability—making 2020 consensus ROE forecasts look somewhat optimistic (Chart 4). But the challenges for banks go well beyond margin compression: the current lackluster growth environment also threatens non-interest income from market-based activities (e.g. underwriting, market-making and trading). Given this, swings in investment and consumer sentiment could hit banks that rely heavily on non-interest income. This varies across regions: for example, commissions and fees for large North American banks makes up over 35% of their total revenues on average vs. 20% for Chinese banks. Trading revenues for Japanese banks account for some 15% of total revenues, compared to 12% and 4% in the U.S. and Western Europe, respectively.

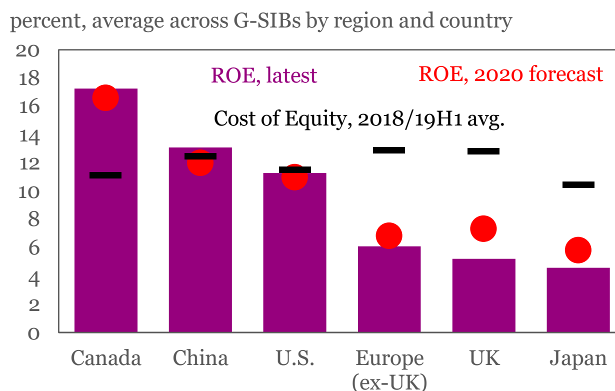
Improving cost efficiency remains a major challenge. The cost of equity for large European and Japanese banks remains persistently higher than ROE—an ongoing drag on stock prices and valuations. Most large U.S. and Chinese banks have seen some improvement on this score in recent years. Indeed, the cost-to-revenue ratio for U.S. banks has declined from over 70% in 2013/14 to some 60% in 2019 (Chart 5). In contrast, this ratio has deteriorated for large Japanese banks, in part reflecting a secular decline in loan demand associated with the country's declining population. Euro Area banks continue to trail their peers on cost efficiency. While large banks cut cost/revenue ratios between 2013 and 2018, the first half of 2019 has seen them creep back up again. Moreover, while low interest rates represent an opportunity for European banks to access cheap funding for their operations, the striking gap between the costs of equity and debt has induced some banks to favor debt over equity financing—which to some degree has hampered deleveraging efforts.

Chart 3: Bank earnings and sales remain under pressure



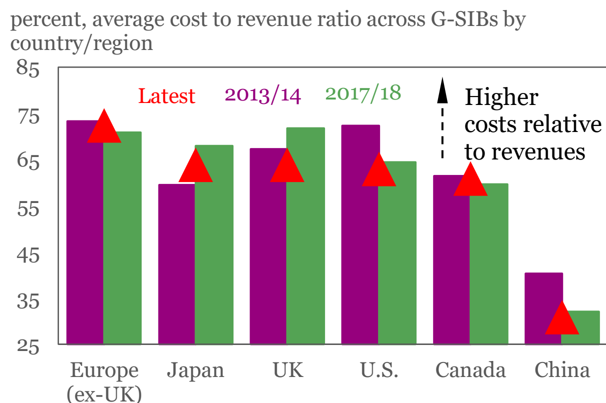
Source: Bloomberg, IIF; based on the largest 60 banks listed in exchanges in the U.S., Europe and Japan

Chart 4: Will 2020 bank ROE hold up to headwinds of low/negative rates and slowing global growth?



Source: Bloomberg, IIF; G-SIBs= Global Systemically Important Banks

Chart 5: Banks have had some success in bringing down cost/revenue ratios—notably in the U.S. and China



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